House of Commons
Treasury Committee

Project Verde

Sixth Report of Session 2014–15

Volume II
Oral evidence

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Treasury Committee

The Treasury Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of HM Treasury, HM Revenue and Customs and associated public bodies.

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Oral evidence

Taken before the Treasury Committee
on Tuesday 18 June 2013

Members present:

Mr Andrew Tyrie (Chair)
Mark Garnier
Mr Andrew Love
John Mann
Mr George Mudie
Mr Brooks Newmark
Jesse Norman
Mr David Ruffley
John Thurso

Examination of Witnesses

Witnesses: António Horta-Osório, Group Chief Executive, Lloyds Banking Group, and Sir Winfried Bischoff, Chairman, Lloyds Banking Group gave evidence.

Q1 Chair: Thank you very much for coming to give evidence on this extremely interesting and controversial subject. May I begin with you, Sir Win? Is it true, as has been alleged, that the decision to award Verde to the Co-op was made on political rather than commercial grounds?
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.

Q2 Chair: There was no political pressure.
Sir Winfried Bischoff: No.

Q3 Chair: And no indirect contact via others.
Sir Winfried Bischoff: No direct contact either to me or, I think, to António. No, not that we are aware of.

Q4 Chair: Colleagues will come back to aspects of that question in more detail later, but I want to ask a second preliminary question to which both of you may have a response: how difficult is it to peel off part of a bank in order to satisfy, for example, these EU requirements?
Sir Winfried Bischoff: Perhaps I might start on that. There are obviously some technical aspects in relation to peeling off a bank because, whether you distribute it on an IPO basis or whether you do it on the basis of distribution to your shareholders, you have to produce a prospectus and you have to go back three years. To reconstruct that obviously takes some time, because it has to be a separation of the two. Secondly, in our case, that would be something that would need to be discussed both with the Government and with the Commission in that, in our case with a 40%, 38% shareholding, there would be two banks that would be owned 38% by the Government. Those are some overarching technical aspects, but I think there are some other aspects that António can speak to in relation just to the banking side of it.

Q5 Chair: I think it would also be helpful just to have on record whether these difficulties multiply the larger the number of banks that the single initial bank is broken into.

Sir Winfried Bischoff: Yes. We are obviously going through some of that process with the IPO process and we know how difficult it is, how time consuming it is and, obviously, how expensive it is. I can only assume that if there were multiple, it would be that much more difficult.

Q6 Chair: The reason I am raising this is that from time to time there are proposals for a multiple breakup of Lloyds, or a multiple breakup, in particular, of RBS. You are both well placed, having just been through the Verde process, to give us a view on the obstacles. Mr Horta-Osório, do you want to add anything?
António Horta-Osório: Yes, Chairman. Good morning, everyone. I think it is a very interesting question. I can tell you that I have, for the last 20 years in different countries, merged banks, but have considered as well spinoffs, like in the case of Portugal where we had to buy a big bank and extract part of it in a complex deal. What I can tell you is it is much more difficult to spin off a bank than to merge a bank. The simple reason to understand is that when you acquire a new bank and you put it together, you always have the option of leaving the systems, and everything that the client doesn’t see, separate. When you spin it off, you cannot, because you need to do a new entity, and therefore all the client approaches—in today’s world, that is a multi-channel approach through branches, telephone, internet and mobile—have to be totally spun off from the existing bank in a way that customers do not have any disadvantage when it starts operating. That is a much more difficult process than merging two banks, where even if you change a branch, you can leave everything as it is; the client doesn’t see it and you complete it over time. That is exactly the reason why you have in the UK, decades after certain mergers that have been done, still separate systems in those existing merged banks.

