House of Commons

Treasury Committee

Project Verde

Sixth Report of Session 2014–15

Volume I

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Volume I

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Treasury Committee

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Timeline

May 2008	David Anderson, Chief Executive of Co-op Bank, initiates merger discussions with Neville Richardson, Chief Executive of Britannia.
August 2008	Co-op Bank and Britannia boards commence merger due diligence.
January 2009	Co-op Bank and Britannia sign a merger agreement.
August 2009	Merger between Co-op Bank and Britannia completed. Neville Richardson becomes Chief Executive of Co-op Bank.
April 2010	Paul Flowers appointed Chairman of Co-op Bank. Rodney Baker-Bates and David Davies appointed Deputy Chairmen.
June 2010	Government announces that the Financial Services Authority (FSA) will be disbanded and replaced with the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).
March 2011	António Horta-Osório, Chief Executive of Lloyds Banking Group (LBG) announces an acceleration of the process to divest the Verde branches.
April 2011	Andrew Bailey joins the FSA as Director of UK Banks and Building Societies.
May 2011	Neville Richardson tells Andrew Bailey that Co-op Bank is considering a bid for Verde.
July 2011	Andrew Bailey addresses Co-op Bank's strategy awayday.
July 2011	Neville Richardson resigns as Chief Executive of Co-op Bank. Barry Tootell becomes acting Chief Executive.
July 2011	Initial bids for Verde are submitted.
September – November 2011	Round 2 bids for Verde are submitted.
November 2011	LBG decides to progress with Verde bids from NBNK and Co-op Bank only.
December 2011	LBG announces Co-op Bank as its preferred bidder for Verde branches. It commences a period of exclusive negotiation.
December 2011	Andrew Bailey writes to Paul Flowers expressing concerns over Co-op Bank's ability to take on Verde.

April 2012	Co-op Bank's period of exclusive Verde negotiations with LBG lapses. NBNK re-enters the bidding process.
June 2012	Co-op Bank and NBNK submit final bids for the Verde branches.
June 2012	Lloyds confirms Co-op Bank as its preferred bidder for Verde.
July 2012	Rodney Baker-Bates and David Davies vote against Verde at Co-op Bank's board meeting. The rest of the board votes in favour. Co-op Bank and LBG sign 'Heads of Terms'.
Second half of 2012	FSA performs its stress testing exercise, revealing that Co-op Bank has a capital shortfall.
November 2012	FSA informs Co-op Bank that its capital guidance will increase significantly.
January 2013	FSA gives Co-op Bank an indication of the size of its capital shortfall.
March 2013	Co-op Bank reports losses of £674 million in its Financial Statements 2012.
April 2013	FSA formally disbanded. The PRA and the FCA come into operation.
April 2013	Co-op Bank announces its withdrawal from the Verde transaction.
May 2013	Moody's downgrades Co-op Bank's debt rating to junk status.
May 2013	Peter Marks, Co-op Group Chief Executive, retires. Euan Sutherland becomes new Group Chief Executive.
May 2013	Barry Tootell steps down as Chief Executive of Co-op Bank.
June 2013	Paul Flowers steps down as Chairman of Co-op Bank.
June 2013	The Treasury Committee announces its inquiry into Project Verde.
June 2013	PRA publicly announces the results of its stress testing exercise, revealing a capital shortfall for Co-op Bank of £1.5bn.
July 2013	Sir Christopher Kelly appointed by Co-op Bank and Group to conduct an independent inquiry into Co-op Bank's capital shortfall.
September 2013	Treasury Committee hearing with Neville Richardson.
October 2013	Treasury Committee hearing with Peter Marks.
October 2013	Treasury Committee hearing with Barry Tootell.

November 2013	Treasury Committee hearing with Paul Flowers.
November 2013	Treasury Committee hearing with David Anderson.
November 2013	Len Wardle steps down as Chairman of Co-op Group
November 2013	Treasury announces independent review into events at Co-op Bank. PRA and FCA announce that they are considering whether to launch enforcement action.
December 2013	Co-op Bank successfully completes £1.5 billion recapitalisation.
December 2013	Lord Myners commissioned by Co-op to conduct an independent review of the Group's governance.
January 2014	The PRA and FCA announce enforcement investigations in relation to Co-op Bank.
January 2014	The Financial Reporting Council launches an investigation into the preparation, approval and audit of Co-op Bank's financial statements.
March 2014	Co-op Bank announces further conduct redress losses of over £400 million.
April 2014	Sir Christopher Kelly publishes independent report into Co-op Bank's capital shortfall.
May 2014	Lord Myners publishes independent review of Co-op Group's governance.
May 2014	Co-op Bank completes additional capital raising of £400 million.

1 Introduction

1. In April 2013, the bid of the Co-operative Bank plc ('Co-op Bank') for 632 branches of Lloyds Banking Group, which were set to be divested under 'Project Verde', collapsed.[1] In June 2013, the Treasury Committee launched an inquiry into the divestment and the collapse of Co-op Bank's bid.[2] Days later, the Prudential Regulation Authority revealed a shortfall of £1.5 billion in Co-op Bank's capital position.[3] Since then, at least five separate reviews have been launched into events at Co-op Bank, many of which were triggered by this Committee's work:

- In July 2013, Co-op Bank and The Co-operative Group ('Co-op Group') commissioned an independent investigation, to be led by Sir Christopher Kelly, into the events that led to the capital shortfall. Sir Christopher reported his findings in April 2014.[4]
- In November 2013, following several Committee evidence sessions with former directors and executives of Co-op Bank, the Treasury commissioned an independent inquiry into events at Co-op Bank and the circumstances surrounding them. This inquiry, commissioned under the Financial Services Act 2012, will be led by an independent person appointed by the financial services regulators with the approval of the Treasury.[5]
- In January 2014, the regulators announced that they were undertaking formal enforcement investigations in relation to Co-op Bank. The independent Treasury-commissioned review will not commence until it is clear that it will not prejudice any possible enforcement action.[6]
- In the wake of the Committee's hearings, in December 2013, Lord Myners was appointed as Senior Independent Director to the Co-op Group Board, and asked to lead a comprehensive, independent review of the Group's governance. Lord Myners published his final report in May 2014.[7]
- In January 2014, the Financial Reporting Council (FRC) launched an investigation under the Accountancy Scheme into the preparation, approval and audit of the financial statements of Co-op Bank, up to and including the year ended 31 December 2012. Co-op Bank's auditor for the period in question was KPMG.[8]

1 The Co-operative Group, *'The Co-operative Group Announcement re: Lloyds Bank Branch Assets'*, 24 April 2013

2 Treasury Committee, *'Treasury Committee to inquire into Project Verde'*, 13 June 2013

3 Prudential Regulation Authority, *'News release – Prudential Regulation Authority (PRA) completes capital shortfall exercise with major UK banks and building societies'*, 20 June 2013

4 The Kelly Review, *'About the Review'*

5 HM Treasury, *'Chancellor confirms inquiry into events at Co-op Bank'*, 22 November 2013

6 Prudential Regulation Authority, *'News Release – Co-operative Bank enforcement investigation'*, 6 January 2014; Financial Conduct Authority, *'Statement on Co-operative Bank enforcement investigation'*, 6 January 2014

7 The Myners Review, *'About the Review'*

8 Financial Reporting Council, *'Investigation announced in connection with KPMG Audit Plc and The Co-operative Bank plc'*, 20 January 2014

Those reports that have already been published drew in places on this Committee's work; this Report likewise draws on their findings.

2. The Committee's inquiry has been into Project Verde. To examine this topic fully, the Committee has had to consider the wider issues facing Co-op Bank, which played a critical role in its withdrawal from the Verde process. This Report examines the causes of the bank's financial collapse, the circumstances leading to its successful Verde bid, the collapse of the bid and its consequences, and considers how an institution revealed to be so fragile came so close to becoming the UK's leading new challenger bank. It also considers the allegations that political pressure was brought to bear in the Verde process.

3. The Committee is grateful to all those who have given oral and written evidence to this inquiry. It also records its thanks to its Specialist Advisers, Jonathan Fisher QC and Robert Law.[9]

9 Jonathan Fisher QC and Robert Law declared interests, relevant to the Committee's work, on 16 July 2012 and 4 September 2013 respectively. Both declarations of interest are available at http://www.parliament.uk/documents/commons-committees/treasury/Formal_Minutes_2014-15.pdf

2 Background

Searching for scale

4. Prior to August 2009, Co-op Bank was a small firm with around 100 branches and a balance sheet of around £15bn.[10] David Anderson, former Chief Executive of Co-op Bank, described the bank's outlook in the middle of 2008:

> We had been reviewing the strategy for the Co-op's financial services businesses […] and we had looked at the investments that were needed. We had looked at the continuingly high cost base for the bank and we knew that we had to make very significant investments. We really did not have the distribution reach in order to get a return on those investments, so if we were to make those investments we had to do something.[11]

5. Andrew Bailey, Chief Cashier at the Bank of England in 2008, now Chief Executive of the Prudential Regulation Authority (PRA), confirmed Mr Anderson's view:

> Being in the personal current account market has expensive overheads attached to it. […] there was a view in the Co-op that this was not sustainable and I think they were right. The costs were too high to sustain that sort of business.[12]

6. At around this time the Building Societies (Funding) and Mutual Societies (Transfers) Act 2007—which for the first time would allow for mergers between mutual firms—was becoming law.[13] This opened up the possibility of Co-op Bank, as a wholly-owned subsidiary of a mutual firm, participating in consolidation in the building society sector. Of the possible partners for a merger, Co-op's attention was drawn to Britannia, which was seen by Co-op as:

> […] a very complementary fit in terms of distribution reach […] the expertise in mortgages and savings that would help take the bank away from the over-dependence [on] unsecured lending […] and give us scale to make the investment in IT that we needed.[14]

David Anderson approached Britannia's then Chief Executive, Neville Richardson, about a possible merger in May 2008, and serious discussions between Co-op Bank and Britannia began in the autumn.[15] Despite these discussions taking place at the height of the financial crisis, none of the parties involved—not Co-op Bank, not Britannia, and not the regulator—considered that the merger was a rescue.[16]

10 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), paragraph 3.3

11 Q 992

12 Q 1922

13 Q 992. The Building Societies (Funding) and Mutual Societies (Transfers) Act 2007 is also known as the 'Butterfill Act'.

14 Q 992

15 Qq 994-996

16 Qq 1080, 1363, Neville Richardson (PV 04)

7. Due diligence was performed over the remainder of 2008 and into 2009, and the merger completed on 1 August 2009.[17] The balance sheet of the enlarged Co-op Bank stood at around £47bn, and its branch presence swelled from 90 to 340.[18] Neville Richardson became Chief Executive of the enlarged Co-op Bank, and David Anderson stood down. Rodney Baker-Bates, Chairman of Britannia, became a member of the Co-op Banking Group board, and the Co-op Bank Chairman, at that point Bob Burlton, became Chairman of the enlarged entity.[19]

8. Almost two years on, however, in early 2011, Co-op Bank still felt itself to be sub-scale. According to Peter Marks, group Chief Executive, the bank "needed to build scale to compete and survive".[20] Andrew Bailey said that as a result of the Britannia merger, Co-op Bank had gone "from being a small high-cost bank to being a larger high-cost bank", and that it "never solved the cost problem".[21] Co-op Bank told the regulator in 2011 that despite a tally of 340 branches, it needed to have over 500 to achieve critical mass and scale for its costs.[22]

Governance

9. Co-op operated a unique governance structure. Co-op Bank, while itself a public limited company, was part of the wider 'Co-operative Banking Group' (known as 'Co-operative Financial Services' until September 2011), which also included the Co-operative Insurance business. This banking group was, in turn, wholly-owned by the mutual Co-operative Group. Co-op Group was therefore the bank's sole shareholder, and had a heavy interest in, and influence on, the affairs of the bank.

10. At the top of the group sat a wholly non-executive board of 20 Co-operative representatives, elected on the basis of one member, one vote from Co-op Regional Boards and Independent Co-operative Societies.[23] Beneath the board sat the group Chief Executive, who oversaw Co-op's underlying businesses, including the bank and supermarket chain. In 2011, Len Wardle, a former university lecturer, was Chairman of Co-op Group, and Peter Marks, a life-long Co-op executive, was Chief Executive.[24]

11. The Co-operative Banking Group had its own board of 14 members, but was heavily integrated with the group board: the banking group Chairman, Paul Flowers, was Deputy Chairman of the wider group, and Peter Marks, Len Wardle and two other members of Co-op Group board sat on the banking group board.[25]

17 Qq 541, 645

18 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), paragraph 3.8; The Co-operative Bank plc, '*Financial statements 2009*', page 39

19 The Co-operative Bank plc, '*Financial statements 2009*', pages 14-15

20 Q 290

21 Q 1933

22 Prudential Regulation Authority (PV 16) page 18

23 The Myners Review, *'Report of the Independent Governance Review'*, 7 May 2014, paragraphs 2.6-2.10

24 The Co-operative Group, *'Annual Report 2011'*, pages 4, 6

25 The Co-operative Bank plc, *'Financial Statements 2011'*, page 10

12. Financial services experience throughout this governance structure varied considerably. Few members of the group board or executive had financial experience, and neither therefore did many of the non-executives on the banking group board.[26] This included the Chairman himself, Paul Flowers, who, on his appointment in April 2010, had at his own instigation appointed two Deputy Chairmen with financial services experience—Rodney Baker-Bates in banking, and David Davies in insurance—to support him in his role.

13. The Co-op Banking Group board acted as the bank's board. It is therefore referred to throughout this Report as the Co-op Bank board.

The Lloyds divestment

14. Following Lloyds TSB's acquisition of HBOS at the height of the financial crisis, the Government injected £20.5bn into the combined institution to recapitalise it in the wake of enormous HBOS losses.[27]

15. Now a significant banking entity, and the beneficiary of state aid, the new 'Lloyds Banking Group' received a communication from the European Commission in July 2009 requiring it to divest a proportion of its branches to limit the resulting distortions of competition.[28] Lloyds drew up a plan for this divestment, under which over 600 of its branches were to be sold off. This plan was approved by the Commission in November 2009.[29]

16. Planning continued throughout 2010, and in early 2011, coinciding with the arrival of António Horta-Osório as Chief Executive, Lloyds announced the imminent commencement of the divestment process, known within Lloyds as 'Project Verde'.[30]

26 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), paragraphs 13.14-13.18

27 Parliamentary Commission on Banking Standards, Fourth Report of Session 2012-13, *'An accident waiting to happen: The failure of HBOS'*, HC 705, paragraph 2

28 European Commission, 'State aid: Commission presents guidelines on restructuring aid to banks', 23 July 2009

29 European Commission, 'State aid: Commission approves restructuring plan of Lloyds bank', 18 November 2009

30 Lloyds Banking Group, *'Lloyds Banking Group moves ahead with Project Verde'*, 1 March 2011

3 Bidding for Verde

The run up to Verde: February to July 2011

Co-op

18. Co-op Bank was first approached by the investment bank Credit Suisse about a possible bid for Verde in February 2011.[31] Co-op Bank's board was first consulted in April 2011.[32]

19. Peter Marks, Chief Executive of Co-op Group, was, by numerous accounts, the driving force behind Co-op's pursuit of Verde. The Kelly Report notes that, following the approach by Credit Suisse, Mr Marks "became a strong advocate" for the deal and "remained so until the end".[33] Mr Marks supported the deal because, as he told this Committee:

> The bank, in our view, was sub-scale. It needed to build scale to compete and survive. Verde represented a great opportunity to achieve that scale, and brought with it significant capital—£1.5 billion, I think, was the number; a high quality CEO, Paul Pester, who was appointed, if the deal went ahead, as the new chief executive, and was approved by the [Financial Services Authority]; and a management team to strengthen the Co-op management team.[34]

20. Mr Marks was not alone in his support for Verde. At a meeting with the regulator in May 2011, Neville Richardson, then Chief Executive of Co-op Bank, and Paul Flowers, then Chairman of Co-op Bank, said that:

> [T]he Board […] recognised there were many obstacles to overcome if it was to be seen as a viable proposition. However, the Board had recognised that such a transaction could transform its business and an initial pessimism had given way to one of cautious optimism—provided the hurdles could be overcome and due diligence was satisfactory.[35]

David Davies, former Deputy Chairman of Co-op Bank, confirmed that, while they were not "driving" the deal in the same way that Mr Marks was, Co-op Bank board members initially "supported" the transaction:

> [T]he bank saw this as a strategic acquisition that would move us from, let us say, a division one side into the premier league and that the acquisition of market share was a good thing for the bank, but the bank was not necessarily going to be asked to provide the capital.[36]

31 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), para 9.4; Q 1825

32 Q 1825

33 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), para 9.7

34 Q 290

35 Prudential Regulation Authority (PV 16) page 18

36 Q 1837

21. There was, however, some doubt about Verde within Co-op. David Davies considered that the Co-op Group board was initially somewhat more sceptical about Verde than the bank, since it "took a view that this was a very stressing, stretching acquisition for the group, and it was not necessarily financially that well placed to take advantage of it".[37] Neville Richardson also expressed some concerns about Verde, saying that he was "in favour" of the acquisition, but that it was "the right deal at the wrong time".[38]

22. Evidence from Mr Richardson suggests that his concerns about Verde related to the increased burden on management that it would cause. Two other major change programmes were already in train within the Co-op in 2011: the 'Banking Transformation Programme' (BTP), which involved the replacement of Co-op Bank's core banking IT system and integration with Britannia; and 'Project Unity', which aimed to bring a number of functions (including risk, internal audit and legal services) together across the bank and group, removing duplication, lowering procurement costs and reducing the number of administrative locations.[39] Pursuing Verde at the same time as these other projects was, Mr Richardson felt, "a stretch too far", and were it to proceed, reprioritisation would be required.[40]

23. Other witnesses told us that Mr Richardson was not as concerned about Verde as he was about Project Unity. Recalling debate within Co-op Bank at the time, Barry Tootell, Chief Financial Officer of the bank in July 2011, and later Chief Executive, said that:

> The debate was not a severe disagreement on Verde. There was a much more severe disagreement on the ability of the bank to embrace Project Unity, but Verde was presented as another example of stretch and working on many fronts that Neville talked about.[41]

24. One feature of Project Unity was to place Neville Richardson, in early 2011, in a direct reporting line to the group Chief Executive, Peter Marks, rather than to the Chairman and board of Co-op Bank.[42] Peter Marks told the regulator in a meeting in July 2011 that "Richardson's principal issue was nothing to do with Unity, but the fact that he did not want to report to someone else, or want his management team to do so".[43] Mr Richardson himself told the regulator that he felt the change "diluted his position".[44]

25. In July 2011, as Co-op was preparing to submit its initial bid for the Verde branches, Mr Richardson held separate conversations with Peter Marks, Paul Flowers and Rodney Baker-Bates in which he expressed his concerns about the burden on Co-op Bank's management.[45] A script prepared by Mr Richardson for these conversations read:

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37 Q 1836

38 Neville Richardson (PV 04), Prudential Regulation Authority (PV 16) page 5

39 Neville Richardson (PV 24)

40 Prudential Regulation Authority (PV 16) page 5

41 Q 565

42 Neville Richardson (PV 04)

43 Prudential Regulation Authority (PV 16) page 13

44 *Ibid.* page 5

45 Neville Richardson (PV 04)

> As you know, I believe running Transformation, Project Unity and Project Mars [Co-op's term for the purchase of the Lloyds 'Verde' branches] in tandem will cause management and staff to be overloaded. I have made this clear innumerable times. To push through all projects simultaneously could lead to disastrous consequences and would be completely to disregard the interests of key stakeholders, namely employees and customers. This breaches directors' duties and also is likely to breach contractual and other obligations. […]
>
> I do not want these consequences to happen and I do not believe you do either. Peter keeps saying it is achievable but I will not have my reputation damaged by his misjudgement. I do not understand why he is prepared to take the reputational risk himself. I believe he is being reckless and I am deeply worried.[46]

Mr Richardson stopped short, however, of calling for Projects Unity or Verde to be scrapped; he instead proposed a compromise solution, in which Co-op would "proceed with all three projects—Transformation, Project Unity and Project [Verde]", and "implement project [Verde] and Transformation as currently planned but to place project Unity on a much slower implementation timetable".[47]

26. Peter Marks said that he considered Mr Richardson's concerns, but disagreed with them, and that having "consulted widely with Neville's team, none of us on the bank board thought that management stress was so great that we should not go ahead either with Project Unity or Project Verde".[48] Mr Marks said he also raised the issue with the bank's executive team:

> I did consult, on a number of occasions, the banking team, the executive team of the bank, and ask the specific question, "Are we doing too much? Is this going to cause a problem?" The answer was no. There was an enormous amount of enthusiasm for both Project Unity and Project Verde among the management team of the bank.[49]

Barry Tootell agreed with Mr Marks:

> We were stretched, but that did not stop us doing the right thing by the business and at the same time considering the [Verde] opportunity, and at the same time embracing the Unity programme.[50]

27. At its meeting on 13 July, the Co-op Bank board "reaffirmed its objective" on Unity.[51] Mr Richardson told the Committee that, once it was clear that his view would not be acted on, his position became "untenable", and he and the group "mutually agreed that I would

46 Neville Richardson (PV 24) page 3

47 Neville Richardson (PV 24) page 4

48 Q 278

49 Q 288

50 Q 558

51 Prudential Regulation Authority (PV 16) page 12

leave".[52] Mr Richardson resigned later that month, and Barry Tootell became interim Chief Executive in his place.[53]

28. Mr Richardson outlined these events to the regulator in his exit interview in September 2011. However, he also said in this interview that his departure was prompted in part by a long-term plan to retire at the age of 55.[54]

The regulator

29. The Financial Services Authority (FSA) voiced concerns over Co-op's Verde bid from an early stage. Co-op Bank informed the regulator that it was considering a bid for Verde in May 2011, at which point Andrew Bailey, then Director of UK Banks and Building Societies at the FSA, said that "Co-op would need to demonstrate its ability to manage the capital position in a 'steady state', such that the bank could withstand any shocks".[55] Mr Bailey also wrote to Co-op Bank in June 2011, setting out certain "issues that they would have to address to convince [the FSA] on Verde".[56]

30. Attending the Co-op Financial Services Strategy awayday on 12 July 2011, Andrew Bailey set out the FSA's general views on Co-op Bank. In a presentation to the board and senior management team, he said that the FSA had "serious concerns" about several aspects of Co-op Bank: its capital position was low relative to its peers'; it had recently misreported its liquidity position to a significant extent; there were deficiencies in its risk management which indicated broader weaknesses throughout the group; and its record on Payment Protection Insurance (PPI) complaints handling was poor. These problems "called into question [Co-op Bank's] ability to entertain transactions such as Verde", and "suggested the bank was not ready to make the transformational step that Verde would bring".[57]

31. On capital in particular, the FSA said that Co-op Bank needed to be looking at a Core Tier 1 ratio of 10 per cent on a sustainable basis. Looking forward, under Basel III—the internationally-agreed regulatory framework for banks—an additional £900m of capital would be needed. This figure would rise to £2bn in the event of a successful Verde acquisition.[58]

32. Andrew Bailey told us that Co-op began to make progress on the regulator's concerns at this stage, in particular with respect to risk management:

> [I]mmediately after the July board meeting, we raised explicitly with the Co-op the fact that we did not believe that their risk function and their chief risk officer was up to the job. I raised that with Paul Flowers, and Paul Flowers said to me, "I understand

52 Neville Richardson (PV 04)

53 The Co-operative Group, *Neville Richardson to leave CFS, Barry Tootell appointed Acting Chief Executive*, 22 July 2011

54 Prudential Regulation Authority (PV 16) page 4

55 Prudential Regulation Authority (PV 16) pp 18-19

56 Q 1941

57 Prudential Regulation Authority (PV 16) pp 7-8

58 *Ibid.* page 9

> the point you are making. He will be replaced", and he was. They overhauled their risk. Between mid-2011 and the end of 2011, they did that.[59]

33. Co-op had, however, already submitted its first bid for the Verde branches, just days before the regulator's warnings at the Strategy awayday.[60]

The initial bids: July to December 2011

34. Lloyds Bank was considering a number of competitor bids for the Verde branches at this stage, including one from NBNK Investments. NBNK was a new investment vehicle, established in 2010 and chaired by Lord Levene of Portsoken, which brought together funds from a number of major investors with the aim, through the acquisition of the Lloyds branches, of establishing a new challenger bank in the UK.[61]

35. A number of rounds of bidding were held between July and November and, on 18 November 2011, the Lloyds Banking Group board met to discuss the three remaining bidders—Co-op Bank, NBNK, and the private equity group Sun Capital. The board decided to "continue detailed negotiations" with Co-op Bank and NBNK. The board also agreed to continue preparations for an IPO—an 'Initial Public Offering'—in parallel.[62]

36. Further bids were submitted by Co-op Bank and NBNK in mid-December and discussed by the board on 14 December 2011. The board concluded that "[t]he [NBNK] offer was potentially (albeit marginally) more valuable to the Group" but felt that "[o]n balance, the lower execution risk was probably with [Co-op]". Balancing these factors, the board agreed to offer a period of exclusive negotiation to Co-op Bank. Again, preparations for a potential IPO were to continue in parallel.[63]

37. Lloyds's consideration of Co-op Bank's and NBNK's bids is considered in greater detail in section 6.

Co-op

38. In the wake of Neville Richardson's departure, Rodney Baker-Bates—former Chairman of Britannia and then Deputy Chairman of Co-operative Banking Group—began to have similar doubts about progressing with Verde and Unity. He told the Committee he felt that Verde was "a giant step too far" when overlaid with Project Unity, which he considered a "major error".[64]

39. Mr Baker-Bates described to the Committee his main objection to Verde:

> The group was pursuing two parallel strategies: to invest heavily in food and to invest heavily in finance. My fundamental question around Verde was simply: did the Co-

59 Q 1954

60 Lloyds Banking Group (PV 08) page 17

61 Lord Levene (PV 02)

62 Lloyds Banking Group (PV 34) page 8, Q 10

63 *Ibid.* page 10

64 Q 1762

> operative Group have the capital and the competence to compete in two parallel industries that are highly capital intensive and when they had already merged with Britannia, which was a threefold increase in the bank at the same time? That is the overarching point and when Verde came along, if you have that as your overall view, it is an enormous risk to take.[65]

Mr Baker-Bates had expressed these concerns in an email to Len Wardle and Paul Flowers in September 2011, noting that they applied more broadly than to just the Verde transaction:

> [W]hilst I [have] been focussing on the transaction both at the bank and group level and expressing my concerns in that context, I [have] much broader concerns for the group beyond the specifics of Project [Verde].
>
> I expressed these deeper concerns at the group board by asking its members to form their view on Project [Verde] 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 the two most competitive retail markets in the UK [i.e. food and banking].[66]

40. With these concerns in mind, Mr Baker-Bates—who, like Neville Richardson, was also concerned about the consequences of Project Unity—tendered his resignation:

> Once I understood the implications—and I may have been a bit slow as they were not immediately clear—of Unity and the likely impact of that on the bank, and then Verde following on, I had a private meeting in October 2011, I think, with Paul Flowers and Len Wardle, the group chairman, to say that I wished to resign and that I was convinced that Verde was a giant step too far, given what was also happening in the bank's day-to-day business.[67]

41. Given that a final decision to proceed with the transaction had not yet been taken, however, Mr Baker-Bates was asked to stay on in his role. He therefore remained on the board because, as he told this Committee, "I wanted to make the argument and persuade the bank board not to proceed with Verde".[68]

42. Barry Tootell said that he too was concerned about the transaction towards the end of 2011, but described this as "concern that it was the right transaction for us to do" and "concern that we approach it with appropriate diligence to make sure it was the right transaction". It was, he said, "not a concern that we could not do the transaction in 2011".[69]

65 Q 1862

66 Rodney Baker-Bates (PV 29) page 10

67 Q 1769

68 Qq 1769, 1908

69 Q 496

The regulator

43. The regulator's concerns had not gone away. Andrew Bailey had spoken to Paul Flowers the day before Lloyds's decision to award preferred and exclusive bidder status to Co-op, and on 20 December he wrote to Co-op Bank re-iterating the points he had raised.[70]

44. In order for Co-op Bank to acquire the divested branches, it would ultimately have to secure the regulator's approval for a 'change in control' of the ownership of Verde. This approval would be conditional on, among other things, the ability of the bank "to comply with [the regulator's] prudential requirements".[71] The FSA would also need to consider the application against its "financial stability and consumer protection objectives", which, at the time, were:

- Financial stability objective: contributing to the protection and enhancement of the stability of the UK financial system; and
- Consumer protection objective: securing the appropriate degree of protection for consumers.[72]

45. In his December letter, which he described as being similar to his letter to Co-op Bank in June, Mr Bailey said that the FSA had "not taken any decision on whether an application for a change in control of 'Verde' would be approved", but that its current view was that it was "not clear that the Co-operative Banking Group [had] the ability to transform itself successfully and sustainably into an organisation on the scale that would result from acquiring the Verde assets".[73]

46. Consistent with this position, Mr Bailey set out five issues that Co-op Bank would "need to have addressed fully and have implemented before regulatory approval could be granted". These were: a credible liquidity and risk management framework; a credible integration strategy and plan; an effective governance framework; a permanent and suitable senior executive management team; and a feasible and sustainable capital plan. These formed, as Mr Bailey told us, "a pretty full set".[74]

47. In particular relation to Co-op's management, Mr Bailey noted that it was "not clear who [would] fill the key roles of Chief Executive, Finance Director and Chief Risk Officer on a permanent basis": at this point, Barry Tootell was still only 'interim' Chief Executive following Neville Richardson's departure. These uncertainties over the executive team were "critical" to the FSA's concerns about "management's ability to execute the transaction and integrate the business" and whether Co-op Bank would be able "to establish an effective risk management framework to manage such a transaction and support a much larger business".[75]

70 Andrew Bailey (PV 25)

71 Financial Services and Markets Act 2000, Section 186

72 Andrew Bailey (PV 25) page 1; Financial Services and Markets Act 2000, Sections 3A, 5

73 Andrew Bailey (PV 25) page 1; Q 1941

74 Andrew Bailey (PV 25) page 2; Oral evidence taken on 2 July 2013, HC (2013-14) 459, Q 100

75 Andrew Bailey (PV 25) page 1

48. Mr Bailey said that the FSA would work with Co-op Bank to monitor progress in the five areas and to consider "whether it is likely that the regulatory and statutory hurdles would be met in the required timeframe". In order to "avoid any possibility of ambiguity", Mr Bailey asked Co-op Bank to provide a copy of his letter to Lloyds.[76] Barry Tootell confirmed to the Committee that he did so.[77]

49. Mr Tootell was clear that the five issues set out by the regulator did not reflect concern about Co-op Bank's business in 2011, but were merely "areas we would have to specifically address in order to proceed with the transaction".[78] Moreover, in some cases Mr Tootell did not appear to consider the regulator's concerns to be any stronger than those held by Co-op Bank itself. On the regulator's warnings that Co-op Bank would need a feasible and sustainable capital plan in particular, Mr Tootell told us:

> We did not need telling that by the regulator. That was absolutely what our board would have evidenced to itself before it even considered the transaction.[79]

50. Peter Marks, when asked what Co-op did in response to the regulator's concerns, said: "We pursued the Verde deal, which would have delivered three of them".[80] Specifically, Mr Marks said that Verde would have delivered "capital—because Lloyds were putting capital in—management and IT systems".[81] Mr Bailey, however, described the five requirements as "five issues that they would have to address to convince us on Verde", rather than things Verde could solve.[82] Mr Tootell agreed that Verde was not the answer to the five issues, but rather that the list needed to be dealt with before Verde could proceed.[83]

51. Despite Mr Marks's apparent misunderstanding, Mr Tootell told us that Co-op Bank was "working tirelessly" towards the five issues identified.[84] Mr Bailey told us that Co-op did indeed begin to deal with the five issues: the bank had already begun overhauling its risk function following the July Strategy awayday, over 2012 "there was an overhaul of the board", and "there was capital put into the business by the Co-op Group".[85]

52. Sir Christopher Kelly confirmed that Co-op Group injected capital into Co-op Bank over 2012.[86] He also reported, however, that Mr Tootell's temporary appointment as Chief Executive was prolonged because of the Verde negotiations, and "because of the decision, part way through, to appoint a Lloyds executive as Chief Executive of the enlarged entity should the negotiations be successful".[87] This suggests that, at least in respect of

76 Andrew Bailey (PV 25) page 2

77 Qq 611-613

78 Q 606

79 Q 617

80 Q 373

81 Q 286

82 Q 1941

83 Q 639

84 Q 608

85 Q 1954

86 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), para 14.6

87 *Ibid.*

management, Co-op Bank was acting in line with Mr Marks's mistaken interpretation of the regulator's requirements.

NBNK

53. NBNK was dissatisfied with the outcome of the initial bidding process. Gary Hoffman, then Chief Executive of NBNK, told this Committee that he felt that NBNK's bid "was more compelling and much further advanced than [Co-op's]", and believed NBNK "had not had a fair hearing at that point in December 2011".[88]

54. NBNK also believed that "there was a significant risk that the Co-op acquisition would fail".[89] Gary Hoffman told the Committee: "it was crystal clear to me that the execution risk for the Co-op was extremely high", and that:

> I had lots of informal conversations with senior bankers who would share that view. There would be people inside Lloyds that have that view. There would have been people inside the Co-op that would have that view. There would have been people inside the FSA that had that view.[90]

55. With these concerns in mind, NBNK prepared a memorandum entitled "Key risks to the Co-op and Verde transaction". The document set out a number of areas that NBNK felt presented a risk to the transaction proceeding, including: financing, in that Co-op might not be able to provide sufficient certainty or confidence regarding its financing of the Verde transaction; group stretch, in that Co-op had already embarked upon an "ambitious" programme of growth, and the addition of the Verde package would represent an additional strain; and execution risk, in that with an "out-dated" banking platform, the ongoing Britannia integration and implementation of a group-wide IT centralisation programme, Co-op could face great difficulty managing the integration.[91] The memo was presented to the NBNK Board on 26 January 2012 as, in Lord Levene's words, "a report on what we believed to be the status of the Co-op in their bid".[92] The Board discussed the memo, and agreed that "it would be appropriate for the paper to be left with [Lloyds Banking Group's (LBG's)] Chairman" at a meeting the next day.[93]

56. The Committee has heard conflicting evidence regarding whether this memorandum was in fact received by the then Chairman of Lloyds, Sir Win Bischoff. Lord Levene told us:

> Both Mr Hoffman and I attended that meeting [on 27 January 2012] and we can both confirm to you today—if you would like it, on oath, but I am sure you do not—that I gave him that document. […] I said, "Win, I really think you should read this,

88 Qq 1564, 1635

89 Lord Levene (PV 02)

90 Qq 1501, 1504

91 Lord Levene (PV 02a)

92 Q 1597

93 Lord Levene (PV 03) Appendix 1

> because if you read it and if you check it, I think you will think very carefully about whether to accept the Co-op bid or not", and he said, "Thank you very much".[94]

57. However, in a letter to the Chairman of the Committee on 19 December 2013, Sir Win appeared to have no recollection of the letter:

> I can only surmise that [the document] had been prepared by Lord Levene's advisers and was intended as a 'leave behind' after the discussion but which in fact was omitted to be left behind. We certainly have no record of it; nor of it being referenced by Lord Levene again in any of a number of subsequent discussions with me, António [Horta Osório] or our advisers.[95]

58. Regardless of whether or not this memorandum was delivered successfully to the Lloyds Chairman, the issues raised within the memorandum appear to be materially the same as those raised by the regulator—for example, difficulties in financing would require a feasible and sustainable capital plan; and execution risk, based primarily around technical integration, would require a credible integration strategy and plan. Given that Co-op Bank had, as instructed, informed Lloyds of the regulator's concerns, these issues would have been known to Lloyds already. It is at any rate unclear what Lloyds Bank could or should have drawn from one bidder's critique of its rival.

59. Whether Lloyds received the document and whether it acted on its contents does not therefore appear of great relevance to its decision to name Co-op Bank as preferred bidder for Verde. The existence of the document does suggest, however, that concerns about Co-op Bank's Verde bid were held more widely than by the regulator alone.

The lapse of exclusivity, the final bids and Heads of Terms: January to July 2012

60. Lloyds pursued exclusive talks with Co-op Bank in the first few months of 2012, with the target of reaching an agreement by April.[96] However, problems with Co-op's bid were becoming apparent: Co-op had concluded that it would not be possible to migrate Verde customers onto its existing IT platform, and the timetable for the SPA—the 'Sales and Purchase Agreement' confirming the outcome of commercial and pricing negotiations—was slipping.[97] Sir Win Bischoff told us that "Co-op was not able, in terms of time, to meet [the] exclusive arrangement", and that "[w]hen there was a delay with the Co-op bid, we were very, very keen to reintroduce NBNK".[98]

61. NBNK had, according to Gary Hoffman, been of the view that Co-op would not meet the April deadline, "indeed would not be able to get anywhere near" by then, and this being

94 Q 1586

95 Sir Win Bischoff (PV 15) page 1

96 Lloyds Banking Group (PV 18) page 2

97 *Ibid.* page 2

98 Q 130

the case chose to "stay in the game".[99] On 28 March, NBNK submitted a new, unsolicited offer to Lloyds. The following month, Lloyds re-admitted NBNK to the process.[100]

62. Lloyds again revised the Verde package on offer in the summer of 2012, and a final round of bidding was held, with Co-op and NBNK submitting their final offers in June 2012.[101]

63. At its meeting on 27 June 2012, the Lloyds board considered the final bids. This time, Lloyds judged Co-op Bank's bid to be superior from a financial standpoint, and said that "a solution had been found to the IT platform issue" which had earlier afflicted Co-op. It also said that "[t]he balance of other risks considered in December 2011 remained broadly constant". The board therefore resolved to offer Co-op a further period of exclusivity, at the end of which the Heads of Terms would be signed.[102]

Co-op

64. In an email to Paul Flowers on 28 May 2012, Rodney Baker-Bates said that he remained "deeply concerned" about management capability.[103] Between April and July 2012, David Davies, Co-op Banking Group's other Deputy Chairman, also began to have doubts about Verde. He told this Committee:

> My points of concern were, first, the economic environment that we were still in and the future. Success depended on base rate increases and we were predicting base rate increases in 2014. I was worrying that base rate increases would not be there until 2017, in which case the viability of the whole thing suffered. Secondly was the doability argument […]. I did not think that management could do this integration process even though we were getting Paul Pester and management from Lloyds. This was such an enormous scale thing that I was concerned. The third aspect was capital. It seemed to me that storm clouds were gathering all around us. […] I could see that the regulator was going to increase our capital guidance numbers and gradually capital was going to get tighter and shorter. All of that convinced me that we should not do this deal.[104]

65. Mr Davies's concerns on integration were heightened by the difficulties that Co-op had encountered in the spring in planning to migrate Verde customers onto its existing IT platform. He told us:

> [W]e got to April when we changed our systems strategy. Instead of suggesting that we would migrate all the Lloyds business that we acquired on to Co-operative's new

99 Q 1564

100 Lord Levene (PV 02)

101 Lord Levene (PV 03) paragraph 5

102 Lloyds Banking Group (PV 18) page 3

103 Rodney Baker-Bates (PV 29) page 16

104 Q 1866

> platform, we discovered a significant error in the costing of that platform such that it made the Verde deal basically not worth what we were suggesting.[105]

Asked to quantify this error, Mr Davies said "We are talking hundreds of millions of pounds".[106] The Kelly Report describes the discovery of this error:

> In April 2012, Andy Haywood, the new Group CIO, commissioned a recalculation of the cost of the replatforming programme and the additional IT-related implementation cost of the Verde transaction. The plan at this stage, known as 'Plan A', was to complete the replatforming project and then to migrate Verde on to the new platform. The new estimate suggested that the final cost of completing the replatforming and Verde migration would be £1.8 billion, a massive increase on the previous estimate of £0.8 billion for both. The increase made the deal economically impossible.[107]

66. Mr Davies said the problem related to "the peripheral systems that interfaced with the platform", and described Co-op's response to its discovery:

> Within a matter of weeks, we did a U-turn and instead of integrating on to Co-operative platforms we were going to integrate Britannia and Co-op on to Lloyds platforms, which was then going to be split for Co-operative use.[108]

This "U-turn" further undermined Mr Davies's confidence in the ability of Co-op's management to complete the deal:

> I did not believe that our management, which had not been successful in the integration of the Britannia branches on to the Co-op systems, could do something of this nature.[109]

Rodney Baker-Bates also said in May 2012 that his "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 […] the cost 'blow out' for integration under plan A".[110]

67. Following the announcement that Co-op Bank had again been selected as preferred bidder in the June 2012 Verde round, the Co-op Bank board prepared for a vote on whether or not to proceed to sign Heads of Terms with Lloyds. Mr Davies told us that until the Heads of Terms vote there had not been a great deal of dissension within the banking board. The vote, however, "brought matters to a head".[111]

68. The change in the systems strategy, described by Mr Davies as a change from "plan A through to plan C"—'plan B' was to withdraw from the deal—changed the nature of the transaction. "As it got more complex", Mr Davies said, "I think the banking board certainly

105 Q 1864

106 Q 1865

107 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), para 9.19

108 Q 1866

109 Q 1866

110 Rodney Baker-Bates (PV 29) page 16

111 Q 1842

started to get less sure”.[112] The earlier characterisation of support from the bank board and scepticism from the group had also begun to reverse—Mr Davies said that, as the Heads of Terms vote approached:

> [T]he bank board got more nervous because of the financial position of the bank and the financial deal. The group board were more persuaded by Peter [Marks] in the sense of the strategy for the group should support this acquisition.[113]

69. At its meeting on 11 July 2012, the Co-op Bank board held a vote on whether to proceed to sign Heads of Terms with Lloyds. The two Deputy Chairmen voted against the motion; all other members voted in favour.[114] “I failed to win the argument”, Mr Baker-Bates told us. He resigned later that month in consequence.[115] Len Wardle and Paul Flowers, reluctant to lose both Deputy Chairmen as a result of the Verde vote, persuaded Mr David Davies to stay on until the end of the year. But Mr Davies told us that, following the vote, he knew he “could not in all honesty continue”.[116]

70. It was not too late for the directors in favour of Verde to change their minds. Mr Davies pointed out that another vote would have been required to complete the deal:

> The heads of terms was not a clear break. When you got to the [Sale and Purchase Agreement], that would have been a clear break when, if you like, any doubts would have had to have been surfaced. [Rodney Baker-Bates and I] chose heads of terms because certainly in my case I thought this had now got to the point when I could not carry on with this. I thought we had to stop because it was beginning to, in my view, hurt the organisation. But it was not a natural breakpoint because it was still open for negotiations after heads of terms, and that was one of the problems—that there were a number of details still remaining to be negotiated post heads of terms, before SPA, that could have changed the nature of the deal.[117]

Mr Davies told us that, following the heads of terms vote in July 2012 he was “convinced that more and more directors saw the folly of [Verde]”:

> Post the vote in July of 2012, I saw more wavering among my colleagues on the board and I believe more of the banking board directors joined my view and would have, if it had come to a vote, changed their vote.[118]

71. The Kelly Report notes that, in July 2012, the FSA announced that it would not intervene to stop the Heads of Terms being signed. But the FSA “made clear that, prior to the Group signing a Sale and Purchase Agreement, it would need to see further work to improve the Bank's governance framework, address management stretch, ensure the

112 Q 1839

113 Q 1841

114 The Co-operative Bank plc (PV 21); Q 1339

115 Qq 1759-1762

116 Qq 1763-1764

117 Q 1896

118 Qq 1839-1842

financial stability of the bank and demonstrate the long-term viability of using Lloyds' IT platform".[119]

Should the regulator have stopped Co-op's Verde bid?

72. The question of whether the regulator should have taken firmer action in response to the problems with Co-op Bank's Verde enterprise has been raised. Asked why he had not intervened and made clear that Co-op's Verde bid was "doomed to failure", Mr Bailey told the Committee:

> Because it was not necessarily doomed to failure. In my judgment, that is the wrong assumption to make. Had they raised the capital and had they continued, as they were starting to do, to deal with the other issues, then it is not obvious that it was doomed to failure. […]
>
> [W]e set out conditions. Those conditions had to be met. […]We set out quite clearly that we would have to approve that transaction, which we would, and we have the powers to block it, which we do, but in my view it was reasonable to say, "If you can meet these conditions, then there is a case for the transaction going ahead".[120]

Asked how the regulator was able to strike a balance between exercising sufficient oversight and appearing to act as a shadow director, Mr Bailey told the Committee:

> [W]e have to walk very carefully because it would be dangerous, but in some contexts quite easy, for us to get ourselves into the position where […] we are exercising more control and more influence than we should be in our position. I […] I am very conscious of this. It is something that we have to watch very carefully. […][121]

Mr Bailey added:

> We have to be very conscious of how we use our powers as regulators. If we just pile in early on and say, "We don't like that", we will be having different discussions in this room.[122]

73. Asked whether he accepted that the letters from the regulator to Co-op Bank setting out reservations about Co-op's Verde bid needed to avoid ambiguity and be "a bit more robust", Mr Bailey replied:

> No, I am afraid I don't. I think the letters were direct. I think you now have a document, among the ones we sent you, that records a meeting with Neville Richardson after the July board. Funnily enough, I was at the meeting with Neville, but it was a discussion that happened after I left the meeting where Neville essentially said to the supervisor, "I wish you had told me that Andrew was going to be so direct

119 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), para 9.26

120 Qq 1957, 1959

121 Q 1968

122 Q 1959

> and so blunt with them because I would have warned the board". So, no, I am afraid I don't accept that proposition.[123]

For his part, Barry Tootell characterised the concerns that Andrew Bailey raised as follows:

> These were not challenges of things that we had to fix in 2011 because the business had a problem. These were very clearly things that the regulator was saying, "If you are going to do a transaction the size of the Verde transaction, these five things are fundamentally important.[124]

Rodney Baker-Bates said that he did not consider the messages that the regulator delivered at the Co-op Strategy Awayday in July 2011 to be "stark":

> To me, the regulator was raising five key issues, which, as an experienced banker, I would have raised and I had raised already in my own mind, so what he was raising matched with my concerns. I would not have described it as a stark warning.[125]

Sir Christopher Kelly concluded that the regulator's numerous interventions on Verde "do not appear to have been interpreted [by Co-op] as the warnings they were undoubtedly intended to be".[126]

74. The question of whether the regulator should have acted on the concerns of Co-op Bank's Deputy Chairmen in particular has also been raised. This question is born in part of the notion that the regulator had required the appointment of the Deputy Chairmen to compensate for Paul Flowers's lack of financial experience when he became Chairman in 2010. Clive Adamson, Director of Supervision at the FCA and former director at the FSA, told this Committee, however, that the arrangement was proposed by Mr Flowers, and that there was "an agreement between the both of us that it would be appropriate".[127]

75. Mr Davies did not appear to think that the regulator should have called a halt to Co-op's bid on the basis of their views. He told the Committee: "[o]n the basis that two people voted against this deal, I cannot see that that is justification for the regulator intervening there".[128] Mr Davies also disagreed that the regulator was faced with "overwhelming evidence" against Verde by the Deputy Chairmen, saying to the Committee:

> [D]o not forget that a number of directors—the majority of the directors in the Co-operative Bank—voted in favour of doing this deal, or at least going on to the next step. Therefore, they were convinced that things could be done, things could improve; changes might happen that would make this deal doable.[129]

123 Q 1950

124 Q 608

125 Q 1899

126 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), para 9.11

127 Q 1336

128 Q 1871

129 Q 1896

In addition, Mr Baker-Bates said that the concerns raised by the regulator were issues "which, as an experienced banker, I would have raised and I had raised already in my own mind, so what he was raising matched with my concerns".[130]

76. Moreover, neither of the Deputy Chairmen expressed an unequivocal view to the regulator that the Verde deal should be stopped. Andrew Bailey, quoting from an FSA minute of Rodney Baker-Bates's August 2012 exit interview with the regulator, said Mr Baker-Bates had described the revised Verde package announced by Lloyds in summer 2012 as making Verde "more feasible" and "more attractive". Mr Baker-Bates was also quoted as saying: "I recommend that, as it approaches the signing of the sale and purchase agreement the FSA should exert leverage on the Co-op to force changes in governance and management". Mr Davies on the other hand was said to have told the regulator: "I do not want the FSA to reject the deal, given that it has to happen. Co-op are the best show in town. I hope that I will no longer be on the board at the time of signing." Mr Bailey said that there was "no question" that the Deputy Chairmen had voted against Verde for the reasons they described to the Committee, but that their communication to the regulator did not amount to saying "Stop now".[131]

Conclusions

77. **From the start of the Verde process in 2011, the FSA was sceptical of Co-op Bank's ability to take the transformational step represented by the acquisition of the Verde branches. The FSA's concerns spanned almost every material aspect of Co-op Bank's business: its liquidity and risk management framework; its integration strategy; its governance framework; its senior executive management team; and its capital plan. Co-op Bank took steps to address some of these concerns. But the FSA remained unsatisfied on a number of points, and even after Co-op Bank signed Heads of Terms in July 2012, the regulator expressed disquiet about Co-op's governance, its integration plan, and its prospective financial soundness.**

78. **Neville Richardson, the bank's former Chief Executive, warned at the start of the process in mid-2011 of the management burden that the Verde transaction could pose. Co-op Bank's Deputy Chairmen had doubts about the commercial sense of the transaction: whether Co-op possessed the necessary resources and competence to compete in banking as well as other markets, and whether the economic outlook and future regulatory capital pressures might make the deal less attractive. Following a significant costing error in the bank's IT replacement programme, both Deputy Chairmen also began to doubt whether Co-op Bank was even capable of completing the integration with Verde.**

79. **However, it was not clear at the time that the numerous and varied challenges facing Co-op Bank's bid were insurmountable. Despite knowing the FSA's views on the difficulties that Co-op faced, Lloyds chose to pursue a deal with Co-op Bank, both in the December 2011 and the June 2012 rounds of bidding. Co-op Bank's Deputy Chairmen, though they had doubts about the transaction, did not recommend to the**

130 Q 1899

131 Q 1981

regulator in their exit interviews that the deal be stopped. Neville Richardson similarly wanted Verde to go ahead, with the proviso—made clear in the script of his conversation with Peter Marks and others in July 2011—that other projects should be implemented more slowly. Notwithstanding its own deep misgivings, the FSA did not instruct Co-op to call off its pursuit of Verde. Instead, it afforded the bank the opportunity to address its concerns.

80. **By setting out strict conditions that Co-op Bank would need to meet for the deal to go ahead, the FSA permitted Co-op Bank to take its own commercial decision without the regulator's statutory objectives for financial stability and consumer protection being put at risk. While there remained any reasonable prospect that Co-op Bank might be able to meet these conditions, it was appropriate for the FSA to allow the deal to progress.**

81. **The evidence that the Committee has heard does not, however, give cause for great confidence that the management of Co-op Bank in place throughout the bidding process would ultimately have satisfied the regulatory hurdles for Verde to go ahead. It is doubtful that this management team—which had not been successful in completing the integration with Britannia—could have convinced the regulator of its ability to integrate Verde. Furthermore, the regulator's warnings about Verde, while clearly intended to be forthright, do not seem to have been properly understood by Co-op Bank: Sir Christopher Kelly concluded that the bank did not interpret the FSA's concerns as "the warnings they were undoubtedly intended to be". Peter Marks, group Chief Executive, erroneously described the FSA's concerns to the Committee as things that Verde could have solved, rather than things that Co-op would need to have addressed before Verde could go ahead. It would have been crucial for Co-op Bank to have met the regulator's demand for a "permanent and suitable management team", were Verde to have proceeded.**

82. Before it could become clear, however, whether Co-op Bank would address the regulator's concerns, the Verde process was hit by serious financial problems at Co-op Bank.

4 The financial collapse of the Co-operative Bank

Introduction

83. Over the second half of 2012 and the duration of 2013, Co-op Bank's financial position deteriorated significantly. Co-op Bank reported significant loan impairment and other losses in its public financial statements (see Table 1), and a significant shortfall against its regulatory capital requirements emerged.

84. Co-op Bank's reported losses and its shortfall against regulatory capital requirements are distinct, but related. This section examines the three most significant and measurable factors that led to the bank's capital resources being diminished—large impairment losses on Co-op's loan book, particularly on assets acquired from Britannia, write-downs in the value of Co-op's banking system upgrade, and conduct redress. It also examines the effect of the Verde deal on Co-op Bank's finances, other factors contributing to the bank's capital shortfall, and the consequences of Co-op Bank's financial collapse for the Verde bid.

Table 1 – Total impairments and significant items reported by Co-op Bank over 2012 and 2013

£m	**2012**	**2013**	**Total**
Credit impairments	469	516	985
Core	*40*	*40*	*80*
Non-Core	*429*	*476*	*905*
Of which corporate	*425*	*447*	*872*
IT write-down	150	148	298
Conduct redress	150	412	562
Other significant items	94	208	302
Total impairments and significant items	863	1,284	2,147

Source: Co-op Bank Financial Statements 2012, Co-op Bank Annual Report and Accounts 2013; note that 'Core' and 'Non-core' assets were redefined in 2013, and these figures are presented using that definition. 'Other significant items' comprises non-operating costs and Fair Value Amortisation.

Britannia and other impairments

The merger with Britannia

85. When Co-op and Britannia decided to merge in 2008, Co-op engaged external advisors to assist with its assessment of the deal. KPMG was engaged to perform due diligence on Britannia, and JP Morgan Cazenove (JPMC) was hired as a financial advisor on the transaction.[132] KPMG was paid £1.3 million—£841,000 for due diligence and the

132 Qq 540, 547

remainder for associated pieces of advisory work.[133] JPMC's fee was £7 million in total—£2 million up front, and £5 million on completion.[134]

86. David Anderson told us that Co-op's own rationale for the merger included greater 'distribution reach'—through Britannia's branch network—and mortgage expertise that would help Co-op move away from unsecured lending.[135] JPMC's analysis showed that the merger would result in the profits, net assets and dividends of Co-op members being diluted by the inclusion of Britannia members (Table 2).[136] But JPMC agreed with David Anderson's assessment, concluding that, with key benefits to customers including improved distribution and "product offering", the merger was a "one-off transformational opportunity" for Co-op.[137] As is clear from the assets of the two firms at merger (Table 3), the deal was indeed transformational for Co-op Bank—Britannia's large portfolio of non-standard mortgages and commercial real estate assets totally changed the shape of the bank's business. It also resulted in a large increase in Co-op Bank's dependence on wholesale funding (see Table 3).

Table 2 – JPMC's 'Side by side analysis' of Britannia and Co-op Group

	Britannia	**Co-op Group**
Voting members	57%	43%
Profit before tax (PBT) 2007	30%	70%
Net assets 2007	25%	75%
Dividend 2007	32%	68%

Source: JP Morgan Cazenove 'Project Vintage Board Paper', 2009, (PV 13) page 273

87. KPMG was commissioned to examine ten key areas of risk arising from the transaction, as specified by Co-op: impairment; commercial lending; available for sale assets; funding and liquidity; taxation; securitisation; accounting policies; pensions; capital, and adjusted earnings.[138]

88. KPMG performed initial, 'Phase I' due diligence on these areas, and concluded on Britannia's commercial loan book that, apart from two specific tenants, "[no] arrears are being experienced in either the housing association or pure commercial lending portfolios".[139] However, it also drew Co-op Bank's attention to "significant limitations" in the scope of its work:

> We have had very limited access to the premises of [Britannia]. Access to the audit files has not been granted at this stage. Management information available has been

133 Qq 1096-1098

134 Q 1218

135 Q 992

136 JP Morgan Cazenove (PV 13) page 274

137 *Ibid*. page 267

138 David Anderson (PV 10)

139 KPMG (PV 13) page 62

> restricted to specified documents in a data room and supporting work papers have not be available in all instances. These restrictions have had a corresponding impact on the nature of comments we have been able to make on the financial information available.[140]

Andrew Walker, Lead Audit Partner on KPMG's due diligence on Britannia, told the Committee that KPMG recommended that further due diligence on the commercial book "should be done as part of phase II".[141] Asked how hard KPMG pressed for this additional work to be done, Mr Walker said: "Other than pointing it out in our report and spelling that out for management, no further."[142]

89. Rather than engage KPMG on this further due diligence, Co-op Bank decided to perform it itself. According to David Anderson, Co-op considered Britannia's commercial loans to be "closer to the lending that [Co-op] did as a bank" than other elements of the Britannia book. Co-op Bank therefore focused KPMG on "things that we did not do as a bank, which were the sub-prime, the intermediary lending and the securitisations, of which we had significantly less experience", and sent in its own team to examine the commercial loan book.[143] David Anderson described the team performing the additional due diligence on the corporate book as "a very, very experienced risk team, who we relied upon to put all our own corporate loans on the book".[144] Asked whether KPMG ever saw the results of Co-op Bank's further work, Andrew Walker said:

> No. There was no KPMG report on that, and I didn't see any subsequent Co-op reports to the board.[145]

However, Mr Walker added:

> I had no reason at the time to doubt their capability to do it. […] They had the right experience to be able to do that piece of work.[146]

140 KPMG (PV 13) page 58

141 Q 1137

142 Q 1214

143 Q 1043

144 Q 1017

145 Q 1181

146 Q 1216

Table 3 – Simplified composition of Co-op Bank and Britannia assets in 2008/09

£ bn	Britannia (July 2009, at merger)	Co-op Bank (December 2008, last reported figures before merger)
Total assets	34.0	15.0
Of which loans	23.8	10.3
Retail loans	20.1	5.7
Standard mortgages	10.7	4.1
Non-standard mortgages	9.4	0
Other (unsecured, e.g. credit cards)	0	1.6
Corporate loans	3.7	4.6
Property and construction (commercial real estate)	3.7	1.6
Other corporate loans	0	3.0
Customer deposits	19.9	11.9
Wholesale funding	10.4	1.6

Source: Britannia Cessation Accounts, Co-op Bank Financial Statements 2009. 'Non-standard mortgages' comprise loans secured on residential property which do not conform to traditional mortgage lending standards. They include buy-to-let mortgages, self-certification mortgages (where the lender does not have documentary proof of the borrower's income), and loans to higher risk borrowers (such as those with high existing debt levels, or with poor credit or other histories).

90. In his report into the events at Co-op Bank, Sir Christopher Kelly cast doubt upon the quality of the additional due diligence:

> The Review has faced considerable difficulty in establishing how extensive this was in practice. There was no written report and the individuals concerned could remember little about it five years later. But it appears to have been limited. As far as it has been possible to ascertain, three members of a Co-operative Bank team including the Head of Banking Risk, Kevin Blake, reviewed about 30 of the largest commercial loans over a two-day period in early January 2009 (about two weeks before signing the sale and purchase agreement). In the time available it cannot have looked at them in any great detail. Moreover, the high concentration risk which would have been apparent might have been expected to raise some important questions.[147]

Overall, Sir Christopher describes the due diligence on Britannia's corporate book as "cursory", and concludes:

> The cursory due diligence on Britannia's corporate lending portfolio is startling in view of how different that lending was to the Co-operative Bank's own business and

147 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), para 3.46

> that of comparable building societies. It is particularly surprising in respect of the commercial real estate lending, with its high concentration risk at a time of a deteriorating macroeconomic environment characterised by collapsing commercial real estate prices. [148]

This did not prevent JPMC describing the due diligence to the Co-op Bank board at the time as "exceed[ing] that normally undertaken for listed companies".[149] David Anderson, Chief Executive of Co-op Bank at the time of the merger, also described this due diligence as "very full".[150]

91. Commenting on the results of the due diligence, Mr Anderson said:

> It was clear to us from what they reported that there were some parts of that loan book that were appraised differently than we would have appraised them. Specifically, their limit to an individual counterparty was greater and the concentration in some sectors was greater. There were some risks that they identified. We evaluated those as being acceptable in the context of the whole transaction.[151]

One individual interviewed by Sir Christopher's review appears to have taken a stronger stance, describing the Britannia book as "the worst lending I have ever seen".[152]

92. In response to the risks identified, Co-op Bank made a number of downward fair-value adjustments to the Britannia assets upon acquisition. An asset's fair value at acquisition is equal to the discounted expected future cash flow from that asset at acquisition. Fair value adjustments reflect the difference between this fair value and the current carrying value on the acquiree's balance sheet. Mr Anderson said the adjustments made to the Britannia assets—including £238m to protect against credit risk to the corporate book—"looked like a pretty solid insurance policy against problems that may arise in different parts of the book".[153] Mr Anderson added that, at the time, Britannia's commercial book seemed unlikely to be the main source of potential risk to Co-op Bank (see Table 3):

> The total actual pure commercial lending from Britannia at the time of the merger was £2.2 billion […] the pure commercial was a relatively small book […]. It was also a book that was not recently lent. Most of it was quite well established. It had been put on the books over a four or five year period, so there was not a big surge in new things. At that time it would have been pretty hard to envisage that that was going to be the source of most of the problems […].[154]

The fair value adjustments made were assessed and "blessed" by KPMG.[155]

148 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), paragraph 3.49

149 *Ibid.* paragraph 3.51; Qq 541, 1013

150 Q 1001

151 Q 1022

152 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), paragraph 3.47

153 Q 1022; KPMG (PV 13) page 225

154 Q 1043

155 Q 1053

93. At the same time, the regulator was performing its own analysis on the possible effects of the merger. The FSA had no formal, legal role in the merger, since it involved mutual firms and was not therefore strictly a 'change in control' requiring regulatory approval. Nevertheless, Clive Adamson, director at the FSA at the point of merger, told us: "I decided we should go well beyond what was legally required and treat it as close to a change of control as we could".[156] Describing the FSA's analysis, Mr Adamson told us:

> At the time when we subjected the firm to our stress test approach and our capital framework approach, it did suggest that under stress—and it is not a forecast it was under stress—the core tier 1 capital position could fall to 4.3% [...]. It was tight but it did meet our framework at the time.[157]

94. As described previously, none of the parties involved considered the merger a rescue of any sort at the time: David Anderson told the Committee that, although there were risks involved in merging with an unknown entity in such a febrile period, Co-op believed that "the risk of the two organisations together was less than the risk of each separately and less than the risk of our organisation separately"; Neville Richardson said that the merger "was not a rescue"; the former board of Britannia told us that it "was not a rescue of either party"; and Clive Adamson said that "[i]t certainly was not in our view a rescue".[158]

95. The merger went ahead on 1 August 2009. At the end of 2008—the final full year before the merger—Britannia had Tier 1 capital resources of £1,158 million: a Tier 1 capital ratio of 10%.[159]

96. For the next three years, impairments continued at low levels. This persisted even as other banks reported significant spikes in impairment losses, particularly in 2009 (see Table 4). Statements from senior members of Co-op Bank over this period made reference to the bank's prudent business model. In Co-op Bank's 2011 Financial Statements, Barry Tootell, Chief Executive wrote:

> Our underlying capital position continues to be a source of strength, and reflects our prudent approach to the stewardship of our customers' money [...].[160]

In the same set of financial statements, Chairman Paul Flowers wrote:

> As a 'co-operative' we are member led rather than shareholder led. This model allows us to focus on the 'bigger picture' rather than react to short term trends. It encourages prudent stewardship, customer focus and a responsible approach to growth.[161]

And in an article in January 2012, Mr Flowers linked Co-op Bank's financial performance to its ethical policy:

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156 Q 1381

157 Q 1364

158 Qq 1001, 1363; Neville Richardson (PV 04)

159 The Co-operative Bank plc, *Presentation to Wholesale Credit Counterparties*, 10 July 2009, page 19

160 The Co-operative Bank plc, *'Financial Statements 2011'*, page 4

161 *Ibid.* page 3

> It is no coincidence, for example, that our bank remains the only main high street bank with a clear ethical policy, while at the same time it did not ask for or need government support throughout the credit crunch.[162]

Table 4 – Impairment losses on loans and advances to customers at major UK banks, 2007-2013

£ m	2007	2008	2009	2010	2011	2012	2013
Co-op Bank and Britannia	116	155	161	97	121	474	516
Barclays	2,782	4,913	7,358	5,625	3,790	3,303	3,062
HSBC Bank	1,043	1,864	3,364	1,633	1,122	1,213	1,102
Lloyds and HBOS	3,733	12,732	15,783	10,727	8,020	5,125	2,725
Nationwide	106	394	549	359	390	589	380
RBS	2,106	6,360	13,056	9,157	7,241	5,292	8,427
Santander	344	348	773	712	501	988	475

Source: The Co-operative Bank plc, 'Financial statements 2007', page 41; The Co-operative Bank plc, 'Financial statements 2009', page 36; The Co-operative Bank plc, 'Financial statements 2011', page 30; The Co-operative Bank plc, 'Annual report and accounts 2013', page 128; Britannia Building Society, 'Annual report and accounts 2008', page 26; Britannia Building Society, 'Report and cessation accounts', page 13; Barclays Bank plc, 'Annual report 2007', page 33; Barclays Bank plc, 'Annual report 2010', page 87; Barclays Bank plc, 'Annual report 2013', page 292; The Royal Bank of Scotland Group, 'Annual Report and Accounts 2007', page 154; The Royal Bank of Scotland Group, 'Annual Report and Accounts 2010', page 328; The Royal Bank of Scotland Group, 'Annual Report and Accounts 2013', page 437; HSBC Bank plc, 'Annual report and accounts 2007', page 30; HSBC Bank plc, 'Annual report and accounts 2009', page 30; HSBC Bank plc, 'Annual report and accounts 2011', page; HSBC Bank plc, 'Annual report and accounts 2013', page 128; Santander UK plc, '2007 Annual Report on Form 20-F', page ; Santander UK plc, '2010 Annual Report on Form 20-F', page 186; Santander UK plc, '2013 Annual Report', page 238; Nationwide, 'Annual Report and Accounts 2008', page 12; Nationwide, 'Annual Report and Accounts 2010', page 11; Nationwide, 'Annual Report and Accounts 2012', page 16; Nationwide, 'Annual Report and Accounts 2014', page 18; Lloyds Banking Group, 'Annual report and accounts 2008', page 122; Lloyds Banking Group, 'Annual report and accounts 2010', page 178; Lloyds Banking Group, 'Annual report and accounts 2013', page 240; HBOS plc, 'Annual report and accounts 2008', page 73. Nationwide's financial year runs to 4 April; for example, '2010' means the year to 4 April 2011. Co-op Bank and Britannia figures, and Lloyds and HBOS figures, for 2007 and 2008 are formed by summing the figures for the individual banks prior to the mergers. Co-op Bank and Britannia figures for 2009 are formed by summing the year-end Co-op Bank figures with the standalone Britannia figures up to 31 July, as shown in the Britannia Cessation Accounts.