Q7 Chair: The question there was not to compare merger with separation, but to compare single separation—perhaps a good bank, bad bank split—with multiple separation. Could you answer that question?
**António Horta-Osório:** Relating to bad banks, the question is a bit similar, because if you are going to take away a bad bank, normally that is done by taking away assets, not customers—the assets do not have this multi-channel approach with this internet, telephone, branch, brands relating to the customer; you just take away the assets—or, as I told you in terms of the merger, if the original merger has not been integrated, you can split the banks again. For example, if a bank existing in a country bought a bank in another country, it is quite easy to wave it off, because you have never integrated. So when you are considering a bad bank, either through separation of assets or separating off units that have not been integrated in the first place, that is much easier then to do a spinoff.

In our case, just to complement your question, when I was appointed Lloyds CEO in March 2011, I said that my first priority was immediately to start the Verde process as mandated by the EU, and at the time, contrary to what certain people thought, that was not too long. We had then two and half years and, as we see now where we are six months away from the deadline, it has been an incredibly difficult and costly process. It cost Lloyds £3 billion to integrate completely the systems of Lloyds and HBOS, which are now completely merged. It is going to cost us £1.6 billion pre-tax to spin off the TSB bank.

**Q8 Chair:** You are implying that there would be a multiple of that cost if you did it to create more than one bank.

**António Horta-Osório:** Yes. If you did that in three, the cost would probably be almost as similar for each of the two banks.

**Q9 Mr Newmark:** You said that there was an approach to 42 potential bidders, but only three made a bid for the business. Why were the others you approached not interested?

**Sir Winfried Bischoff:** One supposition is that when looking at it at the time that they did, the banking industry was not in very good shape. The attractions of owning a bank at that particular time were not all that great. I can only assume that they were not interested. It is not a question of price, necessarily. They may have had a view on price and what other people might bid but, anyway, they were not interested. There were actually four at one stage and it came down to three.

**António Horta-Osório:** That is a very interesting question, which I have debated in this Committee already at other sessions. I was very surprised myself because I thought that 5% of the UK banking market should be a very attractive asset for people either from outside the UK, or a new entrant in the UK, to bid for. I personally visited several CEOs in Europe and the US in order to raise interest. Complementing what the chairman says, my conclusion was that for one reason or another—because of IT difficulties, because of the moment of the markets then, or because they saw the UK retail market as very competitive—they were not interested.

**Mr Newmark:** I totally get what you are saying, but when one draws up a list and you go out there in such a public way, it becomes a little self-defeating if your filtering system originally—As you have said, you know and spoke to many of these potential bidders. Would it not have been better to have a little bit more of a narrow focus in terms of who you approached? If you go out to the market and say, “Gee, we approached 40-plus people and there were only three interested parties,” which quickly became two, it sends a powerful message to the two or three remaining people saying, “Well, what is there about this asset that maybe we are not picking up that the 37 or so others did not like?” Do you understand what I am saying in terms of the psychology of going out there?

**António Horta-Osório:** You have to bear in mind that this information was not public then. It is only with our written evidence to you that you know that we approached 42 potential bidders, but at the time nobody knew how many bidders we had approached—point one. Secondly, I think that the best way to approach this is to have as wide a net as possible because you might have forgotten a bidder. Then you should speak specifically to the ones you think might be more interested. We did both. We received some interest; only three bids, but eight or nine parties showed some interest. Nobody knew at the time that we had approached 42 bidders.

**Sir Winfried Bischoff:** The other thing is that we felt—I think it is right—that there was a fiduciary interest that we had to see what interest, and what interest in bidding, there was. I think, as António said, that we would not want to leave any out. Did we think that we would get 42 bids out of 42 approaches? No, obviously not.

**Q10 Mr Newmark:** No, I am not saying that. I am just curious, though. You said that there was a fourth bidder as well. At least can you tell me who the third bidder was, if not the fourth?

**Sir Winfried Bischoff:** Sun Capital.

**António Horta-Osório:** Sun Capital, a private equity group.

**Q11 Mr Newmark:** You said that NBNK offered £630 million to £730 million in cash up front. The Co-op Bank offered almost half that—£350 million—in cash up front and the rest, I gather, was done on some sort of net-present-value terms to be paid over 15 years. I am just curious: what value did you attach to the fact that the upfront payment of NBNK was around double of the Co-op?