New regulatory guidance and the capital shortfall

97. In the second half of 2012, the FSA began a round of stress testing on UK banks. Alongside this, the regulator was performing a review of the quality of banks' assets.

98. At its meeting in November 2012, the Financial Policy Committee (FPC) discussed what appeared to be an emerging picture of under-provisioning by banks against future impairment losses. The FPC noted:

> While there was a degree of uncertainty surrounding estimates, bottom-up information from supervisory intelligence and banks' own public disclosures painted a consistent picture in this area. They suggested that expected losses on loans were in some cases greater than current provisions and regulatory capital held to meet UK banks' expected losses.[163]

The FPC said that concerns were especially apparent "for some UK commercial real estate (CRE) lending", adding:

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162 PR Week, *'The Co-operative Group: Capturing the ethical opportunity'*, 17 January 2012

163 Interim Financial Policy Committee, *'Record of the interim Financial Policy Committee Meeting, 21 November 2012'*, (4 December 2012), paragraph 12

> Given falls in prices, a substantial proportion of CRE loans in the UK were now at loan to value ratios at which it would be hard to refinance if current market conditions persisted.[164]

"Under-recognition of expected losses", the FPC concluded, "would imply that the banking book valuations of banks' assets were overstated".[165]

99. The FPC therefore recommended that the FSA take action "to ensure that the capital of UK banks and building societies reflects a proper valuation of their assets", and, where capital buffers were revealed as being in need of strengthening, "to ensure that firms either raise capital or take steps to restructure their business".[166] The following month, the FSA sent a letter to all UK banks "concerning the interpretation by banks of the provisioning standards".[167]

100. David Davies, still at that point Deputy Chairman of Co-op Bank, described the letter to the Committee:

> [We] received a letter from the regulator advising us that they thought that a number of institutions […] needed to be more prudent with regard to their corporate loan books, and inviting us to reconsider our impairments.[168]

While Co-op Bank had been set to record year-end impairment losses of £185 million for 2012, its response to the letter boosted the final reported figure to £474 million.[169]

101. The FSA's stress-testing and asset quality review work continued into 2013. Based on a range of factors, the regulator reached a judgement on the impairment losses in excess of existing provisions that could emerge over the three years from December 2012. It also considered costs that firms might incur over the same period as a result of LIBOR fines and conduct redress.[170]

102. In November 2012, the FSA had informed Barry Tootell, then Chief Executive, that the stress tests would lead to a "quite markedly larger capital requirement" for Co-op Bank.[171] In January 2013, the regulator gave Co-op Bank its first indication of that heightened level of capital.[172]

103. The final results of the PRA's capital exercise for major UK banks were announced in June 2013. The regulator—by this time the PRA, following the split of the FSA into separate prudential and conduct supervisors—took the results of its stress tests, and assessed the banks' resulting capital positions against the Basel III, 7 per cent Common

164 *Ibid.*

165 *Ibid.* paragraph 13

166 *Ibid.* paragraph 22

167 Q 1924

168 Q 1786

169 Q 1786; The Co-operative Bank plc, *'Financial Statements 2012'*, page 33

170 Financial Services Authority, *'Methodology note on calculating capital pressures'*, 27 March 2013

171 Q 1942

172 Q 622

Equity Tier 1 standard.[173] This followed a recommendation by the FPC at its meeting on 19 March 2013 that banks should attain such capital levels as a near-term objective by the end of 2013.[174] On this basis, the PRA announced that Co-op Bank had a capital shortfall of £1.5bn; in comparison, its core capital resources at the end of 2012 had been £1.7bn.[175] Andrew Bailey told the Committee that this £1.5 billion shortfall was different to the £900 million that he had told Co-op Bank it would need to raise in July 2011:

> [T]he £900 million and the £1.5 billion are different. The £1.5 billion is additive in that sense.[176]

Table 5 – Results of PRA capital exercise, June 2013

£ bn	**Barclays**	**Co-op**	**HSBC**	**Lloyds**	**Nationwide**	**RBS**	**Santander UK**	**Standard Chartered**
Core capital resources (end-2012)	40.7	1.7	77.6	28.0	4.3	37.2	8.5	20.0
Risk-weighted assets at end-2012	476.0	21.3	823.1	342.8	49.6	576.9	81.0	205.2
Regulator's adjustments to capital resources	-8.6	-1.5	-7.8	-12.1	-0.4	-7.1	-0.7	0.0
Regulator's adjustments to risk-weighted assets	+24.7	0.0	+45.0	+8.3	+10.6	+56.3	+5.6	+19.0
Additional capital raising required as a result of PRA capital exercise (beyond that already in banks' plans)	1.7	1.5	0.0	7.0	0.0	3.2	0.0	0.0

Source: Prudential Regulation Authority website

Why was Co-op affected so badly and so late?

104. Peter Marks did not appear to accept that primary responsibility for the capital shortfall resided with Co-op. He pointed to changes in regulation as the primary cause of Co-op's financial difficulties, telling the Committee:

173 Prudential Regulation Authority, *'News release – Prudential Regulation Authority (PRA) completes capital shortfall exercise with major UK banks and building societies'*, 20 June 2013

174 Interim Financial Policy Committee, *'Record of the interim Financial Policy Committee Meeting, 19 March 2013'*, (5 April 2013), paragraphs 19, 26-27

175 Prudential Regulation Authority, *'PRA capital recommendations including firm-specific shortfalls'*, 20 June 2013

176 Q 1939

> [N]ormally accounting rules say that you don't provide for something that has not gone bad until it has gone bad. We had a letter from the regulator saying that we had to ignore accounting rules and we had to use our judgment about what might go bad. […] There has been acceleration of provisioning. The other part of the £1.5 billion [was] the regulator saying that all banks needed to keep more capital. […] The Co-op was in a difficult position. It cannot raise equity capital. The bank board, myself included, believed that we had more time to build capital and that we would not be subject to what appears to be the acceleration of, first, the provisioning for risk in a loan book and secondly, building up but for capital. […] I do not in any way blame the regulator. What I am saying is that the goalposts have well and truly been shifted.[177]

105. The PRA provisioning guidance applied, however, to all UK major banks and building societies. Andrew Bailey told the Committee:

> [W]e sent this to all banks, and Co-op was the only bank that was seriously affected by this. The others may have made some adjustments at the margins, and I know they did, but that was not a big issue for them. Co-op was the one that was affected by this.[178]

As is clear from Table 5, Co-op Bank was also more seriously affected than other banks by the PRA's capital exercise as a whole.

106. Mr Bailey explained why Co-op Bank was so particularly affected by the regulator's actions:

> The issue was we felt that within the existing standards there were practices that were leaning towards underproviding, i.e. not looking at questions on a more forward-looking basis, such as refinancing risk.
>
> […] What this tended to reveal was an attitude towards impairment that was out of line not just with what we felt but with what other parts of the industry felt.[179]

He described Co-op as having taken a "looser" approach towards provisioning than other banks, which was "indeed looser than the standards we felt they should have taken".[180] This appears consistent with the picture painted in Sir Christopher Kelly's report, of a risk management approach with "deficiencies in all three lines of defence" which "had severe consequences for the Bank, and ultimately underpinned much of the capital problem".[181]

107. Mr Bailey told the Committee that particular problems were uncovered in the commercial loan book brought over from Britannia. Describing the PRA's work on these assets, he said:

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177 Q 415

178 Q 1924

179 *Ibid.*

180 Q 1938

181 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), paragraphs 6.6, 6.51

> What that has tended to reveal is that more of the book is difficult to refinance in the sense that when the loans come up to maturity, unless the commercial property can be refinanced, there is a problem with the loan. More of the loans are structurally subordinated in ways that do not seem to be appreciated.[182]

Expanding on his comments to the Committee that the Britannia assets had been a significant contributory factor to the weakness in Co-op Bank's capital position, Mr Bailey said in a letter to the Committee:

> [M]y concern was not just that the former Britannia assets had contributed a significant proportion of Co-op Bank's loan losses but that the nature of those assets meant that they were likely to lead to further impairment. The former Britannia assets were those on the bank's balance sheet that were most vulnerable to further stress. This was consistent with our assessment of the capital shortfall at Co-op Bank.[183]

108. The PRA’s capital exercise focused on expected losses over the coming three-year period. Of the impairments actually reported by Co-op Bank over 2012 and the first half of 2013, Mr Bailey said:

> It is our understanding, based on information provided to us by the bank, that over 75% of 2012 non-core loan loss impairments and around 85-90% of H1 2013 non-core loan loss impairments related to Britannia-originated assets.[184]

Given the figures provided in Mr Bailey’s letter, this implied that approximately £550 million—“well over half”—of the losses over 2012 and the first half of 2013 originated from Britannia assets.[185] By implication, this left roughly £420 million attributable to the pre-merger Co-op Bank. Asked more broadly where primary responsibility for the financial collapse of Co-op Bank lay, Mr Bailey said: “I think more of the responsibility for the embedded problems goes back to Britannia”.[186]

109. The former management of Britannia queried the culpability of the Britannia assets for Co-op’s financial troubles. They have raised four main points.

110. First, Neville Richardson, former Britannia Chief Executive, has said that impairments relating to Britannia assets account for only a minority of Co-op Bank’s total losses over 2012 and 2013, citing the figure of 27 per cent—though clearly this is still a very significant figure.[187] Evidence to this Committee from Andrew Bailey suggests that, of losses reported up to mid-2013, Britannia impairments accounted for around a third.[188]

182 Q 1922

183 Andrew Bailey (PV 06)

184 *Ibid.*

185 *Ibid.*

186 Q 1922

187 Neville Richardson (PV 39) page 2

188 Andrew Bailey (PV 06), Neville Richardson (PV 05)

111. Second, Mr Richardson has pointed out that "these are not yet actual losses, but provisions against potential losses".[189] Former members of the Britannia board agreed, telling the Committee that "it is essential to draw the distinction between [...] impaired lending, provisions and actual cash losses", adding:

> In the 18 month period ended June 2013, Co-op Bank made impairment charges in its accounts of £965 million, but by contrast incurred significantly smaller cash write offs of £148 million.[190]

112. The International Accounting Standards Committee describes the conditions that must be met for a loan to be impaired:

> A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated.[191]

In contrast, a cash write-off—rather than being an estimation of the effect on future cash flows from the asset—is made only when it is deemed finally that no more value will be recovered from the asset. Co-op Bank described its process for writing off assets in its 2013 Annual Report:

> A write off is made when all or part of a claim is deemed uncollectable or forgiven after all the possible collection procedures have been completed and the amount of loss has been determined.[192]

113. Mr Bailey agreed that the impairments may yet be reversed:

> If we see a sustained recovery of the economy and the commercial property market [...] it is possible, because this is a probability assessment, that the outcome will turn out to be better. I can't rule that out if there is a sustained recovery.[193]

Co-op Bank's Interim Financial Report 2014 revealed that £86.7 million of Co-op Bank's allowances for losses on loans and advances had in fact been recovered over the first half of 2014. They also showed, however, that £104.6 million of allowances previously made for losses had been written off entirely over the period.[194]

114. Third, the former Britannia management have queried why the Britannia assets are being impaired so heavily so long after origination. Mr Richardson told the Committee:

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189 Neville Richardson (PV 04)

190 Former board members of Britannia Building Society (PV 27) page 2

191 International Accounting Standards Committee, IAS 39.59

192 The Co-operative Bank plc, *'Annual report and accounts 2013'*, page 142

193 Q 1926

194 The Co-operative Bank plc, *'Interim Financial Report 2014'*, pages 77, 79

> Commercial property loans represented only 5% of the Britannia balance sheet and were originated between 6–10 years ago. Commentary suggesting that these loans were all 'toxic' at the time of origination and yet have been subject to 6–10 statutory audits and approval by boards, and extensive due diligence, lacks credibility.[195]

Rodney Baker-Bates similarly commented that "[l]oan books generally do not function that way. If you make a poor loan […] it is fairly obvious in the first two or three years".[196]

115. Mr Richardson, like Mr Marks, appeared to place more of the blame for Britannia's heightened impairments on the actions of the regulator, telling the Committee that "of those [losses] that are attributed to Britannia, much has come about […], very importantly, because of regulatory change in the way that provisions are being required".[197]

116. Mr Richardson also suggested that Britannia-related losses had come about because of "the way in which the businesses have been run".[198] The former Britannia board agreed, telling the Committee that it was "difficult not to conclude" that the "management stretch" at Co-op from mid-2011 was "a contributing factor" to the performance of the loan book.[199] The Kelly Report acknowledged that Co-op Bank's management had been over-burdened following the commencement of the Verde process:

> Management stretch was a particularly acute issue for the Bank from 2011 onwards when it started the negotiations with Lloyds Banking Group and began Project Unity. The protracted negotiations over Verde were a major distraction for senior executives of the Bank. Without the distraction caused by Verde the emerging capital issue might have been better recognised and more effectively addressed at an earlier stage.[200]

Sir Christopher does not, however, consider that this was a significant contributor to the capital shortfall, noting:

> Had management not been so distracted, they might have taken a different approach to the capital issues faced by the Bank. But the direct effect of Verde and Unity on the emerging capital shortfall was limited. The commercial real estate problems, the weak risk management framework, PPI mis-selling and the difficulties with the replatforming project were the most significant causes of the shortfall.[201]

117. This third contention of the former management of Britannia points to a broader question, of why Co-op's losses—including those on the Britannia book—have emerged so late in the banking cycle compared to those of other banks (see Table 1). Andrew Bailey pointed to two reasons:

195 Neville Richardson (PV 04)

196 Q 1778

197 Q 184

198 *Ibid.*

199 Former board members of Britannia Building Society (PV 27) page 4

200 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), paragraph 2.32

201 *Ibid.* paragraph 2.33

> Why did it come out later? There are two things I would say there. First of all, it does reveal a different approach by Co-op management to the treatment of provisions and impairments than had been the case in other institutions. Secondly—and I will be quite honest with you, we have to hold our hand up on this, and I have said this to other people—if we had had the system and engineering that we are currently designing to implement concurrent annual stress testing across the major UK banks earlier we would have arrived at the £1.5 billion earlier, but we didn't have that.[202]

Mr Bailey added: "We have been on a path to deliver better regulation, as you know, and a big part of that has been to improve the capacity and the technology to conduct things like stress tests […] That is what we have done since the middle of 2011 and, although you may say, 'Here we are in early 2014', it has been a very substantial investment on our part."[203]

118. Mr Bailey told us that he had in fact held suspicions about vulnerabilities arising from the Britannia book prior to the asset quality review and stress testing on Co-op. He said that, in mid-2011, he "had a view—and the supervisors had sympathy with the view—that there was an inherited problem in Britannia";[204] he expressed this view to Co-op's management at a meeting in July 2011, telling Peter Marks, Paul Flowers and Barry Tootell that, in his opinion, "Britannia would have failed had it not been for the Co-op".[205] Mr Bailey told the Committee why he was of this opinion:

> Britannia was one of the building societies in 2008-09 that was in trouble. There was a group of them. Bear in mind that this merger [with Co-op] happened over a year between summer 2008 and summer 2009, the most febrile period in the whole of the financial crisis […].
>
> [T]he Co-op merger took Britannia out of the spotlight, but it did not solve the problem because obviously it did not deal with the underlying problem.[206]

Providing more detail on the particular "trouble" at Britannia, Mr Bailey told us:

> Going back to 2008–09, Britannia was one of a small group of building societies that stood out when the work was done by the tripartite authorities looking across the board. The others that stood out have also had to have some form of either resolution or remedial measures taken on them. Why did that come about? I think this is very important in the context of thinking about mutuals. The common feature of those societies was that they had expanded their lending activities into outside the traditional prime mortgage market that building societies occupied. Why had they done that? I think the reason they had done that—and this is a theme that runs through a number of the failures—is that, during the period of five to seven years prior to 2007, lending margins in the mortgage market had been squeezed very heavily. […] The problem was that they did not have the risk management skills to

202 Q 1939

203 Qq 1953, 1960

204 Q 1925

205 Andrew Bailey (PV 16) page 13

206 Q 1922

> manage those sorts of loan books and, as mutuals, they do not have the same flexibility to raise capital to manage those sorts of lumpier risks.[207]

Mr Bailey's view that Britannia would have failed without a merger also related to its ability to fund itself. Mr Bailey told the Committee:

> [T]he point is that […] in the febrile funding conditions of 2008–09, it was precisely these institutions that were perceived to have these weaknesses in their balance sheets that put themselves in a situation where they could not fund themselves.[208]

Mr Bailey noted that he was "not a supervisor in those days", however, and that while he suspected that there were problems with the Britannia book, the regulator "had not done the detailed asset quality review work […] that has been done subsequently or indeed the stress test" to verify these suspicions.[209]

119. The regulator's late development of stress-testing tools did not, however, in Mr Bailey's view, exculpate individual banks from failing properly to manage their impairments. Asked whether it was reasonable for the board of Co-op to suggest that they had no real awareness of the extent of the capital problem before informed of it by the regulator, Mr Bailey replied:

> The problem with that is that if you strip that comment down they are essentially outsourcing risk management to the regulators. […] What they are saying is, "You can't really expect us to have spotted the problem until you come along and tell us there is a problem". I reject that as a proposition.[210]

120. Some witnesses have queried the extent to which Co-op took a "different approach" to its impairments. Mr Richardson pointed out that the Britannia assets had been subject to a number of annual external audits since they formed part of Co-op Bank's accounts.[211] For over thirty years, Co-op Bank's external auditor had been KPMG.[212] Andrew Walker, KPMG's lead audit partner for Co-op Bank, told the Committee:

> I certainly don't share the view that Co-op was behind others on its impairment. [...] You will appreciate that I don't have access to every other bank's records. I only have access to their public information. For those where I have been able to obtain that information and that I feel are good comparators to Co-op Bank in terms of the loans and advances books, then I have made that comparison of impairment charges and impairment provisions going back to 2009 and I have not found that Co-op Bank was an outlier in any regard.[213]

207 Q 1927

208 Q 1996

209 Qq 1922, 1925

210 Q 1943

211 Neville Richardson (PV 04)

212 Q 1151

213 Qq 1187, 1195

121. Mr Bailey's assertions touch on the fourth contention of the former management of Britannia—that Britannia would have survived as a standalone firm. Former members of the Britannia board said in a letter to the Committee:

> As a stand-alone entity, should conditions have worsened, there were a number of significant measures available to the Board which it could have taken, including sale of assets or business units, cost reduction or buy back of liabilities at prevailing market values. Britannia's loans were managed effectively prior to the merger and this would have continued had Britannia remained independent.[214]

The former Britannia board also rejected Mr Bailey's account of problems at Britannia in 2008/09, saying:

> We are not aware of any evidence of conversations or correspondence with Regulators or others at the time of the lengthy merger discussions with Co-op which indicated that Britannia was anything other than a going concern. It was trading effectively with customers, suppliers and the markets in what were extreme financial conditions. […]
>
> In January 2014 Clive Adamson said very clearly that Britannia was a going concern: "It wasn't in our view a rescue". In February 2014, one month later, Andrew Bailey told your Committee that Britannia was in trouble and would have failed. These are diametrically opposed views from two senior regulators. However Clive Adamson was the Regulator responsible for the supervision of Britannia at the time of the merger, for carrying out stress testing, and had the detailed knowledge of the firm.[215]

122. Clive Adamson told the Committee that he did not believe that the FSA's analysis of the Britannia merger, performed in 2009, was flawed:

> [O]ur stress test approach and our capital framework approach […] did suggest that under stress—and it is not a forecast it was under stress—the core tier 1 capital position could fall to 4.3 per cent […]
>
> [J]ust to indicate, the outcome for the Co-op by June 2013, the latest set of results, shows that its core tier 1 capital position fell to 4.5 per cent. In other words the stresses did materialise.
>
> [A]t the time in 2009, our capital framework, which was agreed with the tripartite, was if a firm could meet that 4% core tier 1 stress, which was considerably above the legal minimum at the time, then it would be okay to do a merger.[216]

Disclosures from June 2013 show Co-op Bank's core tier 1 capital falling to 4.9 per cent, and its common equity tier 1 ratio falling to 3.2 per cent. The PRA's capital exercise, however—the exercise which revealed Co-op Bank's £1.5 billion capital shortfall—looked

214 Former board members of Britannia Building Society (PV 27) page 1

215 *Ibid.* pages 1, 3

216 Qq 1364-65

three years ahead, and so accounted not only for losses experienced up to June 2013, but also for losses expected in the future.[217]

123. Expanding further on the capital framework in place at the time, Mr Adamson said:

> That capital framework was called the H64 framework whereby a firm had to maintain a tier 1 capital position of 8%, a stress tier 1 capital position of 6% and stressed core tier 1 capital position of 4%.[218]

Britannia's Tier 1 capital resources stood at £1,158 million at the end of 2008—a Tier 1 ratio of 10.0 per cent. Other things being equal, £550 million of impairment losses would have brought this figure down to £608 million—a 5.3 per cent Tier 1 ratio, which would have been below the FSA's stressed minimum requirement of 6 per cent.

124. **A very significant factor in Co-op Bank's financial collapse was the emergence of substantial impairments on loans over 2012 and 2013, primarily in its commercial real estate book. The majority of these loan impairments—around £550 million—relate to assets acquired through the Britannia merger. Impairments of well over £400 million have also arisen on assets originated by Co-op Bank itself.**

125. **Attempts have been made to paint Co-op Bank's impairment losses as the result of a shift in the regulatory goalposts. The Committee does not agree. The PRA's capital exercise applied to a number of banks, and only Co-op Bank was so badly affected. Co-op Bank's impairment losses were primarily the result of its own, and Britannia's own, poor-quality lending. The late emergence of these losses appears to have been due to Co-op Bank's comparatively "loose" approach to recording impairments, which was uncovered only once the FSA began its capital exercise in late 2012.**

126. **Co-op Bank's approach to recording its impairments in the years running up to 2013 was described by Andrew Bailey as "looser" than the rest of the industry. This should have been clear to Co-op Bank's management—to all those responsible for risk and accounting, including the board, relevant executives and committees. It should also have been apparent to Co-op Bank's auditor—KPMG—and to the regulator—for the period in question, the FSA.**

127. **The Committee is surprised that, in spite of the evidence it has heard, Co-op Bank's former auditors, KPMG, maintain that Co-op Bank was not an outlier in terms of its impairments. The FRC's inquiry into the approval and audit of Co-op Bank's financial statements should determine precisely how Co-op Bank's approach to recording impairments differed to that of other banks, and why KPMG apparently failed to uncover this. The independent inquiry into events at Co-op Bank should also look closely at the shortcomings of the bank's auditor, KPMG, and its apparent failure to ascertain the extent of the impairments. In so doing, the inquiry should look to see if any shortcomings are unique to the KPMG relationship with Co-op.**

217 Making the regulatory adjustment to Co-op Bank's core capital resources in Table 5 while keeping risk-weighted assets constant implies a forward-looking common equity tier 1 ratio of 0.9%.

218 Q 1364

128. **The PRA—the FSA's successor body as prudential regulator—admits that, with better supervisory tools, Co-op Bank's problems would have been uncovered by the FSA sooner. It was the development of these tools—as part of the transition to the new approach to regulation in which the FSA and now the PRA have been engaged—that led to Co-op Bank's impairment losses being revealed. The independent inquiry into the events at Co-op Bank should consider whether the FSA could or should have developed better supervisory tools earlier, and hence uncovered Co-op Bank's impairments sooner. The inquiry should also consider whether Co-op Bank's impairment profile—which appears to have differed from that of other banks throughout the financial crisis—should have led the regulator to inspect it more closely prior to 2012.**

129. **Notwithstanding any shortcomings in the respective oversight roles played by the auditor and the regulator that may be uncovered by the other inquiries, banks—in this case the Co-op Bank—bear primary responsibility for their own prudent management.**

130. **The losses emanating from Britannia stemmed predominantly from its commercial loan book. The due diligence performed on this book has proved to have been totally inadequate. KPMG's initial due diligence was based on incomplete information. Further due diligence, which KPMG recommended be performed, was carried out by Co-op Bank itself. Co-op Bank's work has been described by Sir Christopher Kelly as "cursory" and "limited". The provisions against future losses, made on the basis of the due diligence, were far too low.**

131. **The Committee is surprised that the additional due diligence—a crucial piece of work—was allowed to be performed to such a low standard. KPMG should have given clear guidance to Co-op Bank about the standard required. The Committee is also surprised that, despite recommending the additional due diligence, KPMG did not scrutinise it once complete. If KPMG considered it outside its remit to examine Co-op Bank's own due diligence, it could still have given particular attention to the inherited Britannia assets in future annual audits; the FRC investigation should examine whether or not KPMG did so.**

132. **Given the evidence it has heard, the Committee is very surprised by JPMC's statement to the Co-op Bank board at the time of the merger that the Britannia due diligence "exceeded that normally undertaken for listed companies". This is not reassuring about the typical quality of professional advisory work, particularly given the substantial sums often involved—KPMG and JPMC received £1.3 million and £7 million—and the important advice and guidance they provided on the Britannia transaction. The Committee expects the independent inquiry into the events at Co-op Bank to examine whether the work provided by KPMG and JPMC met a reasonable standard, in substance as well as form.**

133. **The FSA performed its own analysis of the Britannia acquisition at the time of the merger in 2009. This projected that, under stressed conditions, the combined entity's Core Tier 1 capital ratio could fall to 4.3 percent, marginally above the regulatory minimum of 4 per cent in place at the time. Co-op Bank's losses up to June 2013 reduced its capital ratio to 4.9 per cent—roughly the level the FSA had projected. But the capital shortfall revealed by the PRA reflected not just actual losses, but also the**

vulnerability of the Britannia assets to future impairment. It is not clear that the FSA's analysis on the merger took this additional risk into account. The independent inquiry into the events at Co-op Bank should examine why the FSA apparently failed to account for the prudential risks of the Britannia merger that have since materialised.

134. **Co-op Bank sought the merger with Britannia in part because of the latter's large network of branches. But—as was clear from the work of the external advisors at the time—the merger also brought an immediate dilution of Co-op members' interests in terms of net assets, profits and dividends, as well as an exposure to higher-risk lending and an increased reliance on wholesale funding. Even without the benefit of hindsight, therefore, it is clear that the merger with Britannia exposed Co-op Bank to considerable new risks yet carried comparatively modest benefits. The commercial judgement behind the decision to proceed with the transaction, made by Co-op Bank on the basis of advice from JP Morgan Cazenove, appears questionable.**

135. **Andrew Bailey has said that Britannia would have failed had it not merged with Co-op Bank in 2009. The former management of Britannia rejects this, saying that the merger was not a rescue. There is no way to know for certain what would have transpired without the merger, but the evidence appears to support Mr Bailey's view. In particular, the impairments of £550 million now evident from Britannia would probably have been large enough to bring it down as a standalone firm, given the size of its Tier 1 capital base at merger and the capital requirements in place even in 2008. In addition, without the prospect of the merger, Britannia might well have found it difficult to fund itself had the problems with its balance sheet been perceived.**

136. **Co-op Bank's impairments are as yet only provisions, and not cash write-offs. The distressed loans might yet perform better than expected. But impairments can only be made when there is evidence of a permanent loss of value—a loss which is expected to be made unless conditions improve. The possibility of better performance in no way detracts from the seriousness of the impairments and their effect on the balance sheet. Statements by the former management of Britannia, drawing a distinction between impaired lending and cash write-offs, suggest that they continue to deny the seriousness of the impairments. They should instead accept responsibility for originating the distressed assets.**

Conduct redress

137. Over 2012 and 2013, Co-op Bank set aside provisions of £562m to cover potential conduct redress claims. This comprised £253m in provisions for PPI, £114m for other mortgage products, £110m for interest refunds relating to the Consumer Credit Act, £33m for interest rate swaps and £26m for third party insurance products.[219]

138. As described earlier, the PRA's stress testing exercise considered banks' potential future losses from conduct redress claims, as well as loan impairments. Some of the losses reported over 2013 were therefore included in the £1.5 billion shortfall figure. When Co-op

219 The Co-operative Bank plc, *'Financial Statements 2012'*, page 6; The Co-operative Bank plc, *'Annual report and accounts 2013'*, page 18

Bank announced in October 2013 that it was increasing its total conduct cost provisions by £100-105 million, it also announced:

> The Prudential Regulation Authority (PRA) has confirmed to the bank that the previously announced additional Common Equity Tier 1 requirement of £1.5 billion by the end of 2014 remains unchanged. The impact of this additional provision on the Bank's forecast capital requirements is materially less than the income statement charge, as an element of likely future conduct risk provisions was already included in the Bank's capital planning.[220]

139. However, press reports in March 2014 revealed that Co-op Bank had uncovered £400 million of additional conduct costs, which would require an additional capital injection above the £1.5 billion previously mandated by the PRA. Reports also suggested that this figure was determined just weeks before the publication of the bank's 2013 annual report, since this was the first opportunity the bank's new management had had to review the treatment of its customers.[221] Andrew Bailey had previously told Co-op Bank in 2011 that its handling of PPI complaints was poor—something he noted was particularly poor for a bank that "purported to take a more ethical approach".[222]

140. On PPI provisions in particular, Sir Christopher Kelly concluded:

> As far as it has been possible to ascertain, the scale of the provisions for PPI mis-selling made by the Bank relative to its customer base has so far been less than those made by some of the major high street banks, but much greater than provisions typically made by building societies. The final totals are not yet known. Claims are still being made and evaluated.[223]

141. **Co-op Bank's consumer redress losses are large and damaging for an institution of its size. Combined with its other losses, they pushed Co-op Bank to the brink. Co-op Bank is not alone in having to set aside large sums to pay for past misconduct. However, such misconduct is particularly unacceptable in a bank that trades on its ethical character.**

Banking IT platform replacement

142. Another key contribution to Co-op Bank's financial difficulties was the £298m write-down in the value of its investment in a new banking IT platform.[224]

143. The Kelly report looks in detail at the failed replacement of Co-op's banking platform. Prior to the Britannia merger, Co-op Bank had embarked on a wholesale replacement of its core banking IT platform, originally built in the 1970s. This was, in Sir Christopher's

220 The Co-operative Bank plc, *'Update on provisions for conduct risk'*, October 2013

221 BBC Newsonline, *'Co-op Bank seeks extra capital'*, 24 March 2014

222 Andrew Bailey (PV 16) page 8

223 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), paragraph 5.6

224 The Co-operative Bank plc, *'Financial Statements 2012'*, page 6

words, an "ambitious" undertaking—something which no UK full-service bank had successfully achieved.[225]

144. Following the Britannia merger, the scope of the programme was increased to include Britannia systems. In the process, Sir Christopher concludes that the risk of the programme was also increased:

> Received wisdom in bank mergers is that the safest approach is to migrate one business onto the platform of the other. It is a brave organisation which attempts to migrate both merging entities onto a brand new platform.
>
> That is, however, exactly what the management and Board of the merged organisation intended to do.[226]

145. The Kelly Report describes a "litany of deficiencies" in the way the programme was implemented following the Britannia merger: it enjoyed neither stable executive sponsorship nor consistent day-to-day leadership; the bank lacked the capability necessary to implement such a complex and high-risk programme; communication and co-ordination between different parts of the business involved in the reprogramming was weak; the bank did too little to limit complexity; the scheduling and sequencing of releases changed frequently; and there was a disregard for the importance of detailed work scheduling.[227] In addition, the expected costs of the programme escalated consistently, rising from £184 million in 2008 to £460 million in 2010.[228]

146. After Co-op Bank won the Verde branches, it began to plan for the migration of Verde customers onto the new platform. But, as described earlier, due diligence in early 2012 identified significant costing errors: the programme as a whole would cost £1.8 billion, rather than £0.8 billion as originally thought.[229]

147. As described earlier, following the discovery of these costing errors, Co-op Bank changed its plans and aimed instead to move its customers onto the Verde IT system. In consequence, Co-op Bank's IT programme—on which £349 million had already been invested—was put on hold. The programme was paused in a way that would allow it to be restarted should Verde fall through, although Sir Christopher notes that "[i]n practice, restarting IT programmes of this kind, once paused for any significant time, can be very difficult because teams and knowledge disperse".[230]

148. In the event, the value of Co-op Bank's investment in the banking IT platform programme was written down by £150 million in the 2012 Financial Statements, which reported that "the impact of the continuing and prolonged economic downturn on the future value stream from the new banking platform now indicates that the carrying value

225 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), paragraph 7.11

226 *Ibid.* paragraphs 7.25-7.26

227 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), paragraphs 7.28-7.42

228 *Ibid.* paragraph 7.39

229 *Ibid.* paragraph 9.19

230 *Ibid.*, paragraph 7.55

should be reduced”.[231] Sir Christopher observes that this write-down, of less than half the full investment in the programme, implied that the programme was still thought to carry some value.[232] Following the collapse of the Verde deal in April 2013, however, Co-op Bank decided to cancel the programme entirely.[233] A further write-down of £148 million was recorded in the bank’s 2013 interim report. The bank’s 2013 annual report explained that the IT programme was “inconsistent with the Bank’s simplified strategy going forward”, and that the bank’s revised IT strategy would be “focused on incremental improvements in the existing platform rather than wholesale replacement”.[234]

149. Some who gave evidence to the Kelly Report claimed that the IT programme could have been concluded successfully had it not been put on hold due to Verde. Sir Christopher concludes that this is a “misconception”:

> Even in the early stages of the Verde negotiations, the new IT management were already considering whether to cancel the programme. The weight of evidence supports a conclusion that the programme was not set up to succeed. It was beset by destabilising changes to leadership, a lack of appropriate capability, poor co-ordination, overcomplexity, underdeveloped plans in continual flux, and poor budgeting. It is not easy to believe that the programme was in a position to deliver successfully, with or without the impact of the Verde negotiations.[235]

150. Evidence to this Committee supports a view of a firm incapable of transforming its IT successfully. Peter Marks confirmed that the integration of Co-op and Britannia systems “had not been fully completed” by 2011.[236] Verde compounded the difficulty of this task, and David Davies was sceptical that Co-op’s management “which had not been successful in the integration of the Britannia branches on to the Co-op systems, could do something of this nature”.[237] Andrew Bailey, meanwhile, expressed his surprise at the scale of the losses, which he said were “hugely larger than anybody could have expected”:

> How this came about is one of the stories that needs to be revealed by the investigations because, I will be honest with you on that, I still do not understand how it is possible to have ended up in [that] situation.[238]

151. The extent of the write-off was due to the circumstances of the programme. But Sir Christopher notes that the timing of the programme’s effect on Co-op Bank’s capital position was influenced by the accounting treatment that Co-op Bank adopted for it in October 2010. Co-op Bank chose to finance the programme through a separate service company—Co-operative Financial Services Management Services—which was owned by

231 The Co-operative Bank plc, *‘Financial Statements 2012’*, page 6

232 Sir Christopher Kelly, *‘Failings in management and governance’*, (30 April 2014), paragraph 11.29

233 Sir Christopher Kelly, *‘Failings in management and governance’*, (30 April 2014), paragraph 7.55

234 The Co-operative Bank plc, *‘Annual report and accounts 2013’*, page 18; The Kelly Report notes that the total impairment charge is less than the full cost of the programme up to the point of cancellation because one part of the programme was successfully delivered.

235 Sir Christopher Kelly, *‘Failings in management and governance’*, (30 April 2014), paragraph 7.59

236 Q 340

237 Q 1866

238 Q 1923

the Co-operative Banking Group. In doing so, Co-op Bank ensured that programme costs would have no effect on its capital resources during development, and would only be deducted from regulatory capital gradually once the system was operational. Had the bank funded the programme itself, costs would have been deducted against capital as the programme was developed. The consequence of this accounting treatment was that Co-op Bank recorded no capital deductions from the programme over the first years of development, and then had its capital reduced by almost the full amount of the investment over a period of just six months when the programme was cancelled.[239]

152. Sir Christopher notes that there is some uncertainty over whether the accounting treatment adopted for the programme was ever pointed out to the regulator:

> Some of the former management team believe that the change was pointed out to the Regulator at the time. The auditor was informed by the Bank that the Regulator had agreed. Neither the PRA nor the current Bank management team have found any correspondence to support that contention.[240]

153. **Co-op Bank's banking IT system had been in need of replacement for many years. The prospective acquisition of Verde only made this need more acute. But the bank, through a combination of over-ambition and poor management, failed to deliver a replacement. Following over five years of delays and cost increases, the programme was cancelled, leaving the bank with its original platform still in place and a £300 million deduction from its capital.**

154. **There are signs that difficulties with the programme were accentuated by the Britannia merger and the Verde deal. But the evidence suggests that these deals did not cause the problem: the root cause was a management team incapable both of delivering the necessary IT transformation and of realising its own limitations.**

155. **While it had no effect on the extent of the write-off, the accounting treatment that Co-op Bank adopted for the IT programme had a significant influence on the timing of the impact on the bank's capital position. One method of accounting—funding the programme directly through the bank—would have ensured that the costs of the programme were deducted from Co-op Bank's capital position as they were incurred. The method adopted—financing the programme through a service company owned by the bank—meant that the full cost was recorded over a six month period as the programme was paused and then cancelled. The FRC should consider as part of its investigation whether this accounting treatment was appropriate. The independent inquiry into the events at Co-op Bank should establish whether this accounting treatment was brought to the attention of the FSA, and whether the FSA should have foreseen and acted on its consequences.**

239 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), paragraphs 11.22-11.33

240 *Ibid.* paragraph 11.28

Direct effect of the Verde transaction of Co-op Bank's financial position

156. The Kelly Report considers the direct effect of the Verde transaction on Co-op Bank's capital shortfall. It concludes:

> The direct impact of capital was relatively small. The transaction costs amounted to a total of £73 million in 2012 and 2013—not a trivial amount, but small in relation to the eventual shortfall.[241]

The indirect impact of Verde was "far more significant", Sir Christopher says, noting that the negotiations were a significant distraction from business as usual:

> The general impression was that on this occasion, as at other times, a limited number of capable people in the Bank were assigned to fix all the most pressing problems. These individuals then became severely stretched. Other people were put into roles in which they lacked either the capabilities or experience to perform effectively.[242]

However, Sir Christopher concludes:

> Most of the root causes of the bank's capital problems were in place before the transaction was contemplated. The likelihood is that the bank would still have a significant capital shortfall had the Verde transaction never been attempted. […]
>
> But it must be possible that, had Verde not happened, the Bank would have had a more effective senior management in place before June 2013. Without the distraction caused by Verde, the emerging capital issue might have been better recognised and more effectively addressed at an earlier stage.[243]

Reported losses versus the capital shortfall, and other factors in Co-op Bank's financial collapse

157. Co-op Bank's financial collapse is described not just by its losses reported to date, but by the resulting shortfall against regulatory capital requirements that increased at the same time that Co-op's losses emerged. As Sir Christopher Kelly reported:

> Between 2009, immediately after the Co-operative Bank's merger with Britannia, and January 2013 the Regulator increased the bank's total capital requirement from £1.9 billion to £3.4 billion. Most of the increase came towards the end of the period. The timing was particularly damaging. It coincided with a reduction in the bank's capital resources caused by the recognition of significant impairments on its commercial real estate lending and against its failed IT replatforming project, as well as significant provisions required to remedy the mis-selling of PPI. It was the

241 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), paragraph 9.38

242 *Ibid.* paragraph 9.40

243 *Ibid.* paragraphs 9.36, 9.41

> interaction between an increased requirement and a reduction in the capital available to meet it that led to the bank's capital shortfall.[244]

158. One measure of the capital shortfall has already been described—the PRA determined in June 2013 that Co-op Bank was £1.5 billion short of the 7 per cent Common Equity Tier 1 ratio set out in Basel III, once expected future losses over the a three year period had been taken into account.

159. Sir Christopher's comments about increasing capital requirements refer to a different, but related measure—a £1.9 billion shortfall against the total capital guidance issued by the PRA to Co-op Bank. This total guidance comprised 'Individual Capital Guidance'—a minimum level of capital which Co-op Bank needed to maintain at all times—and a 'Capital Planning Buffer'—a buffer on top of this minimum requirement to help to ensure that Co-op Bank maintained this minimum level even in times of stress.

160. Sir Christopher notes that a "significant proportion" of Co-op Bank's £1.9 billion shortfall against this guidance was due to the size of its Capital Planning Buffer, which the PRA increased in January 2013.[245] This increase reflected, among other issues:

> [F]uture losses which could be incurred in a stress scenario, particularly in the non-prime lending book inherited from Britannia and in corporate lending (much of which was also inherited from Britannia).[246]

Indeed, Andrew Bailey said in a letter to the Committee in September 2013:

> I [previously] noted concerns that the Britannia assets had been a significant contributory factor to the weakness in Co-op Bank's current capital position. […]
>
> [M]y concern was not just that the former Britannia assets had contributed a significant proportion of Co-op Bank's loan losses but that the nature of those assets meant that they were likely to lead to further impairment. The former Britannia assets were those on the bank's balance sheet that were most vulnerable to further stress. This was consistent with our assessment of the capital shortfall at Co-op Bank.
>
> […]
>
> Notwithstanding the level of losses incurred to date, the risk profile of the remaining Britannia assets were, and remain, a key factor in our assessment of Co-op Bank's current capital position.[247]

161. Sir Christopher explains that the PRA also increased Co-op Bank's Individual Capital Guidance, albeit by a much smaller amount, in January 2013.[248] This reflected a number of

244 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), paragraph 2.9

245 *Ibid.* page 103, footnote 157

246 *Ibid.* paragraph 12.29 ii

247 Andrew Bailey (PV 06)

248 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), paragraphs 12.26-12.27

factors, including Co-op Bank's "significant exposure" to concentration risk, particularly in its corporate lending book, and its "inadequate" operational risk framework.[249]

162. While part of Co-op Bank's capital shortfall therefore reflected increased regulatory requirements rather than reported losses, this did not mean, Sir Christopher said, that Co-op Bank's near-collapse was the result of a shift in the regulatory goal-posts:

> The Co-operative Bank was not singled out by the regulator. All banks faced increased requirements. But the increase for [Co-op Bank] was particularly large. That reflected the bank's and the regulator's concerns about the risk profile of the bank, its poor risk management framework, its weak financial performance, its over-extended management and a number of other issues specific to the bank. The regulator had been making warning noises about most of these issues for some time. Had the bank listened more carefully, and responded earlier or more vigorously, the increase in its capital requirement might have been less dramatic.[250]

The collapse of the Verde deal

163. Co-op Bank was first made aware by the regulator that it had a significant capital problem in late 2012 and initial figures were put around this in January 2013.[251] Sir Christopher Kelly notes that the large increase in Co-op Bank's capital requirements in January 2013:

> might have been expected to have put an immediate stop to the [Verde] deal. Surprisingly, it did not.[252]

164. Following the heightened regulatory requirements in 2013, 'Project Pennine' was initiated. Barry Tootell described this project to the Committee:

> There were three primary remediation points. One was deleveraging the corporate asset by taking risk-weighted assets off the balance sheet; secondly, it was selling the general insurance business; and thirdly, it was completing the life and savings sale. The L&S—life and savings—and general insurance sales would have allowed our parent company, which is Co-op Banking Group, to inject capital into the bank.[253]

165. However, Barry Tootell told the Committee that, over February and March, he came to the conclusion that "we were not going to put sufficient remediating actions in place to address the future capital requirements", and on that basis he concluded that Co-op Bank should not pursue the Verde transaction:[254]

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249 *Ibid.*

250 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), paragraph 2.10

251 *Ibid.* paragraphs 12.22-12.23

252 *Ibid.* paragraph 9.31

253 Q 584

254 Q 626

> [In] April 2013 […] I recommended to my board and to Peter Marks as group chief executive, that we should not pursue the transaction because of the lack of capital strength to do so.[255]

Co-op formally withdrew from the deal on 24 April 2013, citing "the impact of the current economic environment, the worsened outlook for economic growth and the increasing regulatory requirements on the financial services sector in general", which meant that it was "not in the best interests of the Group's members to proceed further".[256]

Conclusions

166. **A combination of financial losses and increased regulatory capital requirements together led Co-op Bank to develop a significant capital shortfall. Co-op Bank's loan impairment losses, IT write-offs and conduct redress costs caused a serious depletion of its capital resources. While regulatory adjustments applied to all banks, the increased capital requirements on Co-op Bank were particularly large. This reflected weaknesses particular to Co-op Bank—the vulnerability of its Britannia loanbook to future impairment, high concentration risk in its corporate lending and a poor operational risk framework.**

167. **The collapse in Co-op Bank's financial position prompted its withdrawal from the Verde transaction. Explaining its withdrawal from the process in April 2013, Co-op Bank spoke obliquely of "the impact of the current economic environment, the worsened outlook for economic growth and the increasing regulatory requirements on the financial services sector in general". However, Co-op Bank's former Chief Executive, Barry Tootell, gave a franker admission: he told the Committee clearly that he recommended to Co-op Bank's board, and to group Chief Executive Peter Marks, that Co-op should not pursue the transaction because it lacked the capital strength to do so.**

168. **There is reason to think that the frailty of Co-op Bank's capital position could have been discovered sooner—specifically, if the bank had monitored its loan book and its treatment of customers more effectively, and if it had accounted for its banking IT programme in a different way. Had Co-op Bank's resulting capital shortfall been uncovered earlier, it is likely that the bank would not have progressed so far with Verde. As it was, the rapid and late emergence of the capital problem led to Co-op's withdrawal from the Verde process at a relatively late stage. The Committee recommends in paragraphs 127, 128 and 155 that the FRC investigation and the independent inquiry into the events at Co-op Bank consider the role of KPMG and the FSA in relation to the late emergence of loan impairment and IT losses. On the basis of these findings, the independent inquiry into the events at Co-op Bank should also form a view on whether Co-op's Verde bid could or should have been halted sooner.**

169. **Once Co-op Bank's capital shortfall became clear in January 2013, the bank might have been expected to withdraw immediately from the Verde deal. The Committee**

255 Q 492

256 The Co-operative Group, 'The Co-operative Group Announcement re: Lloyds Bank Branch Assets', 24 April 2013

shares Sir Christopher Kelly's surprise that it did not—instead, Co-op persevered with the deal until late April. It may be that Co-op Bank had confidence that 'Project Pennine'—a plan to bolster Co-op Bank's capital position through disposal of assets—would put it back on a secure financial footing; if so, this confidence proved to be misplaced.

170. **The board and management of Britannia are responsible for having originated the majority of Co-op Bank's distressed assets, as well as assets against which Co-op Bank has been forced to hold substantial protective capital. Co-op Bank itself is responsible in a number of other respects, including its inadequate due diligence on the Britannia merger. Co-op Bank originated loans which have suffered impairment. Legacy conduct issues relate predominantly to past actions by Co-op Bank. Responsibility for the mismanagement of Co-op's banking IT platform upgrade, while complicated by the Britannia merger, lies squarely with Co-op Bank. The former board and management of Co-op Bank and Britannia bear primary responsibility for the bank's resulting financial crisis.**

5 Governance

171. Governance underlies everything a firm does. It is the fundamental mechanism through which decisions are made and a firm is overseen. Co-op operated a unique governance model. This section examines that model further, and considers what responsibility it bears for Co-op's failed Verde venture and the bank's financial collapse.

Links between the bank and the group

172. As has been described, there were considerable links between the governance of Co-op Group and Co-op Bank. At the end of 2008, when Co-op was deliberating on the Britannia merger, seven of the thirteen non-executive members of the bank board—including the Chairman—were sourced from the elected members of the group board.[257] By 2011, when Co-op was first considering a bid for Verde, this figure had fallen to four out of twelve, though two group executives also sat on the board.[258] The remaining group representation was senior, including the group Chairman, Len Wardle, the group Chief Executive, Peter Marks, and the group Deputy Chairman, Paul Flowers, who was Chairman of the bank.[259]

173. The Co-op Bank Chief Executive had, until early 2011, had a single reporting line to the banking group board. This changed with the introduction of Project Unity, which brought with it a requirement for the bank Chief Executive to report to the group Chief Executive.[260] The governance of the bank and group thus became further intertwined.

174. Neville Richardson made clear his opposition to Project Unity, saying that it "diluted his position", although he felt it did not result in any loss of control to the group.[261] Rodney Baker-Bates went further, saying that Unity "changed the whole nature of the relationship with the group and made the group executive and the group management have a much more direct role in the strategic and operational overview of the bank".[262] David Davies, Co-op Bank's second Deputy Chairman, agreed that the bank "lost an element of independence" as a result.[263] Mr Baker-Bates pointed in particular to the change that the amended reporting line brought to the position of Peter Marks, saying:

> With the change in reporting line from Neville Richardson at the beginning of the year, he clearly had become an executive. He was no longer a non-executive, at least in my eyes.[264]

257 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), page 118, Exhibit 30

258 *Ibid.*

259 The Co-operative Bank plc, *'Financial statements 2011'*, page 10

260 Andrew Bailey (PV 16) page 5

261 *Ibid.*

262 Q 1762

263 Q 1907

264 Q 1830

175. Lord Myners, leader of the independent review into governance at Co-op, told us that "on many issues the board of the bank and the board of the group were indistinguishable" and that:

> to understand what happened at the bank, you [need] to understand what happened at the [group] board, because the board [controlled] the bank. It controlled most of the seats on the bank's board for a long period of time […].[265]

In particular, Lord Myners said that "the reckless decision to acquire Britannia was very much a group board decision rather than simply a bank board decision".[266] Sir Christopher Kelly, however, described a lower level of Group involvement in the Britannia deal:

> In contrast to what happened some years later in the negotiations with Lloyds Banking Group over the Verde assets, the Co-operative Group Board and Executive played a limited part in the Britannia transaction. […] But the Group was attracted by the prospect of increased scale for the Bank and by the addition of a large number of Britannia customers to its membership.[267]

176. Following Neville Richardson's resignation, Barry Tootell became Co-op Bank's Chief Executive, under this same reporting line. Though appointed on an interim basis, Mr Tootell stayed in post until May 2013. The Kelly report claims that, although Mr Tootell "struggled" in the role, he was kept in post because of the prolonged nature of the Verde negotiations, and the expectation that Lloyds would provide a new Chief Executive along with the Verde branches.[268] Andrew Bailey said of Mr Tootell:

> I do not think Barry Tootell was at all dominant. […] I think Barry was perfectly competent, but I do not think he was in any sense a strong chief executive. No, I do not.[269]

An oversized board with insufficient financial experience

177. In 2008, when Co-op Bank was considering the Britannia merger, the bank's board of 17 members comprised one Co-op Group executive, seven members of the Co-op Group board, four Co-op Bank Executives and five 'Independent Professional Non-Executive Directors' (IPNEDs).

178. Following the Britannia merger in August 2009, Co-op Bank's board expanded in size, from 17 to 22 members.[270] Clive Adamson, Director of the Major Retail Groups Division at the FSA over the period of the merger, said that the board at this stage "was both too big and the proportion of individuals with financial sector experience was not sufficient".[271] An external review of the effectiveness of the board, commissioned by Co-op Bank and

265 Oral evidence taken on 7 May 2014, HC (2013-14) 1265, Q 42

266 *Ibid.*

267 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), para 3.34

268 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), paragraphs 14.5-14.6

269 Q 1963

270 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), page 118, Exhibits 30-31

271 Q 1428

conducted by Dr Tracy Long in 2010, similarly concluded that "the board's ability to work together effectively is greatly reduced by its size [and] composition".[272]

179. Specifically on its size, Mr Adamson told us that the board following the merger was "somewhat unruly" and "difficult to manage".[273] Rodney Baker-Bates said that the board was "unwieldy" rather than unruly, and that "it was a very big board, and as a result it was hard to have a discussion and interaction around an issue".[274] By 2011, Co-op Bank had taken steps to reduce the size of its Board from 22 to 14, and also made some changes to its make-up.[275] Clive Adamson said that, by this stage, "half the members had some degree of financial services experience".[276] However, while he felt the resulting mix was better, it "still was not perfect in terms of the degree of experience on the board".[277] Andrew Bailey said that the FSA insisted on further restructuring of Co-op Bank's board in the summer of 2011, telling the Committee: "There was not adequate experience on the board".[278] He described the changes that Co-op Bank made in response:

> I think some of the changes were already in train, but between then and sometime during 2012—I cannot remember exactly when—there was an overhaul of the board. It shrank the number of members of the board, it replaced the so-called democratic Co-op members to a greater extent. It also replaced the former Britannia directors and it brought on people who had banking expertise.[279]

The FSA remained concerned about Co-op Bank's governance well into 2012, however, as noted in the Kelly report:

> In its June 2012 Risk Assessment letter to the bank, the FSA stated that the current Board structure "does not provide sufficient oversight, coverage, depth of debate and challenge to management", particularly given the large number of projects under way at that time. In the same letter the regulator said that it had observed over-reliance on just a few IPNEDs, and that the balance between IPNEDs and group [non-executive directors] on the [Co-op Banking Group] board needed to change. The bank was very slow to make the necessary changes.[280]

180. Over the period examined by this Report, fifteen of the Co-op Group board's twenty members were elected from Co-operative Regional Boards, and five from Independent Co-operative Societies. Those from Regional Boards did not need to have any background in financial services.[281] Peter Marks, Co-op Group Chief Executive from 2007 to 2013, had no obvious financial services experience.[282] The extent of overlap between the governance of

272 Dr Tracy Long (PV 31) page 3

273 Qq 1316, 1342

274 Qq 1748, 1802

275 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), page 118, Exhibit 30

276 Q 1428

277 *Ibid.*

278 Q 1962

279 Q 1954

280 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), paragraph 13.53

281 Oral evidence taken on 7 May 2014, HC (2013-14) 1265, Q 4

282 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), paragraph 9.8

the group and the bank meant that this lack of financial services expertise extended onto the banking group board. Rodney Baker-Bates told the Committee:

> Particularly among the democrats, as we call them, there was not really enough knowledge of the risks and opportunities in banking and financial services.[283]

The lack of experience, Mr Baker-Bates said, had implications for the style of debate on the board:

> [T]here was a broad spectrum of skill, and therefore on a particular issue—let us say our capital or the reserving in the general insurance—there was a relatively narrow set of expertise that we deployed and then a rather more general discussion. The way in which people looked at the issue was very diffuse, much more diffuse than you would get on a standard plc board.[284]

David Davies described "shortcomings" in the board members from Co-op Group, present because "they did not have the experience of financial services".[285] But he added that these members "were of good calibre and quality and were very diligent and tried really hard to master the issues that we were wrestling with".[286] He also defended the position of these members on the board, saying:

> I do not want to say they were not up to it, because they added a different dimension to the board. They added a whole range of looking after customers and doing the right thing by the Co-operative Group members.[287]

Sir Christopher Kelly concluded:

> It was reasonable for the Group to wish to have representation on the CBG Board. It is also understandable in the light of co-operative values and principles why it should wish some of these representatives to be democratically elected. It is less clear that the preservation of cooperative principles required representation in such numbers, particularly since few of them were able to add much expertise in other areas.[288]

181. Asked whether he was confident that the board as a whole was adequately experienced and knowledgeable to take decisions, Mr Davies replied "Yes".[289] However, both former Deputy Chairmen told us that what expertise there was on the board was "too thinly spread".[290] Mr Davies said in particular:

283 Q 1748

284 Q 1802

285 Q 1750

286 Q 1749

287 Q 1752

288 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), paragraph 13.36

289 Q 1910

290 Q 1911

> The same people were getting put on to more than one committee and it was asking a tremendous amount of workload. It is not as if all 14 of them had financial services expertise, so that was part of the problem.[291]

182. The problem of expertise being thinly spread was exacerbated by the wide range of activities undertaken by Co-op Banking Group. Mr Baker-Bates said that "the board, although it met as a single board, was in fact overseeing three different businesses: it was overseeing a bank, a general insurance business and a life business". The "range, scope and complexity of the issues" that the board was attempting to examine "made it difficult to get a focus on […] the key issues".[292] The composition of the board reflected this breadth in the business: of the thirteen non-executive directors on the board in 2011—when Co-op was submitting its initial Verde bids—six had financial services experience, but three of these specialised in insurance; only three non-executives had banking expertise.

183. This governance structure, lacking in suitable expertise, is particularly surprising given the transformational step that Co-op was poised to take with Verde. As Lord Myners said:

> [I]f they had gone ahead with Verde, the Co-op would have changed from being a primary grocery business with funerals and pharmacies and a bank to have become primarily a bank with groceries, funerals and pharmacy. […]
>
> [T]his board of directors, as I describe it, could not possibly have been placed in control of 8% of the British banking market […].[293]

Paul Flowers

184. The lack of appropriate financial services expertise within Co-op's governance is epitomised by Paul Flowers. Mr Flowers was elected to the Co-op Group board in 2008. In June 2009 he joined the banking group board, and in April 2010 he became the bank's new Chairman, at the same time being appointed Deputy Chairman of the group.[294] He reached this position despite having no experience in financial services. When he appeared before this Committee, he struggled with basic factual details about the bank, including the size of its balance sheet.[295]

185. Mr Flowers was one of four candidates for the post of Chairman.[296] The selection process—which was run by the group as the bank's sole shareholder—consisted of a psychometric test followed by an interview with group Chairman Len Wardle, and two other members of the group board.[297] Mr Baker-Bates, who was also a candidate for bank Chairman, shared his recollections of the recruitment process:

291 Q 1910

292 Q 1748

293 Oral evidence taken on 7 May 2014, HC (2013-14) 1265, Q 42

294 The Co-operative Group, *'Annual Report and Accounts 2008'*, page 33; The Co-operative Bank plc, '*Financial statements 2009'*, page 14; The Co-operative Bank plc, *'Financial statements 2010'*, page 11

295 Qq 680-685

296 Q 1347

297 Financial Services Authority (PV 23) page 1

> The interview as I recall it was primarily focused around my knowledge, which was not as deep as others', of the Co-operative Group and the Co-operative movement. I do not remember much discussion about my banking and other experience, but I presume they took that from my CV. I think there were three other interviews and no references were asked for.[298]

The day following Mr Baker-Bates's interview, Mr Flowers's selection as the new Chairman was announced to the bank board. David Davies described the group's decision:

> [T]he explanation that was given to the board was that the group had chosen Paul primarily, if not entirely, on his leadership capabilities. They cited as evidence the Walker report where Walker had suggested that ideally you need a balance for a chairman of the board between leadership and financial skills, and if you were not able to have both, then leadership would be the primary recommendation, according to Walker.[299]

Mr Baker-Bates conceded that Mr Flowers "certainly had a much better understanding than I did of the complexity and the politics with a small 'p' of the membership in the Co-operative Group".[300] But both Deputy Chairmen said they felt that Mr Flowers lacked the financial services experience necessary to chair a bank.[301]

186. Following his selection by Co-op, Mr Flowers was interviewed by the FSA. Under the Approved Persons regime, individuals on the boards of banks are required to seek regulatory approval before taking up their positions.[302] Mr Flowers had been approved as "fit and proper" by the FSA when he joined Co-op Bank's board in 2009.[303] However, in 2010, there was no formal requirement for existing board members to seek further approval if they became Chairman.[304] Despite this, Clive Adamson decided to hold an additional interview with Mr Flowers. He told the Committee:

> That was beyond what was required by our process at the time, but I felt it was important, as director of the division at the time, to see an individual who was in the process of being appointed chairman.[305]

187. Mr Adamson and two other FSA officials interviewed Mr Flowers in March 2010, covering areas such as his technical experience, the challenges facing Co-op Bank, and the group's motivation in selecting him as Chairman.[306] Mr Adamson said the fact that Mr Flowers was "deficient in technical banking experience and financial services experience was completely recognised by me and by him".[307] However, Co-op's reasoning behind Mr

298 Q 1789

299 Q 1797

300 Q 1793

301 Qq 1796, 1800

302 Financial Services Authority, *'CP10/3: Effective Corporate Governance'*, (January 2010), paragraphs 2.4

303 Q 1318; Financial Services Authority (PV 22)

304 Financial Services Authority, *'CP10/3: Effective Corporate Governance'*, (January 2010), paragraphs 2.4-2.7

305 Q 1320

306 Financial Services Authority (PV 23)

307 Q 1327

Flowers's appointment accorded with the FSA's own concerns about the size of Co-op Bank's board:

> [T]he reason that he was proposed to be put forward was that, at that time, the board of the Co-op Bank was 22 individuals. It was a somewhat unruly board and it was important that somebody was put in place to better chair that board.[308]

Mr Flowers's lack of financial services expertise did not "make bells ring in the regulator's head", since Mr Adamson thought he was the right person "in terms of his ability to run a somewhat large and unruly board".[309] Mr Adamson confirmed:

> My view at the time was that Mr Flowers did have the competence to perform the role of non-executive chairman. Just to be clear, our view is the non-executive chairman does not run the bank. The role of the non-executive chairman is to run the board.[310]

Mr Adamson said, however, that "today both regulators would insist upon financial services experience at the chairman level".[311] Andrew Bailey also confirmed that the regulatory approach to the approval of senior individuals has changed since 2010: "We would not have somebody in the role of chairman of a large bank who had no financial services experience".[312]

188. There was unanimous agreement among our witnesses that Mr Flowers lacked sufficient banking experience to act as Chairman of a major bank. Notwithstanding this, Mr Flowers was credited with performing a number of aspects of his job well. Andrew Bailey told us:

> I have been through the records and I have looked at the comments made by all the members of the board that we interviewed, both old and new, and none of them criticised Paul Flowers, interestingly. They generally say that he was an effective chairman.[313]

Mr Bailey also said that Mr Flowers acted in response to the areas of concern that the FSA raised with Co-op about its Verde bid:

> [I]mmediately after the July board meeting, we raised explicitly with the Co-op the fact that we did not believe that their risk function and their chief risk officer was up to the job. I raised that with Paul Flowers, and Paul Flowers said to me, "I understand the point you are making. He will be replaced", and he was. They overhauled their risk. Between mid-2011 and the end of 2011, they did that. […]

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308 Q 1316

309 Q 1327

310 Q 1316

311 Q 1379

312 Q 1946

313 Q 1964

> The Paul Flowers scorecard is distinctly mixed, frankly, in that sense, more mixed than you obviously get from the popular camps.[314]

189. Comments from Co-op directors listed in Dr Tracy Long's board effectiveness review show that Mr Flowers was seen to be "good at engaging people's views", and had "radically changed the culture" of the board to be "more open".[315] Co-op Bank's former Deputy Chairmen confirmed these views to the Committee. Mr Baker-Bates told us that Mr Flowers "tried hard to get the board to focus on the issues and to get everybody to express their views, and everybody's views to be heard".[316] And Mr Davies said Mr Flowers performed his duties as Chairman in a manner appropriate to his lack of banking expertise:

> I personally think he recognised his limitations, and if he led us into a financial services discussion where he was not capable, he would get found out. I think he took a consensus view and let the discussions flow and summarised and came to a view at the end and did not put his head above the parapet. I do not mean that unkindly. I mean as chairman he deliberately kept a low profile until he sought the consensus that he was looking for.[317]

The Approved Persons Regime

190. Mr Flowers was appointed as a board member under the Approved Persons Regime, under which the FSA had the power to require certain individuals within banks to seek pre-approval from the regulator before taking up their positions. The Parliamentary Commission on Banking Standards examined this regime, and concluded:

> As the primary framework for regulators to engage with individual bankers, the Approved Persons Regime is a complex and confused mess. It fails to perform any of its varied roles to the necessary standard. It is the mechanism through which individuals can notionally be sanctioned for poor behaviour, but its coverage is woefully narrow and it does not ensure that individual responsibilities are adequately defined […]. In principle, it is the means by which the regulator can control those who run banks, but in practice it makes no attempt to set clear expectations for those holding key roles. It operates mostly as an initial gateway to taking up a post, rather than serving as a system through which the regulators can ensure the continuing exercise of individual responsibility at the most senior levels within banks.[318]

The Commission recommended that the Approved Persons Regime be replaced, in the case of senior individuals, with a Senior Persons Regime. Regulatory guidelines around this regime, the Commission said, should make clear that senior individuals "should be fit and proper to carry out responsibilities assigned to them, and be able to demonstrate the necessary skills and experience". [319] The Government accepted these proposals and

314 Qq 1954, 1964

315 Dr Tracy Long (PV 31) page 7

316 Q 1803

317 Q 1834

318 Parliamentary Commission on Banking Standards, '*Changing banking for good*', HC 175-I, paragraph 86

319 *Ibid.* paragraph 100

introduced them as the 'Senior Managers Regime' in the Financial Services (Banking Reform) Act 2013. The FCA and PRA began a consultation on the workings of the new regime in July 2014.[320]

191. The new regime applies only to deposit-takers and investment firms regulated by the Prudential Regulation Authority.[321] The Approved Persons Regime remains in place for other financial services firms. During Commons consideration of Lords amendments to the Financial Services (Banking Reform) Act 2013, the Chairman of the Treasury Committee said:

> Everyone now seems to be agreed that the APR adds little or nothing, yet over the past few weeks we have discovered that the discredited APR will survive in legislation. In doing that, the regulators are perpetuating a myth that the APR affords any real protection. It will continue to apply to several groups. First, about 20,000 people in the financial services industry outside banking will still be covered, mainly in fund management and insurance.
>
> This is unfinished business. The Banking Commission had the remit to look only at banking. It would be absurd to retain a system for one part of financial services that has so clearly failed in another. The Government and Parliament both need to encourage the regulator to look at this and do what is necessary to extend the coverage of the new regime and to remove the APR from other parts of financial services. To rely on the APR is asking for trouble.[322]

192. Clive Adamson, when asked why the Approved Persons Regime would continue to be fit for other financial services institutions, given that it was not fit for banking, told us:

> We would have preferred the new regime to apply to all financial services firms.[323]

Governance and Verde

193. Barry Tootell, former Chief Executive of Co-op Bank, told us that both the bank and the group had a role in Verde:

> Project Verde or the acquisition of a major new business is a matter reserved for the group board. As the shareholder of the banking group, the bank could not acquire a major new subsidiary or a major new undertaking without the approval of the group board. However, it would be for the bank to decide whether it was able and wished to do the transaction.[324]

194. However, other witnesses described more than simply an 'approval' role for the group. Peter Marks, group Chief Executive, was described as the "driving force" behind Co-op's

320 Financial Conduct Authority and Prudential Regulation Authority, *'Strengthening accountability in banking: a new regulatory framework for individuals'*, 30 July 2014

321 Financial Services (Banking Reform) Act 2013, Section 33

322 HC Deb, 11 December 2013, col 267 [Commons Chamber]

323 Q 1434

324 Q 490

Verde bid by witnesses.[325] In leading Co-op's Verde enterprise, Mr Marks appeared to be acting in his capacity as group Chief Executive, not as a bank non-executive. "This was very clearly a Group matter", Mr Davies told us.[326] Mr Baker-Bates agreed: "We were very clear it was a group-led project."[327]

195. Mr Marks himself accepted that he was the driving force behind Verde.[328] But he also said, in particular in relation to negotiations with Lloyds, that "Barry Tootell, who was the chief executive of the bank […], was the main person supervising the day-to-day running of the process".[329] Asked what qualifications he, Mr Marks, had to examine, scrutinise and ensure thorough due diligence of a banking deal, Mr Marks replied: "I don't think I needed it […] because the Chief Executive of the bank was actually running the process".[330] Mr Marks also told us he was "very careful not to interfere with the running of the bank", and when discussing accountability for goings-on at the bank, said:

> I couldn't be accountable because I wasn't approved by the FSA to run a bank. That was not my role in the organisation.[331]

196. Co-op Bank's former Deputy Chairmen painted a very different picture. Mr Davies told us that Mr Marks was "leading the negotiations and he was dealing with Lloyds", that "the discussions with Lloyds were principally Peter and the group team", and that Mr Marks acted as "the main conduit of information from Lloyds".[332] Andrew Bailey told us, however, that:

> the Co-op Bank board had to take the decision to recommend the Verde transaction to the group. Peter Marks could not take that decision on his own.[333]

197. When asked whether Paul Flowers, like Peter Marks, was driving forward Verde, Rodney Baker-Bates, said: "I am less clear on that". David Davies, agreed:

> I think Paul was very good at not nailing his colours to the mast. As chairman, I thought he deliberately avoided trying to push people in a certain direction. He let the arguments develop.[334]

However, emails from Rodney Baker-Bates at the time suggest a sense that senior figures within the group, including Paul Flowers, had already made their mind up about the Verde deal and were unwilling to listen to dissenting voices. In a message to Paul Flowers on 28 May 2012, Mr Baker-Bates said that "I have a strong sense that Len [Wardle, Co-op Group

325 Qq 1607, 1829
326 Q 1830
327 Q 1875
328 Q 289
329 Q 352
330 Q 300
331 Qq 304, 272
332 Qq 1840, 1873, 1846
333 Q 1963
334 Q 1833

Chairman] and Peter have already come to a positive conclusion".[335] Following the Heads of Terms vote in July 2012, Mr Baker-Bates said in an email to Ursula Lidbetter, then Deputy Chairman and now Chair of Co-op Group:

> 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 and Peter want to do this deal and seem to be "deaf" to objective risk analysis.[336]

198. The Committee heard evidence that the banking group board was not sufficiently involved in the Verde process more generally. Asked whether, in retrospect, the Deputy Chairmen were as much in the loop as they should have been in the negotiations, Mr Baker-Bates said: "Certainly not in the negotiations. Absolutely not in the negotiations."[337] Mr Davies agreed, referring to Verde's status as a group-led project. The bank board also appears not to have been fully briefed on interaction with the regulator on Verde: both Deputy Chairmen denied having seen Andrew Bailey's December 2011 letter to Paul Flowers setting out the FSA's five areas of concern in respect of the deal.[338] Mr Davies told us: "I have tracked the board papers and I can find nothing in the board papers to show it was shared with the board."[339]

199. In Mr Marks's testimony to the Committee, he did not even appear to appreciate that there were concerns about Verde on the bank board, despite being a member himself. He told us:

> On each occasion when I asked them for their opinion and we voted on it, it was unanimous. That was the same in the group boardroom and the bank boardroom.[340]

It is clear from the testimonies of Co-op Bank's Deputy Chairmen—both of whom voted against Verde in July 2012—that this was not the case.

200. The Deputy Chairmen did point to some engagement of the bank board on Verde. Mr Davies said that "the risk committee were briefed very thoroughly on the progress of agreeing the parameters of the integration and all the nuts and bolts and the risks involved", but admitted that the board was "not engaged was the financial terms of the offer".[341]

201. Mr Baker-Bates, responding to the question of why the bank board did not stand up for itself and insist on more involvement in Verde, said:

> I think the bank board did stand up. That assumes that there was unanimity of opposition and I think the Committee needs to understand that there were six,

335 Rodney Baker-Bates (PV 29) page 14

336 *Ibid.* page 17

337 Q 1875

338 Qq 1886-87

339 Q 1888

340 Q 483

341 Qq 1875, 1913

> seven, eight NEDs; there was a range of views there. I was at one end, being trenchantly opposed to it for reasons that we have discussed; there were other colleagues at the other end who were, in fact, strongly in favour of it. You are trying to convey the concept of a united board on this particular issue and the fact is there was a wide range of views.[342]

In an email to Ursula Lidbetter in October 2011, however, shortly after a discussion about Verde at the Co-op Group board, Mr Baker-Bates said:

> Peter appeared to have a vision (which is easy to share), but limited grasp of the detail. His enthusiasm and organisational power and personality seems to be driving the process. I have had several [Co-op Banking Group] executives privately express very valid reservations. As an aside, it is a pity they do not have the "guts" to express them in a public forum.[343]

The Kelly report on the overall effectiveness of Co-op Bank's governance

202. The Kelly Report considers the contribution of failures of management and governance at the bank and group to Co-op Bank's problems. It concludes:

> The Bank Executive failed to exercise sufficiently prudent and effective management of capital and risk. The Banking Group Board failed in its oversight of the Executive. The Group Board failed in its duties as shareholder to provide effective stewardship of an important member asset. Collectively, they failed to ensure that the Co-operative Bank consistently lived up to its ethical principles. In all these things they badly let down the Group's members.[344]

On the Banking Group Board specifically, Sir Christopher said:

> As in any organisation, the responsibility for running the business lay with the Executive. It is the Executive, and in particular the successive Chief Executives, who are accountable for the large number of poor decisions taken during the period under review.
>
> But it was the role of the Board to ensure that the Bank had the capability to do what was required of it, to agree an appropriate strategy, and to monitor and challenge the way the strategy was implemented. It should also approve and monitor the Bank's risk appetite. Judging by the results, it failed in all these areas.
>
> Crucially, it failed to focus on capital, even though that is an essential duty of any bank board and despite the capital difficulties the Bank was facing. Capital was a major preoccupation at this time for most other UK banks.

342 Q 1915

343 Rodney Baker-Bates (PV 29) page 6

344 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), paragraph 2.1

> There are dangers in generalising because the composition of the Board changed over the period. But the explanation for the extent of the governance failure appears to lie in five factors:
>
> i) The capability of the Executive Team. Even a good, well-skilled board cannot make up for ineffective Chief Executives and senior teams. The CBG Board had little chance of doing so.
>
> ii) Its Chair. The chair is critical to any board. If he or she for reasons of experience lacks the capability to understand the business of the organisation, the board as a whole is unlikely to be effective, whatever the quality of its other members. This is particularly the case where the business is as complex and technical, and as inherently risky, as banking.
>
> iii) The small number of Board members with any banking experience. The IPNEDs were never in a majority until 2013, and not all of them had a banking background. Their influence on major issues was constrained accordingly, even though other members relied on them heavily on technical issues. It is noteworthy that the Verde negotiation continued even after the two experienced Deputy Chairs came to oppose it.
>
> iv) Poor process. The assessment of Paul Flowers by his colleagues possibly reflected the fact that he ran meetings better than his predecessor. But meetings still appear to have been overly formal. The normal procedure was said to be for Bank executives to deliver a presentation, followed by all Directors being invited in turn to ask questions. That is not an approach that encourages debate.
>
> v) Poor management information. The Board was presented with a lot of information, but not always in a way which brought out the key issues very clearly. Management information presented to the CBG Board often lacked sufficient quantitative analysis and was sometimes one or two months out of date.
>
> Most if not all of the IPNEDs, and some of the other Board members, were aware of these deficiencies. But they seemed unable to do anything about them. Some, particularly those appointed in the latter part of the period when the causes of the capital shortfall were already well-established, became increasingly frustrated.[345]

In his overarching conclusion about Co-op Bank's governance over the period his report examined, Sir Christopher said:

> It is hard to avoid the conclusion that the Group Board, as constituted, was never likely to be able to exercise any form of effective shareholder oversight of its banking subsidiary. The [Co-op Banking Group] Board did include some experienced and capable individuals. But it was greatly handicapped by the lack of banking experience of its Chair, by poor process and by inadequate information. If the Executive had

345 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), paragraphs 13.48-13.51

been more capable, that might not have mattered so much. The combination of poor decisions by the Executive and weak governance proved very damaging.[346]

Conclusions

203. **Co-op Bank's governance structure up to the middle of 2013 was entirely inadequate for a bank of any size; it is shocking that it was in place in an institution that came so close to becoming a major new challenger bank. Co-op Bank's board was dominated by members from the parent group who lacked financial services experience. Those members with financial services experience were responsible for overseeing a very broad range of business. Being small in number, their expertise was spread too thinly, and ran the risk of being over-ruled by possibly well-meaning, but inexperienced, democratic members of the board. Yet, at least from 2009 to 2011, the board was also too large and unwieldy to allow for meaningful discussion and debate. The executive was also subject to influence from Co-op Group, with the bank's Chief Executive in a direct reporting line to the group's Chief Executive from 2011.**

204. **There was a place for representation of Co-op Group on the bank board. As sole shareholder, the group's views needed to be heard. But this should not have come at the expense of the experience necessary to run the bank. Indeed, in the context of a controlling interest in the bank, the group's board structure and inexperience should have been of more concern to the regulator than it apparently was.**

205. **The deficient composition of Co-op Bank's governance was embodied in Paul Flowers, who lacked any of the requisite financial services experience to act as Chairman of a bank. In this regard he appointed two experienced Deputy Chairmen to strengthen the advice to him and the board. Mr Flowers was appointed on the basis that he would be able to navigate the 'politics' of Co-op Group and chair the board. We took evidence that he had performed these functions well. But this was an inappropriate basis for his appointment. An effective bank Chairman should usually possess a good deal of experience of financial services. He or she should be at least capable of understanding financial issues. Mr Flowers lacked both the desirable experience and the minimum essential skills. He should not have put himself forward for the role. Co-op should not have selected him. The regulator should not have permitted his appointment.**

206. **Clive Adamson and Andrew Bailey have said that an individual with as little financial experience as Mr Flowers would not be appointed as Chairman of a bank today. That he was allowed to perform the role at all is further proof, if it were needed, of the inadequacy of the Approved Persons Regime. This regime, in principle the means by which the regulator can ensure that those who run banks have the requisite expertise, is in practice a narrow box-ticking exercise. It operates mostly as an initial gateway, providing very little subsequent oversight of those at the most senior levels in banks. The new Senior Managers Regime—recommended by the Parliamentary Commission on Banking Standards, given statutory underpinning by the Government and now being consulted on by the regulators—seeks to address these deficiencies.**

346 *Ibid.* paragraph 13.54

Properly implemented, the regime provides a better prospect that the most senior individuals will have sufficient financial expertise to perform their roles effectively, or at least have the capacity to understand the questions put before them and to ask some of their own.

207. **While the Approved Persons Regime will be abolished for the banking industry, it will be retained for many in the remainder of the financial services industry, including insurance and asset management. Given its manifest failings, this appears hard to justify. Clive Adamson, Director of Supervision at the FCA, appeared in oral evidence to agree with this view. The Government and the regulators should at the earliest opportunity make proposals to extend the coverage of the Senior Managers and Certification Regimes to, and remove the application of the Approved Persons Regime from, other parts of the financial services industry.**

208. **Co-op's governance was not the source of all the bank's problems. The bank was also hampered by an ineffective executive team. Failures of risk management within the bank itself are to blame for taking on and obscuring excessive risk. But defective executive management can only persist if there is ineffective board oversight. The bank's board was incapable of providing the necessary guidance and challenge to the executive.**

209. **All boards make mistakes, and take decisions that, in retrospect, they should not have taken and which may incur large losses. But the previous governance of Co-op Bank—in its structure and its composition—seems to have invited the risk of failure, whether in the decision to merge with Britannia, in the failure to uncover the bank's impairments, or in the failure to act decisively on the regulator's warnings about the Verde deal. What's more, the previous management of Co-op Bank presided over the bank's prudential and conduct failures while presenting customers with the façade of a prudent and ethical business.**

210. **Evidence heard and seen by the Committee during this inquiry paints a picture of specific, serious governance failings at the Co-op which contributed to the losses in the bank. In pointing out these governance failings the Committee is mindful that other financial institutions with more conventional PLC boards also collapsed in recent years at huge cost to the taxpayer.**

211. **Rodney Baker-Bates and David Davies, Co-op Bank's two Deputy Chairmen, opted to resign from the bank's board because they dissented on Verde. In the circumstances, they took an honourable course. However, board members should not always feel obliged to resign merely because they disagree with a major business decision or transaction. Resignation can deprive a board of valuable skills and experience. But there may be circumstances in which there is no alternative to resignation. Such circumstances may include non-executives believing that the firm's future is endangered by the board's failure to heed their warnings, or senior board members obstructing constructive criticism. The FRC should examine whether there is value in providing guidance in the UK Corporate Governance Code on the circumstances that might call for a board member to resign, and the factors that board members should take into account when making their decision.**

212. **Peter Marks has been identified by our witnesses as the driving force behind Co-op's Verde bid. He appeared to lack any of the financial services experience that would warrant such a role. He also lacked the necessary regulatory approval, being approved only as a non-executive yet appearing to have acted in a de facto executive capacity. Barry Tootell claims to have had responsibility for the Verde deal as bank Chief Executive, but other witnesses have described Mr Marks as leading the negotiations, and were clear that Verde was a group-led project.**

213. **The Committee has heard that Verde would not have gone ahead unless the bank had approved it. But the group's dominance on the bank board and the apparently cursory engagement of the experienced board members on the detailed Verde negotiations made credible dissent unlikely. Moreover, what disagreement there was—from the bank's two Deputy Chairmen—appears to have been forgotten or ignored by Peter Marks, who told the Committee that Verde at all times had the unanimous support of the bank board. Rodney Baker-Bates also described Peter Marks, Len Wardle and Paul Flowers as being "deaf" to objective risk analysis of the deal. This was scarcely the way for a bank to consider a major acquisition.**

214. **Earlier in this Report, the Committee concluded that the management of Co-op Bank in place during the Verde bidding process was unlikely to have been able to address the regulator's concerns about the bid. This same management, and all those in Co-op Bank's management since the Britannia merger, bear some responsibility for the manner in which the deal ultimately collapsed. Co-op Bank should have come to terms sooner with the risks it was running; having done so, it might have decided not to pursue Verde. As it was, the leadership of Co-op Bank proved incapable of appreciating and addressing the problems in the bank, and the Verde deal was allowed to continue, driven by the enthusiasm of a small number of Co-op Group members, until Co-op Bank's capital shortfall finally emerged.**

6 Was the bidding process fair?

Lord Levene's allegations

215. Following the collapse of Co-op Bank's financial position, and its Verde bid along with it, Lord Levene, Chairman of Co-op's rival bidder NBNK, began to question whether the Verde process run by Lloyds had been fair, and alleged political interference in the deal. He told the Committee that he believed "that Lloyds were swayed by political considerations", and that in his view NBNK's bid had been rejected in favour of Co-op's because "there was considerable pressure on Lloyds to accept a bid from the mutual". [347]

216. Lord Levene made specific allegations to the Committee:

- That there was political interference to public detriment in the Verde process and that this constituted bad faith.[348]
- That Lloyds moved the goalposts of the auction to help ensure the Co-op won and that that constituted bad faith.[349]

He also told the Committee that it was "not a reasonable conclusion" of Lloyds's to have decided that "the final bid from the Co-op for the Verde branches was superior to the one that [NBNK] offered, both financially and in terms of its execution risk".[350]

217. In January 2014, Lord Levene told the Committee that he no longer had a personal standing in the matter of Verde, since he was no longer a director or shareholder of NBNK.[351] In a letter to the Chairman of the Committee in July 2014, he explained that he was pursuing the matter:

> Quite simply because I believe that Governments of any political persuasion in this country should stick to the truth, however inconvenient at times that might prove to be. […] I do not believe that that is what has happened in this case.[352]

Lord Levene also told the Committee that the vigour of his response was triggered in part by the allegations which he and his NBNK colleagues were "very unfairly tarred with—that we were a bunch of incompetents who did not know what we were doing".[353]

Were the goalposts moved?

218. Lord Levene has pointed to "repeated changes to the [Verde] bidding process and the package on offer", and in oral evidence to this Committee alleged "that Lloyds moved the

347 Qq 1451, 1578

348 Q 1478

349 Q 1479

350 Qq 1497-1499

351 Q 1460

352 Lord Levene (PV 40)

353 Q 1462

goalposts of the auction to help ensure the Co-op won and that that constitutes bad faith".[354]

219. Lloyds requested that initial bids for the Verde branches be submitted by 11 July 2011, and both NBNK and Co-op Bank did indeed submit their 'Round 1' bids by this date.[355] However, Lloyds then stipulated that Round 2 bids should be submitted by 28 September: a deadline which NBNK met, but Co-op Bank missed.[356] Co-op Bank was granted additional time to put together a second bid, and announced on 4 November 2011 that it was going to submit an updated offer.[357]

220. Lord Levene claims that "NBNK was the only bidder to meet the Round 2 deadline in September 2011 and it could be argued that, if LBG had played by its own rules, then its decision at that time should have been only between NBNK and an IPO".[358] Lloyds claims, however, that "in addition to NBNK's bid we received one other letter of interest on 28th September" (the private equity firm Sun Capital), and that "Co-op was still conducting due-diligence and requested additional time, which was in Lloyds shareholders' interest to grant".[359] Further, Lloyds points out that "The Round 2 process letter made it clear that we could vary the process as we deemed necessary as is normal market practice and we did this to maintain competitive tension for the benefit of LBG shareholders".[360] Lord Levene himself told this Committee that "the timetable for the bidding process was a matter for LBG and that, frustrating though it may have been, NBNK had to (and did) accept that LBG was under no obligation to comply with its own publicly communicated timescales for the Verde Process".[361]

221. As well as extending the deadline to allow a Co-op bid, Lloyds made changes to the package of assets on sale in November 2011. Lord Levene contends that this was done "presumably to induce the Co-operative to submit a bid".[362] However, Lloyds states that these revisions were intended "to address concerns of all bidders around the quantum of funding gap".[363] This gap was described by NBNK as "a funding shortfall between loans and deposits of c.£40bn [which] represents a 'gap' that even the largest banks in the world could not accommodate, far less the new or small banks envisaged (not least by the EC who mandated the process) as bidders".[364] Lloyds invited all bidders, including NBNK, to submit a revised bid following these changes to the Verde package, and told this Committee that, in its revised offer letter, NBNK said: "In our [previous] offer letter we stated our concern about the quantum of funding gap, the level of wholesale funding and the resulting high encumbrance levels […] This presented a challenge to Verde […] This

354 Lord Levene (PV 03) paragraph 8; Qq 1479-80

355 Lloyds Banking Group (PV 08) page 17; Lord Levene (PV 02)

356 Lord Levene (PV 02)

357 *Ibid.*

358 Lord Levene (PV 03) paragraph 18

359 Lloyds Banking Group (PV 08) page 4

360 *Ibid.*

361 Lord Levene (PV 17) page 2

362 Lord Levene (PV 02)

363 Lloyds Banking Group (PV 08) page 5

364 Lord Levene (PV 19) page 5

Revised Offer seeks to resolve these issues by reducing the quantum of assets in the transaction."[365] Lord Levene himself told the Committee in written evidence that "The revised asset package was much improved and presented greater scope for profitability and producing stronger and earlier return on equity".[366]

222. Lloyds considered the revised bids on 18 November, and decided to progress only with Co-op Bank and NBNK, while leaving the option of an IPO on the table.[367] Because, in Lord Levene's words, "key variables […] again changed (including the terms of the package on offer and certain macro-economic assumptions)", Lloyds invited a round of further, final bids in December 2011.[368] Lloyds considered these bids on 14 December 2011 and decided to pursue a period of exclusive negotiations with Co-op Bank.[369]

223. Despite the period of exclusivity being granted, NBNK was re-admitted to the process in April 2012 because of "a delay" by Co-op.[370] Asked whether this was an argument to suggest that the goalposts were being changed to facilitate NBNK at that point, Lord Levene replied "I think it was an argument to suggest that they could not get anywhere with the Co-op and so they had to start again".[371]

Whose bid was better?

224. There were two key rounds of bidding in the Verde process that resulted in a preferred bidder being chosen: one in December 2011, in which Co-op Bank was named as preferred bidder and granted a period of exclusivity; and one in June 2012, following the lapse of Co-op Bank's exclusivity in April 2012, in which Co-op Bank was again pronounced the winner over NBNK. Lloyds claims that "the board of LBG made its decision between NBNK and Co-op on financial and execution grounds".[372] Lord Levene told the Committee that, in his view, deciding that Co-op Bank was superior to NBNK in these respects "was not a reasonable conclusion".[373]

Financial terms

225. Lloyds engaged JP Morgan Cazenove (JPMC) as a financial adviser in the Verde process, a role that included "considering proposals received from prospective purchasers by assessing such proposals from a financial perspective".[374]

226. In December 2011, JPMC examined the bids from Co-op and NBNK and decided that "the terms of NBNK's latest offer were, from a financial perspective, favourable compared

365 Lloyds Banking Group (PV 08) page 5

366 Lord Levene (PV 02)

367 Lloyds Banking Group (PV 34) page 8

368 Lord Levene (PV 02)

369 Lloyds Banking Group (PV 34) page 10

370 Q 130

371 Q 1575

372 Lloyds Banking Group (PV 08) page 15

373 Qq 1497-1499

374 JP Morgan Cazenove (PV 20) page 1

to those from the Co-op", although JPMC notes that "this did not take account of the significant non-financial aspects and risks relevant to the consideration of the proposals, including substantial technical and operational matters";[375] these other matters are examined below. The minutes of the Lloyds board meeting on 14 December 2011 also noted that NBNK's bid "was potentially (albeit marginally) more valuable to the Group, but the costs of delivery to [NBNK] would be higher".[376]

227. Further changes were made to the Verde perimeter between December 2011 and the second Lloyds Board decision in June 2012. Lord Levene said that Lloyds also issued "revised financial data (showing a reduction in projected profit of several hundred million pounds)", which "led NBNK to radically reduce the price it was prepared to pay".[377] JPMC assessed the new bids in June 2012 and determined this time that "the terms of Co-op's final offer were, from a financial perspective, favourable compared to those from NBNK".[378] The financial terms of NBNK's bid at this point were described by Lord Levene as follows:

- £630m–£730m in cash paid in escrow as soon as the sale and purchase agreement was signed and well in advance of completion;
- NBNK stated that it would pay at the top of the range if the figures quoted by LBG were confirmed by them.
- Additionally, NBNK said that there would be a further upward price adjustment of £50m dependent on a number of items that might be included in the package.
- NBNK also offered to discuss a further upside for LBG depending on future profitability during heads of terms negotiations.[379]

228. In comparison, Lloyds described Co-op Bank's bid in the following terms:

- £350 million upfront
- £100 million additional to that, in net present value (NPV) terms, as a net contribution to the build cost of Verde
- A further £250 million above NBNK's offer, in NPV terms, in respect of the amounts paid to the Group for running the IT systems over the life of the long-term contract
- An 'earnout'—additional payment based on the future performance of the business—of up to £800 million over time (£400 million in NPV terms).

This amounted to "£700m from The Co-operative excluding the earnout, and up to £1100 million including the present value of the earnout".[380]

375 JP Morgan Cazenove (PV 20) page 2

376 Lloyds Banking Group (PV 34) page 10

377 Lord Levene (PV 03) paragraph 10

378 JP Morgan Cazenove (PV 20) page 2

379 Lord Levene (PV 02)

229. Lord Levene claims that "NBNK's bid [in June 2012] was quite demonstrably higher than the Co-operative's", saying that "NBNK's offer exceeded the quoted £700m offered by the Co-operative and would have delivered LBG £280m more cash at completion than that offered by the Co-operative".[381] However, Lloyds responded that "Assuming a range of outcomes for the earnout of £0–£400m, Coop's offer represented a range of £700m–£1100m. […] This compared to NBNK's offer of £630m–£730m. Hence at the lower end of both ranges, Co-op's offer was superior and at the higher end of the ranges, Co-op's offer was also superior".[382] In addition, Gary Hoffman told the Committee that, while in his view NBNK's bid was superior, he had "not seen all the detail of the Co-op bid".[383]

230. NBNK believed that "[t]he material point to make is that NBNK's bid was £630–730m in cash upfront (i.e. at completion)", and that while £350m of Co-op's bid was also to be paid in cash, "everything else was subject to further execution risk".[384] NBNK stated: "It appears this is not considered as a factor. In a typical M&A process this would be a material point of difference."[385] Lloyds pointed out, however, that there were also risks surrounding the financial aspects of NBNK's bid. In particular, though NBNK offered a possible "upward price adjustment of £50m", its bid also contained "a negative price adjustment of up to £400m after which NBNK had a unilateral right to terminate the deal".[386] NBNK accepted that its bid was subject to these price adjustments, but said that they "were primarily a mechanism to protect NBNK after a deal had been signed but while LBG still controlled Verde".[387] Lloyds also noted that "NBNK's offer was noncommittal within the valuation range", and "payment in this range [was not] linked to any formula—it was entirely at NBNK's discretion". In comparison, Co-op's earnout offer was "a contractual commitment".[388]

231. In addition, Lloyds said that "[i]t is customary in an M&A process only to consider the low end of any offer range", and that the process letter to Verde bidders "clearly stated: 'A range is not acceptable. If you do provide a range we will assume that your Binding Offer is the lowest value in the range.'" In spite of this, Lloyds claims that it "gave a full consideration to NBNK's offer".[389]

232. Setting aside the value of each bid, Lloyds also had concerns over NBNK's funding arrangements, saying: "NBNK had no committed funding above their initial £50m capital raise", and that its offer of cash held in escrow upfront "turned out to be subject to being able to issue a prospectus to raise money in the capital markets, which they said they were not in a position to do ahead of signing".[390] NBNK was therefore "dependent on raising the

380 Lloyds Banking Group (PV 01) paragraphs 7-8

381 Lord Levene (PV 03) paragraphs 5, 10

382 Lloyds Banking Group (PV 14) page 2

383 Q 1501

384 Lord Levene (PV 19) page 1

385 *Ibid.* page 2

386 Lloyds Banking Group (PV 14) page 2

387 Lord Levene (PV 19) page 3

388 Lloyds Banking Group (PV 14) pages 1-2

389 *Ibid.* page 1

390 *Ibid.* page 5, Lloyds Banking Group (PV 08) pages 8-9

full purchase price in the public market at a time when the public equity markets were effectively closed”.[391]

233. Lord Levene rejected that funding certainty was a point of differentiation between NBNK and Co-op Bank, saying that “unlike Co-op which as a mutual did not have the option of traditional equity funding, NBNK had a strong and tested route to raise equity capital from a number of large institutional investors”, and that “[n]either NBNK nor Co-op had underwriting at the time of submitting their bids and neither would usually be expected to”.[392] Further, Lord Levene said that NBNK “had already explained to LBG and they had accepted that, given the names of our shareholders, underwriting at that stage would not be required and we would not need any other form of financing”. NBNK had also provided “comfort letters from all our principal investors at very short notice when requested”.[393]

234. Lloyds stated, however, that: other acquisition vehicles have been able to pre-fund their acquisitions; that Lloyds, at all stages, had a strong preference for certainty of funding; and that the comfort letters from investors contained the explicit phrasing that they did “not constitute and should not be construed as a proposal, a commitment or an offer by or on behalf of us to provide any financing to [NBNK]”.[394]

235. In addition to contentions over the financial substance of the two bids, NBNK had complaints over the conduct of the auction process. Lloyds had concerns about NBNK’s final bid being within a range, about the lack of contractual commitment regarding where within the range the final payment would fall, and about the potential negative price adjustments. NBNK, however, said that any uncertainty on Lloyds’s part reflected:

> LBG’s unwillingness to engage with us on finalising, to contractual status, some outstanding issues. In particular, for the final bid in July 2012, we were not—despite repeated requests—given sufficient time with, or feedback from, LBG to enable us to complete the documentation. This reflects the asymmetrical process LBG ran—with more attention and effort focussed on the Co-op. It is evidence of bias in the process, not a failing on NBNK’s behalf.[395]

Lloyds painted a different picture, telling the Committee that:

> In the period leading up to the submission of [the June 2012] offer, NBNK confirmed that they were pleased with the support provided to them by the LBG team.[396]

391 Lloyds Banking Group (PV 14) page 5

392 Lord Levene (PV 19) pages 6, 9

393 Lord Levene (PV 02)

394 Lloyds Banking Group (PV 08) pages 9-10, 13; Lloyds Banking Group (PV 14) page 7

395 Lord Levene (PV 19) page 2

396 Lloyds Banking Group (PV 08) page 10

Execution risk

236. Considering the rival Verde bids on 14 December 2011, the Lloyds board concluded that "[o]n balance, the lower execution risk was probably with [Co-op]".[397] In written evidence to the Committee, Lloyds outlined why:

> The Co-op was already a fully functioning bank and, as a group, the Co-operative had diversified revenue streams from its insurance and retail businesses. The Co-op and TSB were recognised brands in the high street. NBNK would need to build customer and non-customer facing capabilities and staffing, as it would in control functions. The Co-op had an existing IT infrastructure, albeit one that required investment and upgrading for any migration of Verde customers. NBNK had no platform or infrastructure and at the time were proposing a new build solution from a supplier without a full working reference site in the UK.[398]

The minutes of the Lloyds board on 14 December 2011 also note, however, that "[Co-op] recognised that, if it acquired the Verde business, it would need to upskill significantly".[399]

237. António Horta-Osório, Chief Executive of Lloyds Banking Group, affirmed these conclusions, telling the Committee that "NBNK had no bank, no treasury, no clients, no infrastructure—nothing".[400] The balance of the risks remained broadly consistent when Lloyds came to consider the bids again in June 2012.[401]

238. NBNK rejected Lloyds's conclusion. Lord Levene said:

> LBG is essentially highlighting NBNK not being a bank as a "risk" to the deal. NBNK was under the strong impression that the aim of the process (from a state aid perspective) was to create a "potential new entrant in the UK retail market" […]. It would appear apparent that such a new entrant may not already be a bank. It is therefore unreasonable and self-defeating to use this factor to discriminate against NBNK.[402]

239. Comparing NBNK's level of execution risk to Co-op Bank's, Gary Hoffman, former Chief Executive of NBNK, told the Committee that "for those that were very close to retail banking at the time, it was crystal clear that the execution risk with the Co-op was extremely high, given their integration issues with the Britannia, given the group structure and given the lack of management capability they had".[403] That these risks to Co-op's bid were clear during the bidding process is evident, Lord Levene said, from the 'Key Risks' memorandum that NBNK prepared at the time. This document, described earlier, set out a number of areas that NBNK felt presented a risk to the transaction with Co-op proceeding.

397 Lloyds Banking Group (PV 34) page 10

398 Lloyds Banking Group (PV 18) page 2

399 Lloyds Banking Group (PV 34) page 10

400 Q 16

401 Lloyds Banking Group (PV 18) page 3

402 Lord Levene (PV 19) page 7

403 Q 1503

Lord Levene and Mr Hoffman claim to have presented it to Lloyds Chairman Sir Win Bischoff in January 2012.[404]

240. As described earlier, Lloyds has disputed that Sir Win was in fact presented with this memorandum. But the substantive point that Lloyds makes in relation to the memorandum, now submitted to this Committee and published as evidence, is that "nowhere in the document is there any reference to the factor which actually caused the Co-op to withdraw from the bid and their current travails, namely the capital shortfall arising from the deterioration in the quality of their loan book [...] because this was not known in the markets at the time, nor did the rating of Co-op's bonds indicate knowledge of the deterioration".[405]

241. NBNK was not the only body to have concerns about Co-op Bank's bid at the time: as described earlier, Andrew Bailey wrote to Paul Flowers in December 2011 setting out five areas of concern—which in large part mirrored NBNK's—in relation to Co-op's Verde prospects. Co-op Bank in fact notified Lloyds of these concerns, and so the substantive points raised in the NBNK memo were known to it anyway. But Lloyds still judged execution risk to be higher with NBNK. Andrew Bailey told this Committee that, had NBNK emerged as the winner of the auction, it would have also received a cautionary letter from the regulator.[406] Lloyds said the FSA had "made it clear that both offers had many hurdles to overcome before final approval".[407]

242. Despite taking a firmly opposing view to Lloyds, when asked whether he thought it reasonable that Lloyds should conclude that higher execution risk attached to NBNK's bid than to Co-op Bank's, Lord Levene replied: "I understand why they said that". He added, however: "I just think they were wrong."[408]

Was there political interference?

Lord Levene's allegations

243. Following NBNK's failure to win Verde in December 2011, Lord Levene claims that he received "a number of messages indicating that there had been significant political involvement leading up to the original [Verde] decision".[409] He told the Committee that a number of sources brought to his attention the Government's commitment, as set out in the Coalition Agreement, "to foster diversity in financial services, promote mutuals and create a more competitive banking industry", and said that he "was therefore advised that the decision was based on an indication from senior politicians within the Coalition that the Co-op deal was to be the preferred and definitive solution".[410] Lord Levene confirmed

404 Q 1586

405 Sir Winfried Bischoff (PV 15) page 2

406 Q 1976

407 Lloyds Banking Group (PV 08) page 12

408 Q 1541

409 Lord Levene (PV 02)

410 *Ibid.* ; HM Government, *The Coalition: our programme for government*, (May 2010), page 9

to this Committee that he was alleging political interference to public detriment in the Verde process, and that this constituted bad faith.[411]

244. Lord Levene told the Committee that he did not know who had been applying political pressure in respect of Verde, but that it seemed likely that it could have been a Treasury Minister.[412] Similarly, he did not know what form this pressure might have taken, but said:

> [I]f I had to guess from what we have heard—and you know as much about this as I do—I would say that a Treasury Minister would have spoken to either the Chairman or Chief Executive of Lloyds Bank and said, "Look, you should be aware that if you end up with the Co-op as the bidder, we think that would be helpful".[413]

Lord Levene's meeting with the Governor

245. Lord Levene said that he had "no hard evidence" to support allegations of political involvement until a meeting with the then Governor of the Bank of England, Lord King, on 28 May 2012.[414] In this meeting, which Lord Levene told us was held at the Governor's instigation, Lord Levene claims to have been told by Lord King that NBNK would not win the Verde bid "because this is going to be a political decision, and so your only way forward, if there is one, is to talk to the politicians".[415] When asked by the Committee what political reasons the Government might have for influencing the decision, Lord Levene said "I can only surmise that they were because there was a wish to further the interests of mutuals".[416]

246. Lord King, however, recalls the meeting with Lord Levene very differently. He told the Committee in writing that "I did not instigate that meeting", and that "the purpose of the meeting was for him to update me on—and not for me to relay concerns to him about—NBNK's bid".[417] A minute of the meeting, taken by a Bank official, includes no reference to political interference.[418] The only reference to political discussions relates to concerns over delays in the process:

> The Governor noted that he was, in general, very supportive of introducing more competition into the banking sector. The delay in Lloyds' offloading of branches (regardless of to whom they were sold) was not helping to achieve that broad objective. The Governor would raise the issue with the Chancellor. Lord Levene noted that he had already spoken to the Chancellor, who had directed him to Mark Hoban and Tom Scholar, but he would speak to the Chancellor again.[419]

411 Q 1478

412 Qq 1651-1652

413 Q 1653

414 Q 1661

415 Qq 1664-66, 1673

416 Q 1714

417 Lord King (PV 35) page 1

418 *Ibid.* page 3

419 *Ibid.* page 3

Regarding claims of political interference in the Verde process, Lord King said:

> [A]lthough it seemed to me that the Government wished to ensure that, if it were possible, a plausible bid from the Co-operative Bank was able to be considered alongside other bids, that was a far cry from any improper conduct in the bidding process. Had I received evidence of improper behaviour I would have raised that with the regulator, the Government and, if necessary, Parliament though the Treasury Committee.[420]

Lord Levene subsequently described Lord King's recollection of the meeting as "extraordinary", and said that it bore "little relation to what happened". He added:

> […] I find it quite extraordinary that, having been called in by him, when he wished to explain to me what he regarded as serious political interference with the process, he subsequently has expressed the view to your Committee that that was simply untrue. I would like to place it on record that the former members of the Board of NBNK all accept my account of what happened, as opposed to the Governor's version, and that the account given by the Governor is simply wrong.[421]

Evidence from Lloyds

247. Other witnesses have denied political involvement in Lloyds's Verde decision. António Horta-Osório, Chief Executive of Lloyds, said to the Committee that "I think it is publicly well known that Government Ministers saw favourably the mutual model, and therefore the Co-op, as a destination for Lloyds' branches".[422] But when asked whether the Government had expressed its preference for the mutual, Mr Horta-Osório replied:

> No. Given that we thought at the board unanimously that […] the Co-operative's bid was better, Government Ministers, in those briefings and those conversations, expressed that they liked the mutual model, and that they agreed and saw Co-op as a good destination for Lloyds' branches. But that was given our decision […].[423]

Mr Horta-Osório confirmed explicitly that the Government had not expressed any preference before Co-op was first named preferred bidder in December 2011.[424]

248. Mr Horta-Osório said that "in the course of my duties, I have periodic meetings with the regulators and with civil servants in which, for sure, over the last two years, the subject of the Co-op would have been raised".[425] He also said that in occasional meetings and telephone conversations with Mark Hoban, Financial Secretary to the Treasury at the time of the Verde bids, he discussed Verde among other matters.[426] But Mr Horta-Osório told the Committee that "I do not have any recollection that my exchanges with Government

420 Lord King (PV 35) page 2

421 Lord Levene (PV 40)

422 Q 103

423 Q 104

424 Q 106

425 Q 41

426 Q 91, 41

Ministers or civil servants on this matter have been different from what would be normal on important matters relating to Lloyds, which has a 39 per cent taxpayer stake", and gave assurances that "the board and the executive committee have always acted on the best interests of shareholders".[427] Asked whether he fundamentally disagreed with the suggestion that political pressure played a part in the Verde deal, Mr Horta-Osório replied "Absolutely".[428]

249. Sir Win Bischoff agreed with Mr Horta-Osório. Asked whether it was true that the decision to award Verde to Co-op was made on political rather than commercial grounds, he replied:

> ***Sir Winfried Bischoff:*** No, it is not. What the board looked at was financial and the ability to execute. Those were the only two things that we looked at; no political.
>
> **Chairman:** There was no political pressure.
>
> ***Sir Winfried Bischoff:*** No.[429]

250. The minutes of the Lloyds Banking Group board meetings on 14 December 2011, at which Co-op Bank was first declared preferred bidder, contain no reference to the Government's views nor to any political considerations.[430] The minutes of the meeting on 27 June 2012, when Co-op Bank was awarded preferred-bidder status for the second time, do, however, refer to the Government. The note includes a list of qualitative factors—following a consideration of the commercial terms of the bid—which "suggested that the Co-op's interest was more attractive"; one of these factors was "the views of Government, customers and broader stakeholders in relation to the relative attractiveness of the Co-op's business model".[431]

Evidence from UKFI, Treasury officials and the Government

251. Robin Budenberg, then Chairman of UKFI, confirmed that, when Lloyds was considering the rival bids from NBNK and Co-op, UKFI "met Lloyds and discussed with them their assessment of the relative values of the two options", assessing the bids in terms of "value and certainty".[432] Mr Budenberg was clear, however, that:

> [W]e did not give advice. We listened to what their views were. Had we disagreed with those views, we would have made our views clear, but we did not disagree with those views.[433]

Asked whether UKFI at any stage recommend to the Chairman or Chief Executive of Lloyds that its preferred disposal would be to Co-op rather than to any other bidder, Mr

427 Qq 102, 41

428 Q 47

429 Q 1

430 Lloyds Banking Group (PV 34) pages 9-11

431 *Ibid.* pages 18-19

432 Oral evidence taken on 12 November 2013, HC (2013-14) 824, Qq 49, 51

433 *Ibid.* Q 52

Budenberg said: “No”.[434] Mr Budenberg also confirmed that UKFI did not proffer any advice before the bidding process started or during the bidding process as to who its preferred purchaser might be.[435]

252. Sir Nicholas Macpherson, Permanent Secretary to the Treasury, told the Committee that he was “not aware of any improper behaviour” by politicians with respect to the Verde transaction, and that he would have expected such behaviour to have been brought to his attention. Sir Nicholas also said that he did not recall anyone making allegations of such behaviour to him at any time.[436]

253. In view of the allegations of political involvement in Verde, the Committee wrote to the Chancellor on 26 March 2014 asking whether, at any time, Treasury Ministers or officials brought any pressure to bear on Co-op Bank or Group, or on Lloyds Banking Group, in respect of the sale of the Verde branches.[437] The Committee also decided to take oral evidence from the Chancellor.

254. The Chancellor replied to the Chairman’s letter of 26 March 2014 on 3 April 2014, saying that the Treasury did not apply undue pressure in respect of the Verde sale process, and that:

> We were always very clear both that the commercial decision on the Verde sale was a matter for Lloyds and that the then-regulator the FSA should decide on whether to allow the sale to proceed or not on prudential grounds.[438]

This echoed the Chancellor’s statement in a letter to Lord Levene in May 2013 that:

> The selection of Co-op as preferred bidder by the Lloyds board was purely a commercial decision. It was not taken to further the Government’s objectives to increase competition and to promote mutual in the UK banking sector.[439]

255. The Chancellor admitted that the Government was pleased to see a successful Co-op bid for Verde.[440] Lord Levene ascribed this to a wish on the Government’s part to further the interests of mutuals.[441] The Chancellor expressed a different rationale. He pointed to the recommendation of the Independent Commission on Banking (ICB) that the entity resulting from the Verde divestment should have at least a 6 per cent share of the personal current account (PCA) market. An enlarged Co-op Bank would have met this target, while NBNK, initially, would not. The Chancellor said in his 3 April 2014 letter to the Committee:

434 *Ibid.* Q 46

435 *Ibid.* Q 49

436 Oral evidence taken on 2 September 2014, HC (2014-15) 630, Qq 1-4

437 Letter from Andrew Tyrie MP to the Chancellor, 26 March 2014

438 Chancellor of the Exchequer (PV 36) page 1

439 Lord Levene (PV 17a) page 24

440 Chancellor of the Exchequer (PV 36) page 2

441 Q 1714

> Of course, this meant we were pleased when Lloyds decided to proceed with Co-op—and I said so publicly at the time—but the decision on who to sell to and on what terms was at all times very clearly for Lloyds, as those directly concerned have explained to you.
>
> Given these interests, both Treasury ministers and officials have kept closely in touch with the Verde process from the beginning and continue to do so. And, of course, from time to time we anyway meet and talk to all of the parties concerned on a wide variety of matters.[442]

256. At the time that Co-op Bank was again confirmed by Lloyds as preferred bidder in July 2012, both the Government and the Opposition supported the announcement. The Chancellor commented:

> This is another step towards creating a new banking system for Britain that gives real choice to customers and supports the economy.
>
> The sale of hundreds of Lloyds branches to the Co-operative creates a new challenger bank and promotes mutuals. This [...] represents another important step towards a more competitive banking sector.[443]

The Chancellor also said:

> The British Government has worked very hard to make this deal come about, and we've been on the phones over recent months to try and get these Lloyds branches into the hands of the Co-op, because we want new names on the high street to deliver more choice for customers, to make sure we've got more banks out there offering good deals for people. So we're very happy with this deal, and I think it's a good thing for the British economy.[444]

Chris Leslie MP, Labour Shadow Financial Secretary to the Treasury, also welcomed the announcement of Lloyds's decision in July 2012:

> This is welcome news. We need a thriving mutual sector and more competition in the banking sector to make banks more responsive to their customers.[445]

257. In its June 2012 paper "Banking reform: delivering stability and supporting a sustainable economy", the Government had said that it had "actively engaged with the European Commission and Lloyds Banking Group (LBG) to ensure that the forthcoming divestment of part of LBG's business results in as strong a challenger bank as possible, regardless of the final commercial arrangements LBG arrives at".[446]

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442 Chancellor of the Exchequer (PV 36) page 2

443 "*Lloyds sells 632 branches to Co-op for £1.25bn less than hoped for*", The Daily Telegraph, 19 July 2012

444 *Ibid.*

445 Chris Leslie Press Release, Politics Home, 19 July 2012

446 HM Treasury, *Banking reform: delivering stability and supporting a sustainable recovery*, Cm 8356, June 2012, page 55

258. The Chairman has written to the Chancellor on a number of occasions to secure more details of the contacts between the Treasury and the parties involved in the bidding process. These exchanges were published on 20 August. In his most recent reply, the Chancellor said:

> As I have confirmed in my previous replies, the Treasury—both at Ministerial and official level—was in regular contact with the regulator and Lloyds Banking Group during this period on a wide range of issues including the Verde bid. I can confirm that in addition, we were in regular contact with+ representatives of the Co-operative Bank once their status had been confirmed by Lloyds as the preferred bidder. We also had periodic contact with representatives of NBNK, including Lord Levene, at various points when they were progressing with their bids. […]
>
> The Treasury had a key interest in the Verde transaction, in particular given the state aid implications; and as you would expect, Ministers and officials met with the relevant parties from time to time to monitor progress on the deal. However, as I hope I have made clear, decisions about whether and how to proceed were commercial matters for the parties to the transaction.[447]

In response to a request from the Committee for a comprehensive account of the contacts between the Treasury and the parties involved in the bidding process, the Chancellor stated his intention to hand the full details of the contacts to the independent inquiry into Co-op Bank "at the appropriate time".[448] This is unhelpful.

Political pressure on the regulator?

259. Andrew Bailey confirmed that the Government's goodwill towards Co-op Bank's bid was appreciable at the time that Lloyds announced Co-op Bank's selection, telling the Committee:

> I think if you go back to that time and you look at the reaction to the announcement of the revised Co-op bid and the acceptance of that bid by Lloyds at that time, you see some pretty strong statements by senior politicians about how welcome this is, in public. They are on the record. I do not think it is unreasonable to conclude, therefore, that there was a view that there was some quite strong endorsement of that approach.[449]

260. Mr Bailey, like the Chancellor, suggested that the Government's support for a successful Co-op Bank bid had its origins in the recommendations of the ICB:

> The Independent Commission on Banking, chaired by Sir John Vickers, had come up with specific recommendations on Verde in the context of competition and challenger banks. The Government had accepted those recommendations.

447 Chancellor of the Exchequer (PV 44)

448 Chancellor of the Exchequer (PV 42)

449 Q 1985

> Therefore, I do not think it is unreasonable for the Government to say, "We do have a public interest in this transaction".[450]

Asked whether this had any influence on the FSA's treatment of Co-op's Verde bid, Mr Bailey said:

> It did not cause any change to the conditions that we set out in the letter [setting out the regulators hurdles for Co-op Bank], to be clear. We would not have compromised on any of that list of issues, but I am acutely aware that in those days we had a "have regards to competition" and these days we have a secondary objective in terms of competition. If you do not mind me saying so, I am aware that we have been criticised for not having taken that particularly as seriously as some people think we should have done. […] [W]e were conscious of that and we were conscious that we had to balance our primary objective of safety and soundness with our secondary, in those days, "have regards to" to say, "We should not stand in the way of a challenger bank emerging if it can be done consistent with our primary objective". I think that is a reasonable interpretation.[451]

But Mr Bailey assured us: "nobody leant on me. I can tell you that".[452]

261. In respect of broader Treasury interaction with the regulator, the Chancellor said:

> At all times, both ministers and officials made clear to the FSA that the regulatory decision on whether to allow the Co-op/Verde deal to proceed—and, in particular, the prudential judgement on whether there were financial stability concerns from doing so—was a matter wholly and solely for it. At no point, did the Treasury seek to interfere in those judgements.[453]

Andrew Bailey confirmed that, after taking over as Managing Director of the Prudential Business Unit of the FSA, he met Mark Hoban—then Financial Secretary to the Treasury—at least once a month, but that "Mark Hoban never put me under any pressure in respect of our primary obligations".[454]

262. Andrew Bailey told the Committee that one area on which the FSA and the Treasury had "quite intense discussions" was on the question of whether Co-op Group would, under European law, be designated as a Financial Holding Company in the event that it acquired the Verde branches.[455] This eventuality, the Chancellor said, "threatened to make it impossible for the Co-op Bank to proceed with the completion of the Verde deal".[456] The FSA believed that Co-op Group would need to be so designated under the Banking Consolidation Directive; the Treasury disagreed. Though it did not change its view on the matter, the Chancellor said the FSA considered that "if a 'ring-fence' were to be established

450 Q 1958

451 Q 1988

452 Q 1958

453 Chancellor of the Exchequer (PV 36) pages 2-3

454 Q 1990

455 Q 1989

456 Chancellor of the Exchequer (PV 36) page 2

between Co-op's financial businesses and the wider group, then Co-op Group would not be a Financial Holding Company under the proposed business plan for Verde".[457] No definitive conclusion on the matter was reached, however, since Co-op's bid never reached that stage.[458]

Political pressure on Co-op?

263. Paul Flowers told the Committee that there had been political "goodwill" towards the deal that Co-op was trying to do with Lloyds:

> [T]here were […] interventions at the time of the long process of looking at the Verde deal with Lloyds; Project Mars, as we called it. To my certain knowledge, those included—and I would not say "pressure"; it was mainly a sense of political goodwill behind the process but there were plenty of politicians who wanted the deal to succeed and were willing it on—in the Treasury team at the time, the Treasury minister who kept most in touch with Peter Marks, as the group chief executive, was Mark Hoban. I think he was financial secretary to the Treasury at the time, and he had many, many telephone conversations and meetings with Peter about the process and whether or not there was anything that the Treasury could do to assist that process. It would be fair to say that we also had nods of support from Vince Cable, who was and still is Secretary of State for Business.[459]

As is clear from this statement, however, Mr Flowers did not believe that contact from the Treasury amounted to pressure on Co-op—a statement he repeated on six further occasions.[460] He said explicitly that "[t]here was no interference in process and there was no undue pressure", and also agreed that the discussions between Co-op and the Treasury were not "inappropriate".[461] David Davies recalled a paper to the Co-op Bank board which spoke of "Peter Marks having contact with a Treasury Minister" and referred to the Government's "goodwill" towards the deal.[462] Peter Marks said, however, when asked whether any political pressure was brought to bear to encourage Co-op to bid for the Lloyds branches: "None that I am aware of."[463]

264. Describing NBNK's own experience, Lord Levene said: "At no point do I recall any calls from politicians of any party asking to be kept informed of progress or encouraging NBNK's bid."[464]

265. In a subsequent press interview, Mr Flowers made some allegations that were at odds with his testimony to this Committee. Asked how much pressure Co-op came under with respect to Verde, he said:

457 Chancellor of the Exchequer (PV 36) page 2

458 *Ibid.*

459 Q 760

460 Qq 770, 771, 816, 817, 831, 927

461 Q 771

462 Q 1901

463 Q 276

464 Lord Levene (PV 17) pages 4-5

> Considerable from the present Government, mainly from Conservatives. They wanted a deal. Remember that the Government was, still is, the major shareholder of that bank, because of the structural support that it had needed in 2008. Clearly they wanted a deal that would help them in terms of public finances. They actually said that they were keen on the Co-op becoming a much more significant player with more scale. We would have had about 7 or 8 per cent of the market if this had gone through. And there was pressure certainly from Mark Hoban but I believe and know that that originated much higher up with the Chancellor himself.

Asked what form the pressure took, Mr Flowers said:

> Regular calls, regular checks to see whether or not we were progressing well, and I mean two or three times a week calls from the junior minister. They wanted a deal, and they wanted us to do it. They might say 'no, no' now, but I know that that was what they wanted, and that was the pressure they were applying.[465]

266. Sir Christopher Kelly's review considered whether political pressure was brought to bear in favour of Co-op in the Verde divestment. He concluded:

> [N]o-one to whom I have spoken has provided compelling evidence of pressure from Government Ministers or anyone else for the Verde transaction to take place. Indeed the Regulator was consistent in pointing out the obvious difficulties. The Co-operative Group and Bank were capable of making mistakes without any help.[466]

267. Governments have shown interest in banking sector acquisitions in the past, including the merger of Co-op Bank and Britannia. Mr Flowers told the Committee that there was "considerable parliamentary support for the merger between the Co-operative and Britannia":

> First of all, there was a Private Member's Bill that was put through by the then-Member for Bournemouth East or West, Sir John Butterfill, which was the Private Member's Bill that, first of all, legally enabled two mutuals of different sorts to join together. At that time we were being given considerable nods and winks by those in the Treasury that that was a wise and good thing to happen.[467]

Asked which particular individuals in the Treasury he was referring to, Mr Flowers said "[Ed] Balls, in particular, was very supportive of the whole process."[468] Describing Mr Balls's role in more detail, Mr Flowers said:

> That was at the time of the Britannia merger and particularly in relation to facilitating the process that was put in place under the Private Member's Act, as it became, because the Treasury had to be involved in facilitating that to happen and Ed Balls was the person who assisted us.[469]

465 *Former Co-op Bank chief Paul Flowers says 'I have sinned'*, BBC Newsonline, 25 March 2014

466 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), paragraph 9.42

467 Q 748

468 Q 749

469 Q 757

Mr Flowers added:

> Mr Balls had specific things that he had to lay before Parliament to enable the legislation to become effective. As it happens, he did so because he clearly supported what we were trying to do, and he made it clear that that was the case.[470]

268. Mr Flowers confirmed to the Committee that Co-op Group had made a donation of £50,000 to Mr Balls's office in 2012, to pay "for a particular researcher to assist the Shadow Chancellor in the work that he needed to do, and that we believed to be a legitimate and proper use of resources".[471] Mr Flowers also confirmed that Co-op Group had made donations "to the Co-operative Party and for its work because we had made a judgment that it was useful to have that political linkage and colleagues working with us in the Co-operative Party", and that he believed that "it was important to support the sister party, the Labour Party as well".[472] The record of donations is available in the Annual Reports of the Co-op Group[473] and in the Co-op Party document "About the Party" available on their website.[474] Co-op Group's 2012 annual report and accounts show donations to the Co-operative and Labour parties in that year of over £800,000.[475]

Did Lloyds simply want an IPO?

269. Lord Levene has alleged political involvement in the Verde process in part in order to explain how Co-op Bank came to be awarded the divested branches. He told this Committee:

> Frankly, given everything that has come to light about the Co-op, it is incredible to suggest that nobody in LBG, in Government or in Regulation could have known about or predicted what was to happen—unless of course there was a collective will to push through the Co-op, bid come what may.[476]

270. For anyone unwilling to accept that Lloyds awarded Verde to Co-op on purely commercial grounds, there is at least one other conceivable explanation for the outcome of the auction which would not have required political interference. Asked at the end of his evidence whether an IPO might have been Lloyds's preferred option all along, and whether the conduct of the Verde auction could have been designed to encourage this, Lord Levene replied:

> That is what Mr Hoffman was saying to me all the way through. He said, "Look, they want to do an IPO. This is it". This is all supposition, of course. What better way to ensure there is an IPO with—as we have said—Lloyds' processes, Lloyds' branches, Lloyds' everything else, than to ensure that you get two bids, one of which is not

470 Q 769

471 Q 958

472 Qq 953-954

473 The Co-operative Group, Annual report and accounts

474 The Co-operative Party, *About the party*, accessed 21 August 2014

475 The Co-operative Group, *'Annual Report 2012'*, page 51

476 Lord Levene (PV 19) page 5

> really credible, the other one is pretty credible; take the other one; you get some political assistance with that as well and bingo, oh dear, NBNK has dropped out, the Co-op has collapsed, so I suppose there is nothing else for it, we will just have to do an IPO. That is probably the real answer.[477]

Conclusions

271. **Lord Levene made a number of serious and specific allegations to this Committee. He alleged that there was political interference to the public detriment in the Verde deal, and that this constituted bad faith. He alleged that Lloyds moved the goalposts of the Verde auction to help ensure that Co-op won, and that this also constituted bad faith. Lord Levene further asserted that it was not reasonable for Lloyds to have concluded that Co-op Bank's bid was superior to NBNK's on commercial grounds.**

272. **The Committee concluded that the allegation of political interference was of sufficient concern to require oral testimony from the Chancellor. He assured us that the Government brought no undue pressure to bear on the Verde process. The Committee also heard from António Horta-Osório and Sir Win Bischoff that the Government applied no pressure to Lloyds in respect of the Verde deal. Andrew Bailey told the Committee that the Government had not put the regulator under any pressure in respect of its primary obligations. Peter Marks told the Committee that he was not aware of any pressure being placed on Co-op by the Government to bid for Verde. Robin Budenberg told us that UKFI had not advised Lloyds of any preference for Co-op Bank's bid. Sir Nicholas Macpherson said that he was not aware of any improper behaviour by politicians with respect to the Verde transaction, and that he would have expected such behaviour to have been brought to his attention.**

273. **Lord Levene's central allegation is of political interference in the Verde process, to the public detriment. The Committee heard strong and unambiguous denials from those involved—Lloyds, the regulator, Co-op and the Treasury. It is difficult to think of an explanation that would sustain Lord Levene's allegation, other than that all our witnesses had either suffered a failure of memory or intentionally misled the Committee. The latter explanation would also require witnesses to have similarly misled Sir Christopher Kelly, who found no compelling evidence of political pressure for Verde to go ahead. Furthermore, for their credibility to be maintained, it would presumably require witnesses to have taken a decision to sustain their mendacity during the forthcoming independent inquiry into the events at Co-op Bank. It would also have required the board members of Lloyds Banking Group to have neglected their fiduciary duty to shareholders—by selecting a bidder which, if Lord Levene's allegation is to be believed, was manifestly unsuitable in commercial terms—at huge reputational, professional and personal risk and for no apparent benefit. And it is likely also to have required the chief legal counsels of Lloyds, the Treasury and the regulator to have countenanced Lloyds's proceeding with an inferior bid on the basis of political expediency. The Committee does not consider all this to be plausible. Nor does it consider it likely that such serious and far-reaching impropriety and bad faith as Lord**

477 Q 1744

Levene alleges could have been covered up in several major public and private bodies for over two years following the conclusion of the bidding process.

274. **In his oral evidence to the Committee, Paul Flowers agreed with other witnesses that there had been no political pressure in the Verde process. In response to six further separate questions from the Committee, he confirmed this view. In a subsequent press interview, however, he contradicted this evidence, claiming that Co-op Bank had come under "considerable" pressure from the Government during the bidding process. Given the flatly contradictory nature of his evidence, the Committee does not consider Mr Flowers a reliable witness—on Verde, on the Britannia deal, or on any other matter—and has not taken his evidence into account in any of its conclusions.**

275. **The only relevant evidence that the Committee has heard claiming that there was political interference in the Verde deal has come from Lord Levene. In turn, Lord Levene admitted that the only "hard evidence" he had of political interference came from a conversation with the former Governor of the Bank of England, Lord King, in which Lord King had informed him that Lloyds's Verde decision would be made on political grounds. Lord Levene told the Committee that the Governor had called for this meeting, creating the impression that there was something that the Governor particularly wanted to communicate to Lord Levene. The Committee has investigated these allegations. Lord King has told the Committee, however, that he did not instigate the meeting. Furthermore, Lord King told the Committee that the concerns he expressed in the meeting related only to delays in the divestment process, and not to political involvement in Lloyds's decision. Lord King's recollection of the meeting is supported by a contemporaneous note of the meeting produced by a Bank of England official. Lord Levene continues to dispute Lord King's position, but on the basis of the evidence that it has taken, the Committee is inclined to accept Lord King's version of events.**

276. **The Chancellor agreed that the Government was pleased to see Lloyds proceed with Co-op's Verde bid. This was consistent with the Government's stated policy both to encourage mutual firms and to deliver a challenger bank of the size proposed by the Independent Commission on Banking. Witnesses from Co-op Bank claimed that the Government had expressed its "goodwill" towards the bank's bid. Lloyds agreed that it was "publicly well known" that the Government looked favourably on Co-op's bid—a preference made clear to Lloyds once it had first named Co-op as preferred bidder in December 2011. The regulator was also aware of the Government's support for Co-op Bank's bid. The Committee has seen no evidence, however, that the goodwill expressed by the Government towards Co-op Bank's bid amounted to pressure on any party. Our witnesses have presented us with overwhelming evidence to the contrary, and the Committee therefore rejects Lord Levene's allegation of political interference in the Verde deal.**

277. **The Committee has not had access to the record of the Government's contacts with Co-op Bank and Group, Lloyds Banking Group, the regulator, UKFI and NBNK during the bidding process, which the Chancellor proposes to hand to the independent inquiry into the events at Co-op Bank. While the Committee is satisfied by the unequivocal statements it has received from witnesses that there was no political pressure brought**

to bear in respect of Verde, the record would usefully provide a fuller picture of the Government's precise involvement in the Verde process.

278. **The Committee has considered Lord Levene's allegation that Lloyds 'moved the goalposts' of the Verde process to ensure a Co-op victory. While Lloyds did change the bidding process on a number of occasions, it was reasonable for it to have done so. The changes that were made appear to have been in the interests of Lloyds's shareholders, and to have benefited on different occasions both Co-op Bank and NBNK. Lloyds also changed the package of assets on offer, but this was in response to requests from both bidders, and was advantageous to both. The Committee therefore rejects Lord Levene's allegation.**

279. **The Committee has also considered Lord Levene's allegation that Co-op Bank's Verde bid could not reasonably have been judged superior to NBNK's. Comparison of the Co-op Bank and NBNK bids was clearly a complicated and technical matter. Lloyds had to weigh up a number of competing factors in coming to its decision. Its view of the financial merits of both bids was based on independent professional advice. It knew that there were execution risks with both bids—the regulator had made this clear—and, while Co-op Bank eventually withdrew from the process following the revelation of the capital shortfall, this was not reasonably foreseeable at the time of Lloyds's decision. On the basis of the evidence it has taken, the Committee rejects Lord Levene's allegation that Lloyds was unreasonable in judging Co-op Bank's bid to be superior on commercial grounds at the time of the Verde bidding process.**

280. **Lord Levene himself accepted that political interference might not have been the explanation for Co-op's Verde victory. He told the Committee that a desire from Lloyds to divest Verde through an Initial Public Offering, and to secure this outcome by awarding Verde to a Co-op bid that was likely to collapse, was "probably the real answer". The Committee does not endorse this view of events. But the Committee notes that Lord Levene, the only voice alleging specific improper political involvement in Verde, has concluded that a sufficient explanation for the outcome of the bidding process could reasonably be provided by Lloyds's own commercial objectives.**

7 Events following the collapse of Verde and the emergence of the capital shortfall

281. This section summarises developments involving Co-op Bank and the Lloyds Banking Group divestment since the revelation of Co-op Bank's capital shortfall in June 2013. It also considers whether the case of Co-op Bank provides any lessons for the mutual model.

Recapitalisation and changes to governance

282. Following the revelation of the capital shortfall, significant changes were made to Co-op Bank's governance. A number of new members with considerable banking experience were appointed to the Board from May to October 2013, including a new Chairman, Richard Pym, former Chief Executive of Alliance and Leicester plc, and a new Chief Executive, Niall Booker, formerly of HSBC and with over 30 years' experience in retail and corporate banking. Barry Tootell and Paul Flowers resigned in May and June 2013 respectively. Peter Marks retired in May 2013, as had been previously arranged in 2012. Len Wardle resigned in November 2013. By December 2013, the majority of Co-op Bank's directors who had been in place at the start of the year, including all of those from the Co-op Group board, had resigned.[478] Co-op Group retains the power, however, to appoint two members to the Co-op Bank board.[479]

283. Co-op Bank's new management team set about designing a recapitalisation plan. Initial plans were drawn up in June 2013 and, following lengthy negotiations, a rescue was finally agreed between Co-op Bank, retail investor groups and the regulators in November 2013.[480] The plan, implemented in December 2013, saw large numbers of retail bondholders written down in a 'bail-in', an injection of funds by two large hedge funds, and the group's stake in the bank reduced to 30 per cent.[481] Additional conduct redress losses uncovered in March 2014 required an additional capital injection of £400m by institutional investors in May 2014, which reduced Co-op Group's stake further to 20 per cent.[482]

284. Sir Christopher Kelly's report noted:

> The new management [of Co-op Bank] have taken positive steps towards reforming risk governance, including a reorganisation of reporting lines and some changes in personnel. Several interviewees told the Review that the Bank has been rebuilding the Risk Management function almost from scratch.[483]

478 The Co-operative Bank plc, *'Annual report and accounts 2013'*, pages 33-34

479 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), paragraph 13.35

480 The Co-operative Bank plc, *'The Co-operative Group announces Recapitalisation Plan for The Co-operative Bank'*, 4 November 2013

481 The Co-operative Bank plc, *'Confirmation of scheme sanction'*, 18 December 2013

482 The Co-operative Bank plc, *'Results of Capital Raising'*, 28 May 2014; The Guardian, *'Co-op Group stake in bank expected to shrink to 20% after rescue fundraising'*, 9 May 2014

483 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), paragraph 6.8

And, on Co-op Bank's outdated IT, Sir Christopher said that the new management was "now addressing a number of issues that should have been dealt with some years ago".[484]

285. Co-op Bank's interim financial report for the first half of 2014 showed considerable improvements to the bank's financial position. Compared with the end of 2013, the bank's Common Equity Tier 1 capital ratio rose from 7.2 per cent to 11.5 per cent, and its liquidity position improved.[485] The bank's loss before tax—excluding the effects of the bank's May 2014 capital raising—was £75.8 million, compared to £844.6 million in the first half of 2013.[486]

Lessons for the mutual model?

286. Co-op Bank was not itself a mutual firm. But it was wholly-owned by the mutual Co-operative Group. As such it shared some of the features of its parent. As has been described, it was afflicted by the group's governance structure. And, in common with all mutuals, it had no access to the public equity markets—its only source of capital was retained earnings, either from its own business or from other Co-op businesses via injections from the group.

287. The Committee asked a number of witnesses whether what happened at Co-op Bank reflected a weakness in the mutual model, or weaknesses particular to Co-op Group. Witnesses agreed that the problems in many areas were particular to Co-op. Andrew Bailey told us:

> I think the governance issues were particular to the Co-op, yes. I do not see those sorts of issues in building societies.[487]

Lord Myners also believed that the issues he had uncovered with the wider Co-op Group were "quite specific to the size and complexity of the Co-op".[488] David Anderson did not see "a read-across about the constitutional status", and furthermore felt that the lessons from the case of Co-op Bank "would probably apply to a proprietary bank just as much as they would apply to a mutual".[489] He added:

> I think that in every sector there are businesses that do well and businesses that make mistakes, and I think it is clear that in this case mistakes have been made. I fundamentally disagree with anyone who says that undermines the financial mutual model.[490]

Sir Christopher Kelly prefaced his report by saying:

> My comments on governance should not be interpreted as a criticism of the co-operative model or of co-operative principles and values, for which I have a great

484 *Ibid.* paragraph 14.30

485 The Co-operative Bank plc, *Interim Financial Report 2014*, (21 August 2014), page 7-8

486 *Ibid.* page 9

487 Q 1971

488 Oral evidence taken on 7 May 2014, HC (2013-14) 1265, Q 61

489 Q 1035

490 Q 1034

> deal of respect. It is the particular method of governance adopted by the Co-operative Group and Bank which in my view has manifestly failed, not the cooperative ideal in general. The current governance structure in the Co-operative Group, which dates only from 2001, is not the only way of putting co-operative principles into practice.[491]

288. Indeed most witnesses were supportive of the mutual model in general, and broadly positive about its future. Despite a stinging assessment of Co-op Group's governance and business management over recent years, Lord Myners told us:

> I hope we will see more mutuals and I hope we will see that in financial services and in other areas. It is a wonderful model for energising people and drawing people together around a common purpose.[492]

Peter Marks gave a downbeat assessment of the future of the mutual model in the "high-volume, low-margin" retail banking market, telling the Committee that "[t]he cost of regulation has escalated, as have the cost of capital and the amount of capital that a bank now has to keep in reserve". This meant it was "going to be difficult going forwards for a mutual to be a really serious competitor in the retail banking market".[493] But other witnesses pointed out that mutual financial firms which had stuck to the traditional model had fared well over recent years. David Anderson told us:

> I believe that building societies that have stayed closer to their traditional approach have remained more secure, and I believe that has turned out to be the best model. That is evident from those that now remain societies and from what happened to the societies that demutualised and chose a more leveraged model. […]
>
> I believe that successful mutuals are a big part and an important part of our financial landscape and will continue to be so.[494]

Andrew Bailey agreed:

> Some [building societies] essentially hunkered down—a phrase they tend to use—in this market and said, "This is really not a business that we can prosper in, but we are here for the long run because we are mutuals". I think they can do this because a mutual can exist on a lower rate of return than an institution in the commercial sector. It is shielded in that sense. They took that strategy, and they are here today and doing pretty well.[495]

This contrasts with the example of Britannia, which, as Mr Bailey told us, "expanded [its] lending activities into outside the traditional prime mortgage market that building societies occupied".[496]

491 Sir Christopher Kelly, *'Failings in management and governance'*, (30 April 2014), paragraph 1.6

492 Oral evidence taken on 7 May 2014, HC (2013-14) 1265, Q 61

493 Q 475

494 Qq 1034, 1039

495 Q 1929

496 Q 1927

289. Britannia's expansion outside traditional building society activity came despite its lack of the necessary risk management skills and, crucially, the ability to raise capital. A number of witnesses acknowledged the latter as a key vulnerability of the mutual model. Lord Myners told us:

> [A] conventional PLC can always turn to its shareholders for a rights issue and can always raise more capital. A mutual cannot do that and, therefore, a mutual has to be run very conservatively.[497]

He added that this made it "folly in the extreme for the Co-op even to contemplate acquiring [Verde]".[498] Peter Marks said that Co-op's inability to raise capital had been "a major problem with why the bank is where it is".[499] Mr Bailey agreed that the more generic issues around the position of mutuals were "all to do with the constraints on raising […] core tier 1 capital":

> This comes back to the risks that Britannia and a few others were taking. This restriction on the ability to raise core tier 1 capital inevitably must have an effect on what risks they take and the way in which they manage risk. Those two things must be related.[500]

Mr Bailey noted that the regulator now took a firm's mutual status into account as part of its day-to-day supervision:

> We have a team of supervisors on the building society side who are specialist building society regulators. They do not, on the whole, do commercial banks in the broader sense. What that means is that they do understand many of the particular challenges. We also have what we call a building society source book, which is a somewhat bespoke approach towards supervising building societies.[501]

He also confirmed that this 'source book' was "entirely new" and "brought in after all these experiences".[502]

290. **The problems at Co-op over the last few years are not an indictment of the mutual model. The problems of Co-op were, on the whole, particular to Co-op. Other mutual firms have come through the financial crisis well.**

291. **The inability easily to raise capital is, however, a marked vulnerability in the mutual model. The PRA now claims to take the particular features of mutual firms into account as part of its approach to supervision. This is an important change of approach.**

497 Oral evidence taken on 7 May 2014, HC (2013-14) 1265, Q 46

498 *Ibid.*

499 Q 474

500 Q 1971

501 Q 1972

502 *Ibid.*

The Lloyds divestment

292. Lloyds TSB and HBOS merged at the height of the financial crisis, amid serious concerns that HBOS would collapse without some form of external support. In the event, even this merger proved insufficient—the enlarged banking group required an injection of £20.5 billion in taxpayer funds.

293. The merger of these two already-large banking institutions resulted in a significant concentration in the UK banking market. In response to the state aid, the Verde divestment aimed to remove the resulting competitive distortions and inject some competition back into the market.

294. In its final report in September 2011, the ICB had recommended that, to have the "best possible chance of becoming a strong, effective challenger", the entity resulting from the divestment should have at least a 6 per cent share of the personal current account (PCA) market.[503] The ICB's final report set out the reasons behind this:

> [T]he entity resulting from the divestiture will […] need to be large enough to exert a competitive constraint on the large incumbents. Evidence from the previous decade shows that small banks (below 5 per cent PCA market share) on average have grown only slowly, with an average annual growth in market share of 0.07 per cent. Banks with a PCA market share of between 5 per cent and 12 per cent, by contrast, grew significantly more quickly, with an average annual growth in market share of 0.34 per cent (although given the relatively small number of challengers, this number is drawn from a small sample). […] With a PCA market share of 4.6 per cent, Verde is on the borderline of sub-scale banks that have failed to grow significantly in the past, and is smaller than most previous challengers over the past decade as measured by PCA market share.
>
> A larger entity would benefit from greater economies of scale, giving it lower cost which could be passed on to customers in the form of better prices. […]
>
> In addition, there is a significant risk that Verde's market share will fall further as it may suffer customer attrition from the divestiture process. […]
>
> Given these factors, there is a real danger that Verde will fall back into the range of small banks that have not exerted a strong competitive constraint in the past, if it remains at its current size.[504]

295. The collapse of Co-op Bank's bid for the Verde branches dealt a blow to this ambition: the combination of Verde and Co-op Bank would have met the 6 per cent target—creating an institution with almost 7 per cent of the PCA market—whereas Verde alone did not.[505] Following Co-op Bank's withdrawal from the process, Lloyds announced that it would embark on its fallback option of an IPO:

503 Independent Commission on Banking, *'Final Report'*, September 2011, paragraph 8.25

504 Independent Commission on Banking, *'Final Report'*, September 2011, paragraphs 8.22-8.25

505 The Co-operative Group, *'Lloyds Banking Group Announcement'*, 19 July 2012; Q 1982

> The Group now intends to divest Verde through an Initial Public Offering (IPO), having maintained this option throughout the process in order to ensure best value for our shareholders and certainty for our customers and colleagues. [...]
>
> The Group continues to make good progress in the creation of Verde as a stand-alone bank. A strong management team is in place and we have made good progress in creating segregated IT systems on the proven Lloyds Banking Group platform and in building the necessary corporate functions to support front-office colleagues, branches and operational sites.
>
> Detailed plans are in place for a rebranding of the business as TSB which will be visible on the High Street during the summer of this year, at which point the TSB Bank (Verde) will operate as a separate business within Lloyds Banking Group.[506]

296. The relevant Lloyds branches were rebranded as TSB on 9 September 2013, and the first tranche of shares was issued in an IPO on 20 June 2014.[507] But, as at June 2014, TSB had only a 4.2 per cent share of the PCA market, still some way short of the 6 per cent the ICB recommended.[508] Moreover, TSB does not expect to reach the 6 per cent target for four to five years.[509] In July 2014, the Competition and Markets Authority (CMA) concluded that:

> TSB has a relatively small size and it is unclear at this stage what its overall impact on competition will be.[510]

297. The Parliamentary Commission on Banking Standards published its final report in June 2013, two months after the collapse of the Verde divestment. The planned divestment of a number of RBS branches to Santander UK had also collapsed in October 2012.[511] The Commission concluded in its final report:

> Regardless of whether these divestments can be put back on track, it looks increasingly unlikely that a significant new challenger bank will soon emerge from them. Additionally, given the delays in the divestments—which now most likely will take until at least 2014 to be completed—it will not be possible to assess whether they have fundamentally altered competition in the sector until 2017 or 2018 at the earliest.[512]

The Commission suggested a number of steps that should be taken in addition to the divestments to increase competition in the UK banking market, including:

- That the PRA be given a secondary statutory objective to lessen the risk that it might neglect competition considerations. This was a concern given the potential for

506 Lloyds Banking Group, *'Lloyds Banking Group update on EC mandated business disposal (Project Verde)'*, 24 April 2013

507 Lloyds Banking Group, '*TSB Banking Group plc IPO: Announcement of Offer Price*', 20 June 2014

508 TSB Banking Group plc, *'Results for the six months to 30 June 2014'*, page 4

509 Reuters, *'Lloyds Bank launches TSB share sale to create new UK lender'*, 27 May 2014

510 Competition and Markets Authority, *'Personal Current Accounts Market Study Update'*, paragraph 2.22

511 Financial Times, *'Santander pulls the plug on RBS deal'*, 12 October 2012

512 Parliamentary Commission on Banking Standards, '*Changing banking for good*', HC 175-I, paragraph 66

prudential requirements to act as a barrier to entry and to distort competition between large incumbent firms and new entrants.[513] The PRA was subsequently granted such an objective in the Financial Services (Banking Reform) Act 2013.[514]

- That the FCA commit to embedding a robust pro-competition culture within itself, which looked to competition as "a primary mechanism to improve standards and consumer outcomes". The FCA expressed its commitment to this aim.[515]
- That the FCA consult on a requirement to publish a range of statistical measures to enable consumers to judge the quality of service and price transparency provided by different banks.[516] The FCA agreed to publish a call for evidence inviting ideas on potential indicators of firm and product quality, before deciding which indicators to take forward.[517]
- That the Competition and Markets Authority (CMA) carry out a market study of the retail and SME banking sector. This study was to be completed on a timetable consistent with making a market investigation reference in respect of the UK banking market, should the CMA so decide, before the end of 2015.[518] In July 2014, the CMA announced its provisional conclusions: that the SME and PCA markets did not appear to be functioning in the way it would expect of effective competitive markets, leading to poorer outcomes for customers and the wider economy. On this basis, the CMA's provisional decision was that a market investigation reference should be made in respect of both sectors. Following consultation, it will announce its final decision later this year.[519]

298. The Commission also welcomed the revised approach to authorising new entrant banks, announced by the FSA in March 2013, and adopted by its successor regulators thereafter. These reforms would ensure that the PRA would require start-up banks to hold proportionately less capital than major incumbents, that automatic new bank liquidity requirement premiums would no longer be enforced, and that capital requirements for rapidly growing new banks would rise gradually, so that they would not be required to operate on the same basis as incumbent firms for three to five years. The Commission considered these reforms "a long overdue correction of the bias against market entrants, who are, at least initially, unlikely to be of systemic importance".[520] The Commission concluded, however, that the implementation of these reforms would require careful

513 *Ibid.* paragraph 212

514 Financial Services (Banking Reform) Act 2013, Section 130

515 Parliamentary Commission on Banking Standards, '*Changing banking for good*', HC 175-I, paragraph 214

516 *Ibid.* paragraph 70

517 Financial Conduct Authority, *'The FCA's response to the Parliamentary Commission on Banking Standards'*, October 2013, page 33

518 Parliamentary Commission on Banking Standards, '*Changing banking for good*', HC 175-I, paragraph 68

519 Competition and Markets Authority, *'Personal current accounts and small business banking not working well for customers'*, 18 July 2014

520 Parliamentary Commission on Banking Standards, '*Changing banking for good*', HC 175-I, paragraph 51

monitoring, and that "the regulator should report to Parliament on progress in two years' time".[521]

299. The FSA's barriers to entry review in March 2013 noted that 39 new banks had been authorised by the FSA between 2006 and 2012.[522] A review by the PRA and FCA in July 2014 on the effect of the barriers to entry reforms reported:

> In the twelve months following the changes, the PRA authorised five new banks and there has been a substantial increase in the number of firms discussing the possibility of becoming a bank with the regulators. In the twelve months to 31 March 2014 the regulators held pre-application meetings with over 25 potential applicants. These firms have a range of different business models from retail and wholesale banking to FCA-regulated Payment Services firms who are looking to enter the banking market and offer deposits and lending to their current client base (including small SMEs) and others who are proposing to offer a mixture of SME or mortgage lending funded by retail and SME deposits.
>
> The review found that the new 'mobilisation' option (where authorisation is granted when a firm has met key essential elements but with a restriction on their activities due to some areas still requiring completion) has been helpful for applicant firms that may previously have faced challenges in raising capital or investing in expensive IT systems without the certainty of being authorised. In the twelve months to 31 March 2014, three of the five newly authorised banks used the mobilisation option, and a number of firms in the pre-application stage have also shown an interest in this route.
>
> Capital and liquidity requirements for new entrants are now lower than before, but are set against a requirement for a firm to show the regulators that it has a clear recovery and resolution plan in place in the event of it getting into difficulty in the future. These changes are a real reduction in the barriers to entry, and now mean that the minimum amount of initial capital required by a new entrant bank is £1m compared to £5m under the previous regime.[523]

300. **One of the most significant consequences of Co-op Bank's near-collapse, from a public policy perspective, was the collapse of Lloyds Banking Group's planned divestment. Co-op Bank's withdrawal forced Lloyds to resort to its fallback option of an Initial Public Offering. The result is a new bank—TSB—which, not having an existing banking presence of its own, consists solely of the business divested by Lloyds. Accordingly, it has a personal current account market share not of 7 per cent, but of 4.2 per cent. There is a risk that a bank of this size might struggle to grow significantly and to act as a true challenger in the market. This is not a judgement on TSB or its management, but reflects an observation of the Independent Commission on Banking**

521 *Ibid*. paragraph 52

522 Financial Services Authority, '*A review of requirements for firms entering into or expanding in the banking sector*', March 2013, Annex 2, pages 1-2

523 Prudential Regulation Authority, *'News Release - Prudential Regulation Authority and Financial Conduct Authority publish review of barriers to entry for new banks'*, 7 July 2014

that the entity resulting from Verde should have a market share of at least 6 per cent to have the best chance of becoming an effective challenger bank.

301. **The Verde divestment alone was never likely to be enough to inject sufficient competition into the UK banking market, which is the best way of improving consumer outcomes. The Treasury Committee, repeatedly, and also the Parliamentary Commission on Banking Standards, have both advocated measures to increase competition.**

302. **The Committee welcomes the news that there has been a substantial recent increase in the number of firms discussing the possibility of becoming a bank with the regulators. However, we have yet to see an increase in the number of new entrants. The regulators will report to Parliament on progress in a year's time.**

8 Questions for future reviews

303. **In this report, we have set out a number of areas that future reviews should examine further. In summary, the Financial Reporting Council's investigation into the preparation, approval and audit of the financial statements of Co-op Bank should consider:**

a) How Co-op Bank's approach to recording impairments differed to that of other banks up until the end of 2012;

b) Why KPMG apparently failed to uncover Co-op Bank's particular approach to recording impairments;

c) Whether KPMG paid particular attention to assets acquired in the Britannia merger in its annual audits from 2009 onwards, given the incomplete due diligence it performed on them;

d) Whether the accounting treatment used to record the costs for Co-op Bank's banking IT platform upgrade was appropriate, given the delayed effect it had on Co-op Bank's regulatory capital.

The independent inquiry into events at Co-op Bank and the circumstances surrounding them should consider:

e) Whether the FSA could or should have developed superior stress-testing tools sooner than it did;

f) Whether superior stress-testing tools would have led to Co-op Bank's loan impairments being discovered sooner;

g) Whether Co-op Bank's impairment profile—which appeared to differ from that of other banks throughout the financial crisis—should have led the regulator to inspect it more closely prior to 2012;

h) Why the FSA's analysis on the Britannia merger failed properly to account for the prudential risks attached to the Britannia assets that have since been uncovered by the PRA;

i) Whether the work provided by KPMG and JPMC on the Britannia merger met a reasonable standard, in substance as well as form;

j) Whether the FSA was made aware of the change made by Co-op Bank to the accounting treatment for its IT platform replacement programme in 2010, and whether the FSA should have foreseen and acted on its consequences—that is, delaying the effect of the IT programme on the bank's regulatory capital;

k) Whether—given the conclusions of the independent inquiry on the forgoing points and the FRC's investigation on the late emergence of Co-op Bank's capital shortfall—Co-op Bank's Verde bid could or should have been halted sooner;

l) What, if anything, further can be learnt from the record of the Government's contacts with Co-op Bank and Group, Lloyds Banking Group, the regulator, UKFI and NBNK during the Verde bidding process.

Conclusions and recommendations

Bidding for Verde

1. From the start of the Verde process in 2011, the FSA was sceptical of Co-op Bank's ability to take the transformational step represented by the acquisition of the Verde branches. The FSA's concerns spanned almost every material aspect of Co-op Bank's business: its liquidity and risk management framework; its integration strategy; its governance framework; its senior executive management team; and its capital plan. Co-op Bank took steps to address some of these concerns. But the FSA remained unsatisfied on a number of points, and even after Co-op Bank signed Heads of Terms in July 2012, the regulator expressed disquiet about Co-op's governance, its integration plan, and its prospective financial soundness. (Paragraph 77)

2. Neville Richardson, the bank's former Chief Executive, warned at the start of the process in mid-2011 of the management burden that the Verde transaction could pose. Co-op Bank's Deputy Chairmen had doubts about the commercial sense of the transaction: whether Co-op possessed the necessary resources and competence to compete in banking as well as other markets, and whether the economic outlook and future regulatory capital pressures might make the deal less attractive. Following a significant costing error in the bank's IT replacement programme, both Deputy Chairmen also began to doubt whether Co-op Bank was even capable of completing the integration with Verde. (Paragraph 78)

3. However, it was not clear at the time that the numerous and varied challenges facing Co-op Bank's bid were insurmountable. Despite knowing the FSA's views on the difficulties that Co-op faced, Lloyds chose to pursue a deal with Co-op Bank, both in the December 2011 and the June 2012 rounds of bidding. Co-op Bank's Deputy Chairmen, though they had doubts about the transaction, did not recommend to the regulator in their exit interviews that the deal be stopped. Neville Richardson similarly wanted Verde to go ahead, with the proviso—made clear in the script of his conversation with Peter Marks and others in July 2011—that other projects should be implemented more slowly. Notwithstanding its own deep misgivings, the FSA did not instruct Co-op to call off its pursuit of Verde. Instead, it afforded the bank the opportunity to address its concerns. (Paragraph 79)

4. By setting out strict conditions that Co-op Bank would need to meet for the deal to go ahead, the FSA permitted Co-op Bank to take its own commercial decision without the regulator's statutory objectives for financial stability and consumer protection being put at risk. While there remained any reasonable prospect that Co-op Bank might be able to meet these conditions, it was appropriate for the FSA to allow the deal to progress. (Paragraph 80)

5. The evidence that the Committee has heard does not, however, give cause for great confidence that the management of Co-op Bank in place throughout the bidding process would ultimately have satisfied the regulatory hurdles for Verde to go ahead. It is doubtful that this management team—which had not been successful in completing the integration with Britannia—could have convinced the regulator of its

ability to integrate Verde. Furthermore, the regulator's warnings about Verde, while clearly intended to be forthright, do not seem to have been properly understood by Co-op Bank: Sir Christopher Kelly concluded that the bank did not interpret the FSA's concerns as "the warnings they were undoubtedly intended to be". Peter Marks, group Chief Executive, erroneously described the FSA's concerns to the Committee as things that Verde could have solved, rather than things that Co-op would need to have addressed before Verde could go ahead. It would have been crucial for Co-op Bank to have met the regulator's demand for a "permanent and suitable management team", were Verde to have proceeded. (Paragraph 81)

The financial collapse of the Co-operative Bank

6. A very significant factor in Co-op Bank's financial collapse was the emergence of substantial impairments on loans over 2012 and 2013, primarily in its commercial real estate book. The majority of these loan impairments—around £550 million—relate to assets acquired through the Britannia merger. Impairments of well over £400 million have also arisen on assets originated by Co-op Bank itself. (Paragraph 124)

7. Attempts have been made to paint Co-op Bank's impairment losses as the result of a shift in the regulatory goalposts. The Committee does not agree. The PRA's capital exercise applied to a number of banks, and only Co-op Bank was so badly affected. Co-op Bank's impairment losses were primarily the result of its own, and Britannia's own, poor-quality lending. The late emergence of these losses appears to have been due to Co-op Bank's comparatively "loose" approach to recording impairments, which was uncovered only once the FSA began its capital exercise in late 2012. (Paragraph 125)

8. Co-op Bank's approach to recording its impairments in the years running up to 2013 was described by Andrew Bailey as "looser" than the rest of the industry. This should have been clear to Co-op Bank's management—to all those responsible for risk and accounting, including the board, relevant executives and committees. It should also have been apparent to Co-op Bank's auditor—KPMG—and to the regulator—for the period in question, the FSA. (Paragraph 126)

9. The Committee is surprised that, in spite of the evidence it has heard, Co-op Bank's former auditors, KPMG, maintain that Co-op Bank was not an outlier in terms of its impairments. The FRC's inquiry into the approval and audit of Co-op Bank's financial statements should determine precisely how Co-op Bank's approach to recording impairments differed to that of other banks, and why KPMG apparently failed to uncover this. The independent inquiry into events at Co-op Bank should also look closely at the shortcomings of the bank's auditor, KPMG, and its apparent failure to ascertain the extent of the impairments. In so doing, the inquiry should look to see if any shortcomings are unique to the KPMG relationship with Co-op. (Paragraph 127)

10. The PRA—the FSA's successor body as prudential regulator—admits that, with better supervisory tools, Co-op Bank's problems would have been uncovered by the FSA sooner. It was the development of these tools—as part of the transition to the new approach to regulation in which the FSA and now the PRA have been engaged—that led to Co-op Bank's impairment losses being revealed. The independent inquiry into the events at Co-op Bank should consider whether the FSA could or should have developed better supervisory tools earlier, and hence uncovered Co-op Bank's impairments sooner. The inquiry should also consider whether Co-op Bank's impairment profile—which appears to have differed from that of other banks throughout the financial crisis—should have led the regulator to inspect it more closely prior to 2012. (Paragraph 128)

11. Notwithstanding any shortcomings in the respective oversight roles played by the auditor and the regulator that may be uncovered by the other inquiries, banks—in this case the Co-op Bank—bear primary responsibility for their own prudent management. (Paragraph 129)

12. The losses emanating from Britannia stemmed predominantly from its commercial loan book. The due diligence performed on this book has proved to have been totally inadequate. KPMG's initial due diligence was based on incomplete information. Further due diligence, which KPMG recommended be performed, was carried out by Co-op Bank itself. Co-op Bank's work has been described by Sir Christopher Kelly as "cursory" and "limited". The provisions against future losses, made on the basis of the due diligence, were far too low. (Paragraph 130)

13. The Committee is surprised that the additional due diligence—a crucial piece of work—was allowed to be performed to such a low standard. KPMG should have given clear guidance to Co-op Bank about the standard required. The Committee is also surprised that, despite recommending the additional due diligence, KPMG did not scrutinise it once complete. If KPMG considered it outside its remit to examine Co-op Bank's own due diligence, it could still have given particular attention to the inherited Britannia assets in future annual audits; the FRC investigation should examine whether or not KPMG did so. (Paragraph 131)

14. Given the evidence it has heard, the Committee is very surprised by JPMC's statement to the Co-op Bank board at the time of the merger that the Britannia due diligence "exceeded that normally undertaken for listed companies". This is not reassuring about the typical quality of professional advisory work, particularly given the substantial sums often involved—KPMG and JPMC received £1.3 million and £7 million—and the important advice and guidance they provided on the Britannia transaction. The Committee expects the independent inquiry into the events at Co-op Bank to examine whether the work provided by KPMG and JPMC met a reasonable standard, in substance as well as form. (Paragraph 132)

15. The FSA performed its own analysis of the Britannia acquisition at the time of the merger in 2009. This projected that, under stressed conditions, the combined entity's Core Tier 1 capital ratio could fall to 4.3 percent, marginally above the regulatory minimum of 4 per cent in place at the time. Co-op Bank's losses up to June 2013 reduced its capital ratio to 4.9 per cent—roughly the level the FSA had projected. But the capital shortfall revealed by the PRA reflected not just actual losses, but also the vulnerability of the Britannia assets to future impairment. It is not clear that the FSA's analysis on the merger took this additional risk into account. The independent inquiry into the events at Co-op Bank should examine why the FSA apparently failed to account for the prudential risks of the Britannia merger that have since materialised. (Paragraph 133)

16. Co-op Bank sought the merger with Britannia in part because of the latter's large network of branches. But—as was clear from the work of the external advisors at the time—the merger also brought an immediate dilution of Co-op members' interests in terms of net assets, profits and dividends, as well as an exposure to higher-risk lending and an increased reliance on wholesale funding. Even without the benefit of hindsight, therefore, it is clear that the merger with Britannia exposed Co-op Bank to considerable new risks yet carried comparatively modest benefits. The commercial judgement behind the decision to proceed with the transaction, made by Co-op Bank on the basis of advice from JP Morgan Cazenove, appears questionable. (Paragraph 134)

17. Andrew Bailey has said that Britannia would have failed had it not merged with Co-op Bank in 2009. The former management of Britannia rejects this, saying that the merger was not a rescue. There is no way to know for certain what would have transpired without the merger, but the evidence appears to support Mr Bailey's view. In particular, the impairments of £550 million now evident from Britannia would probably have been large enough to bring it down as a standalone firm, given the size of its Tier 1 capital base at merger and the capital requirements in place even in 2008. In addition, without the prospect of the merger, Britannia might well have found it difficult to fund itself had the problems with its balance sheet been perceived. (Paragraph 135)

18. Co-op Bank's impairments are as yet only provisions, and not cash write-offs. The distressed loans might yet perform better than expected. But impairments can only be made when there is evidence of a permanent loss of value—a loss which is expected to be made unless conditions improve. The possibility of better performance in no way detracts from the seriousness of the impairments and their effect on the balance sheet. Statements by the former management of Britannia, drawing a distinction between impaired lending and cash write-offs, suggest that they continue to deny the seriousness of the impairments. They should instead accept responsibility for originating the distressed assets. (Paragraph 136)

19. Co-op Bank's consumer redress losses are large and damaging for an institution of its size. Combined with its other losses, they pushed Co-op Bank to the brink. Co-op Bank is not alone in having to set aside large sums to pay for past misconduct. However, such misconduct is particularly unacceptable in a bank that trades on its ethical character. (Paragraph 141)

20. Co-op Bank's banking IT system had been in need of replacement for many years. The prospective acquisition of Verde only made this need more acute. But the bank, through a combination of over-ambition and poor management, failed to deliver a replacement. Following over five years of delays and cost increases, the programme was cancelled, leaving the bank with its original platform still in place and a £300 million deduction from its capital. (Paragraph 153)

21. There are signs that difficulties with the programme were accentuated by the Britannia merger and the Verde deal. But the evidence suggests that these deals did not cause the problem: the root cause was a management team incapable both of delivering the necessary IT transformation and of realising its own limitations. (Paragraph 154)

22. While it had no effect on the extent of the write-off, the accounting treatment that Co-op Bank adopted for the IT programme had a significant influence on the timing of the impact on the bank's capital position. One method of accounting—funding the programme directly through the bank—would have ensured that the costs of the programme were deducted from Co-op Bank's capital position as they were incurred. The method adopted—financing the programme through a service company owned by the bank—meant that the full cost was recorded over a six month period as the programme was paused and then cancelled. The FRC should consider as part of its investigation whether this accounting treatment was appropriate. The independent inquiry into the events at Co-op Bank should establish whether this accounting treatment was brought to the attention of the FSA, and whether the FSA should have foreseen and acted on its consequences. (Paragraph 155)

23. A combination of financial losses and increased regulatory capital requirements together led Co-op Bank to develop a significant capital shortfall. Co-op Bank's loan impairment losses, IT write-offs and conduct redress costs caused a serious depletion of its capital resources. While regulatory adjustments applied to all banks, the increased capital requirements on Co-op Bank were particularly large. This reflected weaknesses particular to Co-op Bank—the vulnerability of its Britannia loanbook to future impairment, high concentration risk in its corporate lending and a poor operational risk framework. (Paragraph 166)

24. The collapse in Co-op Bank's financial position prompted its withdrawal from the Verde transaction. Explaining its withdrawal from the process in April 2013, Co-op Bank spoke obliquely of "the impact of the current economic environment, the worsened outlook for economic growth and the increasing regulatory requirements on the financial services sector in general". However, Co-op Bank's former Chief Executive, Barry Tootell, gave a franker admission: he told the Committee clearly that he recommended to Co-op Bank's board, and to group Chief Executive Peter Marks, that Co-op should not pursue the transaction because it lacked the capital strength to do so. (Paragraph 167)

25. There is reason to think that the frailty of Co-op Bank's capital position could have been discovered sooner—specifically, if the bank had monitored its loan book and its treatment of customers more effectively, and if it had accounted for its banking IT programme in a different way. Had Co-op Bank's resulting capital shortfall been uncovered earlier, it is likely that the bank would not have progressed so far with Verde. As it was, the rapid and late emergence of the capital problem led to Co-op's withdrawal from the Verde process at a relatively late stage. The Committee recommends in paragraphs 127, 128 and 155 that the FRC investigation and the independent inquiry into the events at Co-op Bank consider the role of KPMG and the FSA in relation to the late emergence of loan impairment and IT losses. On the basis of these findings, the independent inquiry into the events at Co-op Bank should also form a view on whether Co-op's Verde bid could or should have been halted sooner. (Paragraph 168)

26. Once Co-op Bank's capital shortfall became clear in January 2013, the bank might have been expected to withdraw immediately from the Verde deal. The Committee shares Sir Christopher Kelly's surprise that it did not—instead, Co-op persevered with the deal until late April. It may be that Co-op Bank had confidence that 'Project Pennine'—a plan to bolster Co-op Bank's capital position through disposal of assets—would put it back on a secure financial footing; if so, this confidence proved to be misplaced. (Paragraph 169)

27. The board and management of Britannia are responsible for having originated the majority of Co-op Bank's distressed assets, as well as assets against which Co-op Bank has been forced to hold substantial protective capital. Co-op Bank itself is responsible in a number of other respects, including its inadequate due diligence on the Britannia merger. Co-op Bank originated loans which have suffered impairment. Legacy conduct issues relate predominantly to past actions by Co-op Bank. Responsibility for the mismanagement of Co-op's banking IT platform upgrade, while complicated by the Britannia merger, lies squarely with Co-op Bank. The former board and management of Co-op Bank and Britannia bear primary responsibility for the bank's resulting financial crisis. (Paragraph 170)

Governance

28. Co-op Bank's governance structure up to the middle of 2013 was entirely inadequate for a bank of any size; it is shocking that it was in place in an institution that came so close to becoming a major new challenger bank. Co-op Bank's board was dominated by members from the parent group who lacked financial services experience. Those members with financial services experience were responsible for overseeing a very broad range of business. Being small in number, their expertise was spread too thinly, and ran the risk of being over-ruled by possibly well-meaning, but inexperienced, democratic members of the board. Yet, at least from 2009 to 2011, the board was also too large and unwieldy to allow for meaningful discussion and debate. The executive was also subject to influence from Co-op Group, with the bank's Chief Executive in a direct reporting line to the group's Chief Executive from 2011. (Paragraph 203)

29. There was a place for representation of Co-op Group on the bank board. As sole shareholder, the group's views needed to be heard. But this should not have come at the expense of the experience necessary to run the bank. Indeed, in the context of a controlling interest in the bank, the Group's board structure and inexperience should have been of more concern to the regulator than it apparently was. (Paragraph 204)

30. The deficient composition of Co-op Bank's governance was embodied in Paul Flowers, who lacked any of the requisite financial services experience to act as Chairman of a bank. In this regard he appointed two experienced Deputy Chairmen to strengthen the advice to him and the board. Mr Flowers was appointed on the basis that he would be able to navigate the 'politics' of Co-op Group and chair the board. We took evidence that he had performed these functions well. But this was an inappropriate basis for his appointment. An effective bank Chairman should usually possess a good deal of experience of financial services. He or she should be at least capable of understanding financial issues. Mr Flowers lacked both the desirable experience and the minimum essential skills. He should not have put himself forward for the role. Co-op should not have selected him. The regulator should not have permitted his appointment. (Paragraph 205)

31. Clive Adamson and Andrew Bailey have said that an individual with as little financial experience as Mr Flowers would not be appointed as Chairman of a bank today. That he was allowed to perform the role at all is further proof, if it were needed, of the inadequacy of the Approved Persons Regime. This regime, in principle the means by which the regulator can ensure that those who run banks have the requisite expertise, is in practice a narrow box-ticking exercise. It operates mostly as an initial gateway, providing very little subsequent oversight of those at the most senior levels in banks. The new Senior Managers Regime—recommended by the Parliamentary Commission on Banking Standards, given statutory underpinning by the Government and now being consulted on by the regulators—seeks to address these deficiencies. Properly implemented, the regime provides a better prospect that the most senior individuals will have sufficient financial expertise to perform their roles effectively, or at least have the capacity to understand the questions put before them and to ask some of their own. (Paragraph 206)

32. While the Approved Persons Regime will be abolished for the banking industry, it will be retained for many in the remainder of the financial services industry, including insurance and asset management. Given its manifest failings, this appears hard to justify. Clive Adamson, Director of Supervision at the FCA, appeared in oral evidence to agree with this view. The Government and the regulators should at the earliest opportunity make proposals to extend the coverage of the Senior Managers and Certification Regimes to, and remove the application of the Approved Persons Regime from, other parts of the financial services industry. (Paragraph 207)

33. Co-op's governance was not the source of all the bank's problems. The bank was also hampered by an ineffective executive team. Failures of risk management within the bank itself are to blame for taking on and obscuring excessive risk. But defective executive management can only persist if there is ineffective board oversight. The bank's board was incapable of providing the necessary guidance and challenge to the executive. (Paragraph 208)

34. All boards make mistakes, and take decisions that, in retrospect, they should not have taken and which may incur large losses. But the previous governance of Co-op Bank—in its structure and its composition—seems to have invited the risk of failure, whether in the decision to merge with Britannia, in the failure to uncover the bank's impairments, or in the failure to act decisively on the regulator's warnings about the Verde deal. What's more, the previous management of Co-op Bank presided over the bank's prudential and conduct failures while presenting customers with the façade of a prudent and ethical business. (Paragraph 209)

35. Evidence heard and seen by the Committee during this inquiry paints a picture of specific, serious governance failings at the Co-op which contributed to the losses in the bank. In pointing out these governance failings the Committee is mindful that other financial institutions with more conventional PLC boards also collapsed in recent years at huge cost to the taxpayer. (Paragraph 210)

36. Rodney Baker-Bates and David Davies, Co-op Bank's two Deputy Chairmen, opted to resign from the bank's board because they dissented on Verde. In the circumstances, they took an honourable course. However, board members should not always feel obliged to resign merely because they disagree with a major business decision or transaction. Resignation can deprive a board of valuable skills and experience. But there may be circumstances in which there is no alternative to resignation. Such circumstances may include non-executives believing that the firm's future is endangered by the board's failure to heed their warnings, or senior board members obstructing constructive criticism. The FRC should examine whether there is value in providing guidance in the UK Corporate Governance Code on the circumstances that might call for a board member to resign, and the factors that board members should take into account when making their decision. (Paragraph 211)

37. Peter Marks has been identified by our witnesses as the driving force behind Co-op's Verde bid. He appeared to lack any of the financial services experience that would warrant such a role. He also lacked the necessary regulatory approval, being approved only as a non-executive yet appearing to have acted in a de facto executive capacity. Barry Tootell claims to have had responsibility for the Verde deal as bank Chief Executive, but other witnesses have described Mr Marks as leading the negotiations, and were clear that Verde was a group-led project. (Paragraph 212)

38. The Committee has heard that Verde would not have gone ahead unless the bank had approved it. But the group's dominance on the bank board and the apparently cursory engagement of the experienced board members on the detailed Verde negotiations made credible dissent unlikely. Moreover, what disagreement there was—from the bank's two Deputy Chairmen—appears to have been forgotten or ignored by Peter Marks, who told the Committee that Verde at all times had the unanimous support of the bank board. Rodney Baker-Bates also described Peter Marks, Len Wardle and Paul Flowers as being "deaf" to objective risk analysis of the deal. This was scarcely the way for a bank to consider a major acquisition. (Paragraph 213)

39. Earlier in this Report, the Committee concluded that the management of Co-op Bank in place during the Verde bidding process was unlikely to have been able to address the regulator's concerns about the bid. This same management, and all those in Co-op Bank's management since the Britannia merger, bear some responsibility for the manner in which the deal ultimately collapsed. Co-op Bank should have come to terms sooner with the risks it was running; having done so, it might have decided not to pursue Verde. As it was, the leadership of Co-op Bank proved incapable of appreciating and addressing the problems in the bank, and the Verde deal was allowed to continue, driven by the enthusiasm of a small number of Co-op

Group members, until Co-op Bank's capital shortfall finally emerged. (Paragraph 214)

Was the bidding process fair?

40. Lord Levene made a number of serious and specific allegations to this Committee. He alleged that there was political interference to the public detriment in the Verde deal, and that this constituted bad faith. He alleged that Lloyds moved the goalposts of the Verde auction to help ensure that Co-op won, and that this also constituted bad faith. Lord Levene further asserted that it was not reasonable for Lloyds to have concluded that Co-op Bank's bid was superior to NBNK's on commercial grounds. (Paragraph 271)

41. The Committee concluded that the allegation of political interference was of sufficient concern to require oral testimony from the Chancellor. He assured us that the Government brought no undue pressure to bear on the Verde process. The Committee also heard from António Horta-Osório and Sir Win Bischoff that the Government applied no pressure to Lloyds in respect of the Verde deal. Andrew Bailey told the Committee that the Government had not put the regulator under any pressure in respect of its primary obligations. Peter Marks told the Committee that he was not aware of any pressure being placed on Co-op by the Government to bid for Verde. Robin Budenberg told us that UKFI had not advised Lloyds of any preference for Co-op Bank's bid. Sir Nicholas Macpherson said that he was not aware of any improper behaviour by politicians with respect to the Verde transaction, and that he would have expected such behaviour to have been brought to his attention. (Paragraph 272)

42. Lord Levene's central allegation is of political interference in the Verde process, to the public detriment. The Committee heard strong and unambiguous denials from those involved—Lloyds, the regulator, Co-op and the Treasury. It is difficult to think of an explanation that would sustain Lord Levene's allegation, other than that all our witnesses had either suffered a failure of memory or intentionally misled the Committee. The latter explanation would also require witnesses to have similarly misled Sir Christopher Kelly, who found no compelling evidence of political pressure for Verde to go ahead. Furthermore, for their credibility to be maintained, it would presumably require witnesses to have taken a decision to sustain their mendacity during the forthcoming independent inquiry into the events at Co-op Bank. It would also have required the board members of Lloyds Banking Group to have neglected their fiduciary duty to shareholders—by selecting a bidder which, if Lord Levene's allegation is to be believed, was manifestly unsuitable in commercial terms—at huge reputational, professional and personal risk and for no apparent benefit. And it is likely also to have required the chief legal counsels of Lloyds, the Treasury and the regulator to have countenanced Lloyds's proceeding with an inferior bid on the basis of political expediency. The Committee does not consider all this to be plausible. Nor does it consider it likely that such serious and far-reaching impropriety and bad faith as Lord Levene alleges could have been covered up in several major public and private bodies for over two years following the conclusion of the bidding process. (Paragraph 273)

43. In his oral evidence to the Committee, Paul Flowers agreed with other witnesses that there had been no political pressure in the Verde process. In response to six further separate questions from the Committee, he confirmed this view. In a subsequent press interview, however, he contradicted this evidence, claiming that Co-op Bank had come under "considerable" pressure from the Government during the bidding process. Given the flatly contradictory nature of his evidence, the Committee does not consider Mr Flowers a reliable witness—on Verde, on the Britannia deal, or on any other matter—and has not taken his evidence into account in any of its conclusions. (Paragraph 274)

44. The only relevant evidence that the Committee has heard claiming that there was political interference in the Verde deal has come from Lord Levene. In turn, Lord Levene admitted that the only "hard evidence" he had of political interference came from a conversation with the former Governor of the Bank of England, Lord King, in which Lord King had informed him that Lloyds's Verde decision would be made on political grounds. Lord Levene told the Committee that the Governor had called for this meeting, creating the impression that there was something that the Governor particularly wanted to communicate to Lord Levene. The Committee has investigated these allegations. Lord King has told the Committee, however, that he did not instigate the meeting. Furthermore, Lord King told the Committee that the concerns he expressed in the meeting related only to delays in the divestment process, and not to political involvement in Lloyds's decision. Lord King's recollection of the meeting is supported by a contemporaneous note of the meeting produced by a Bank of England official. Lord Levene continues to dispute Lord King's position, but on the basis of the evidence that it has taken, the Committee is inclined to accept Lord King's version of events. (Paragraph 275)

45. The Chancellor agreed that the Government was pleased to see Lloyds proceed with Co-op's Verde bid. This was consistent with the Government's stated policy both to encourage mutual firms and to deliver a challenger bank of the size proposed by the Independent Commission on Banking. Witnesses from Co-op Bank claimed that the Government had expressed its "goodwill" towards the bank's bid. Lloyds agreed that it was "publicly well known" that the Government looked favourably on Co-op's bid—a preference made clear to Lloyds once it had first named Co-op as preferred bidder in December 2011. The regulator was also aware of the Government's support for Co-op Bank's bid. The Committee has seen no evidence, however, that the goodwill expressed by the Government towards Co-op Bank's bid amounted to pressure on any party. Our witnesses have presented us with overwhelming evidence to the contrary, and the Committee therefore rejects Lord Levene's allegation of political interference in the Verde deal. (Paragraph 276)

46. The Committee has not had access to the record of the Government's contacts with Co-op Bank and Group, Lloyds Banking Group, the regulator, UKFI and NBNK during the bidding process, which the Chancellor proposes to hand to the independent inquiry into the events at Co-op Bank. While the Committee is satisfied by the unequivocal statements it has received from witnesses that there was no political pressure brought to bear in respect of Verde, the record would usefully provide a fuller picture of the Government's precise involvement in the Verde process. (Paragraph 277)

47. The Committee has considered Lord Levene's allegation that Lloyds 'moved the goalposts' of the Verde process to ensure a Co-op victory. While Lloyds did change the bidding process on a number of occasions, it was reasonable for it to have done so. The changes that were made appear to have been in the interests of Lloyds's shareholders, and to have benefited on different occasions both Co-op Bank and NBNK. Lloyds also changed the package of assets on offer, but this was in response to requests from both bidders, and was advantageous to both. The Committee therefore rejects Lord Levene's allegation. (Paragraph 278)

48. The Committee has also considered Lord Levene's allegation that Co-op Bank's Verde bid could not reasonably have been judged superior to NBNK's. Comparison of the Co-op Bank and NBNK bids was clearly a complicated and technical matter. Lloyds had to weigh up a number of competing factors in coming to its decision. Its view of the financial merits of both bids was based on independent professional advice. It knew that there were execution risks with both bids—the regulator had made this clear—and, while Co-op Bank eventually withdrew from the process following the revelation of the capital shortfall, this was not reasonably foreseeable at the time of Lloyds's decision. On the basis of the evidence it has taken, the Committee rejects Lord Levene's allegation that Lloyds was unreasonable in judging Co-op Bank's bid to be superior on commercial grounds at the time of the Verde bidding process. (Paragraph 279)

49. Lord Levene himself accepted that political interference might not have been the explanation for Co-op's Verde victory. He told the Committee that a desire from Lloyds to divest Verde through an Initial Public Offering, and to secure this outcome by awarding Verde to a Co-op bid that was likely to collapse, was "probably the real answer". The Committee does not endorse this view of events. But the Committee notes that Lord Levene, the only voice alleging specific improper political involvement in Verde, has concluded that a sufficient explanation for the outcome of the bidding process could reasonably be provided by Lloyds's own commercial objectives. (Paragraph 280)

Events following the collapse of Verde and the emergence of the capital shortfall

50. The problems at Co-op over the last few years are not an indictment of the mutual model. The problems of Co-op were, on the whole, particular to Co-op. Other mutual firms have come through the financial crisis well. (Paragraph 290)

51. The inability easily to raise capital is, however, a marked vulnerability in the mutual model. The PRA now claims to take the particular features of mutual firms into account as part of its approach to supervision. This is an important change of approach. (Paragraph 291)

52. One of the most significant consequences of Co-op Bank's near-collapse, from a public policy perspective, was the collapse of Lloyds Banking Group's planned divestment. Co-op Bank's withdrawal forced Lloyds to resort to its fallback option of an Initial Public Offering. The result is a new bank—TSB—which, not having an existing banking presence of its own, consists solely of the business divested by

Lloyds. Accordingly, it has a personal current account market share not of 7 per cent, but of 4.2 per cent. There is a risk that a bank of this size might struggle to grow significantly and to act as a true challenger in the market. This is not a judgement on TSB or its management, but reflects an observation of the Independent Commission on Banking that the entity resulting from Verde should have a market share of at least 6 per cent to have the best chance of becoming an effective challenger bank. (Paragraph 300)

53. The Verde divestment alone was never likely to be enough to inject sufficient competition into the UK banking market, which is the best way of improving consumer outcomes. The Treasury Committee, repeatedly, and also the Parliamentary Commission on Banking Standards, have both advocated measures to increase competition. (Paragraph 301)

54. The Committee welcomes the news that there has been a substantial recent increase in the number of firms discussing the possibility of becoming a bank with the regulators. However, we have yet to see an increase in the number of new entrants. The regulators will report to Parliament on progress in a year's time. (Paragraph 302)

Questions for future reviews

55. In this report, we have set out a number of areas that future reviews should examine further. In summary, the Financial Reporting Council's investigation into the preparation, approval and audit of the financial statements of Co-op Bank should consider:

a) How Co-op Bank's approach to recording impairments differed to that of other banks up until the end of 2012;

b) Why KPMG apparently failed to uncover Co-op Bank's particular approach to recording impairments;

c) Whether KPMG paid particular attention to assets acquired in the Britannia merger in its annual audits from 2009 onwards, given the incomplete due diligence it performed on them;

d) Whether the accounting treatment used to record the costs for Co-op Bank's banking IT platform upgrade was appropriate, given the delayed effect it had on Co-op Bank's regulatory capital.

The independent inquiry into events at Co-op Bank and the circumstances surrounding them should consider:

e) Whether the FSA could or should have developed superior stress-testing tools sooner than it did;

f) Whether superior stress-testing tools would have led to Co-op Bank's loan impairments being discovered sooner;

g) Whether Co-op Bank's impairment profile—which appeared to differ from that of other banks throughout the financial crisis—should have led the regulator to inspect it more closely prior to 2012;

h) Why the FSA's analysis on the Britannia merger failed properly to account for the prudential risks attached to the Britannia assets that have since been uncovered by the PRA;

i) Whether the work provided by KPMG and JPMC on the Britannia merger met a reasonable standard, in substance as well as form;

j) Whether the FSA was made aware of the change made by Co-op Bank to the accounting treatment for its IT platform replacement programme in 2010, and whether the FSA should have foreseen and acted on its consequences—that is, delaying the effect of the IT programme on the bank's regulatory capital;

k) Whether—given the conclusions of the independent inquiry on the forgoing points and the FRC's investigation on the late emergence of Co-op Bank's capital shortfall—Co-op Bank's Verde bid could or should have been halted sooner;

l) What, if anything, further can be learnt from the record of the Government's contacts with Co-op Bank and Group, Lloyds Banking Group, the regulator, UKFI and NBNK during the Verde bidding process. (Paragraph 303)

Formal Minutes

Tuesday 21 October 2014

Members present:

Mr Andrew Tyrie, in the Chair

Steve Baker	Teresa Pearce
Mark Garnier	Mr David Ruffley
Mr Andrew Love	Alok Sharma
Jesse Norman	John Thurso

Mr Andrew Love declared an interest as a Labour and Co-operative Member of Parliament.

Draft Report (*Project Verde*), proposed by the Chair, brought up and read.

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

Paragraphs 1 to 303 read and agreed to.

Resolved, That the Report be the Sixth 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 Wednesday 22 October at 2.00 pm

Witnesses

Tuesday 18 June 2013	*Page*
António Horta-Osório, Group Chief Executive, and **Sir Winfried Bischoff**, Chairman, Lloyds Banking Group	Ev 1
Wednesday 4 September 2013	
Neville Richardson, former Chief Executive Officer, Britannia Building Society and the Co-operative Bank	Ev 16
Tuesday 22 October 2013	
Peter Marks CBE, former Chief Executive, The Co-operative Group	Ev 32
Tuesday 29 October 2013	
Barry Tootell, former Chief Executive, Co-operative Banking Group	Ev 51
Wednesday 6 November 2013	
Reverend Paul Flowers, former Chair, The Co-operative Bank, and former Deputy Chair**,** The Co-operative Group	Ev 71
Tuesday 19 November 2013	
David Anderson, former Chief Executive, Co-operative Financial Services	Ev 96
Tuesday 3 December 2013	
Warren Mead, Partner, Financial Services, Transactions & Restructuring, **Andrew Walker,** and **Jonathan Hurst,** Partners, KPMG	Ev 110
Tim Wise, and **Conor Hillery,** Managing Directors, UK Investment Banking, JP Morgan Cazenove	Ev 123
Tuesday 7 January 2014	
Clive Adamson, Director of Supervision, Financial Conduct Authority, and former Director, Major Retail Groups Division, Financial Services Authority	Ev 136
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1 (PV 01) Lloyds Banking Group
2 (PV 02) Lord Levene of Portsoken KBE, former Chairman, NBNK Investments plc
3 (PV 02a) Appendix: Document submitted by NBNK to the Board of Lloyds Banking Group on 27/01/2012
4 (PV 03) Lord Levene of Portsoken KBE, former Chairman, NBNK Investments plc (supplementary)
5 (PV 04) Neville Richardson, former Chief Executive Officer, Britannia Building Society and the Co-operative Bank
6 (PV 05) Neville Richardson, former Chief Executive Officer, Britannia Building Society and the Co-operative Bank (supplementary)
7 (PV 06) Andrew Bailey, Deputy Governor, Bank of England
8 (PV 07) Peter Marks CBE, former Chief Executive, The Co-operative Group (supplementary)
9 (PV 08) Lloyds Banking Group (supplementary)
10 (PV 09) Curriculum Vitae: Reverend Paul Flowers
11 (PV 10) David Anderson, former Chief Executive, Co-operative Financial Services, gave oral evidence (supplementary)
12 (PV 11) J.P. Morgan Cazenove
13 (PV 12) KPMG
14 (PV 13) KPMG, JP Morgan and Deloitte
15 (PV 14) Lloyds Banking Group (supplementary)
16 (PV 15) Letter from Sir Winfried Bischoff, Chairman, Lloyds Banking Group, dated 18 December 2013
17 (PV 16) Letter from Andrew Bailey, Deputy Governor, Bank of England, dated 13 January 2014
18 (PV 17) Lord Levene of Portsoken KBE, former Chairman, NBNK Investments plc (supplementary, 14 January 2014)
19 (PV 17a) Lord Levene of Portsoken KBE—timeline of papers
20 (PV 18) Letter from Dominic Morris CBE, Director, Group Public Affairs, Lloyds Banking Group, dated 14 January 2014
21 (PV 19) Lord Levene of Portsoken KBE, former Chairman, NBNK Investments plc (supplementary, 15 January 2014)
22 (PV 20) JP Morgan Cazenove (supplementary)
23 (PV 21) The Co-operative Bank (supplementary, 17 November 2013)
24 (PV 22) FSA 'SIF' Interview with Reverend Paul Flowers
25 (PV 23) Financial Services Authority—Minutes of meeting with Co-operative Financial Services Chairman Designate, Reverend Paul Flowers
26 (PV 24) Letter from Neville Richardson, former Chief Executive Officer, Britannia Building Society and the Co-operative Bank, dated 22 January 2014, including draft script for conversations with Paul Flowers, Rodney Baker-Bates and Peter Marks, July 2011
27 (PV 25) Letter from Andrew Bailey, Deputy Governor, Bank of England, to Reverend Paul Flowers, former Chair, The Co-operative Bank, and former Deputy Chair, the Co-operative Group, dated 20 December 2011
28 (PV 26) Sir David Walker, (29 January 2014)
29 (PV 27) Letter from former Board members and officers of Britannia Building Society, dated 19 February 2014
30 (PV 28) Letter from Lord Levene of Portsoken KBE, dated 17 February 2014

31 (PV 29) Emails requested from Rodney-Baker-Bates at his Committee appearance on 28 January 2014

32 (PV 30) Lord Levene of Portsoken KBE, former Chairman, NBNK Investments plc (supplementary)

33 (PV 31) Co-operative Financial Services Board Effectiveness Review 2010

34 (PV 32) Letter from Neville Richardson, former Chief Executive Officer, Britannia Building Society and the Co-operative Bank, dated 28 February 2014

35 (PV 33) Rodney Baker Bates' Board Notes 01-09-11 to 11-07-12

36 (PV 34) Lloyds Banking Group Board Minutes 2011–2013

37 (PV 35) Letter from Lord King of Lothbury, dated 12 March 2014

38 (PV 36) Letter from the Rt Hon George Osborne MP, Chancellor of the Exchequer, dated 3 April 2014

39 (PV 37) Letter from Lord Levene of Portsoken KBE, dated 26 March 2014

40 (PV 38) Letter from Lord Levene of Portsoken KBE, dated 3 April 2014

41 (PV 39) Letter from Neville Richardson, former Chief Executive Officer, Britannia Building Society and the Co-operative Bank, dated 13 May 2014

42 (PV 40) Letter from Lord Levene of Portsoken KBE, dated 3 July 2014

43 (PV 41) Letter from Mr Andrew Tyrie MP, Chairman of the Treasury Committee, to the Rt Hon George Osborne MP, Chancellor of the Exchequer, dated 9 April 2014, regarding Treasury contacts with various parties during the Project Verde bidding process

44 (PV 42) Letter from Rt Hon George Osborne MP, Chancellor of the Exchequer, dated 3 May 2014, in response to Andrew Tyrie's letter of 9 April 2014

45 (PV 43) Further letter from Mr Andrew Tyrie MP, Chairman of the Treasury Committee, dated 23 July 2014, to Rt Hon George Osborne MP, Chancellor of the Exchequer, regarding Treasury contacts with various parties during the Project Verde bidding process

46 (PV 44) Reply from Rt Hon George Osborne MP, Chancellor of the Exchequer, dated 1 August 2014, in response to Andrew Tyrie's letter of 23 July 2014

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