**Sir Winfried Bischoff:** First of all, it was not an upfront payment; it was an agreement to pay an upfront payment. It was not cash. It was not underwritten. It was an indication from the shareholders of NBNK that they felt that they would be able to pay this. If this was an underwritten offer in cash, it might have very much been different. There is an execution risk to it that we had to consider: would the NBNK?

**Q12 Mr Newmark:** But there was an execution risk anyway.

**Sir Winfried Bischoff:** Yes indeed; there was an execution risk in both.
Q13 Mr Newmark: I am just curious. I have been in private equity for 20 years. Sometimes, particularly in deals of this magnitude, at least at the start of a process—Why did you not at least try and parallel track it to see the bona fides of the NBNK deal to see how serious they were and were they going to get there? You seem to have cut them off pretty much at the pass and just handed it over to a bidder that ultimately failed.

Sir Winfried Bischoff: Mr Newmark, we didn’t do that. We took the NBNK bid very seriously. We thought it was a very credible bid. At the £630 million level, it was obviously a credible bid. In our view, the Co-op bid was somewhat higher, but the other side is the execution bit. Co-op had a brand name. You may think it had been tainted, but it had a brand name. It had an established bank. It had a relationship with the FSA. It had staff and it had a rating from two rating agencies. NBNK had none of those. Right at the start, as I said, we had taken into account the execution risk and the financial side of it.

Q14 Mr Newmark: Yes, I hear what you are saying and NBNK were credible bidders.

Sir Winfried Bischoff: Yes, they were.

Q15 Mr Newmark: They were not some fly-by-night operation. With the benefit of hindsight, do you wish you had accepted the NBNK deal, or at least perhaps given them more time?

Sir Winfried Bischoff: NBNK had five bids; they had five opportunities to bid. I don’t think we could have done any more. From our own point of view, it was very clear that we wanted to have a competitive bid in there. We would have been perfectly happy for NBNK to have won this particular transaction. There was no political pressure. We looked at it purely from the point of view of execution and price. Had NBNK had a higher price—and they had five opportunities to bid—we would have been very happy if they had come out on top.

Q16 Mr Newmark: Are you saying their price was not higher, or that it was higher, but was a weak bid?

Sir Winfried Bischoff: No. It was slightly lower in financial terms and, in our view, very heavily disadvantaged on the execution side.

António Horta-Osório: Mr Newmark, just to have the numbers precise because—

Mr Newmark: Yes, that would help me because, at the moment, it looks to me like NBNK were giving double the cash up front.

António Horta-Osório: As per our evidence submitted to you, I think the numbers are, firstly, very clear and compelling. NBNK’s offer was £750 million, at the lower end, but they wanted to retain £120 million for the breakup costs, so it came to £630 million. Co-op’s offer was £350 million upfront, plus £100 million contribution to the breakup costs—£450 million—and £250 million more in terms of net present value from us for running their systems.

Q17 Mr Newmark: But to be paid over—

António Horta-Osório: Over time, but in net present value; so in today’s prices. It was £700 million in net present value equivalent, compared with the £630 million. As the chairman said, in financial terms, the bid was lower than Co-op’s bid, apart from the execution risks. It was absolutely clear for the board in a unanimous way.

Sir Winfried Bischoff: Obviously we discounted that to some extent, but we did bear in mind that on the financial side there was a possibility above the £70 million that was being paid more of an earn out, but obviously the earn out would depend very much on the performance and so on, and was quite a lot less certain.

Q18 Mr Newmark: You noted that there was a risk that NBNK was not able to raise the funds for their bid because their letters of support from their investors were not underwritten or committed. Again, how significant was that risk for you, or was that just one of a number of issues that you were considering?

Sir Winfried Bischoff: In circumstances where the bid, in any case, was lower, it assumed slightly less importance, but it was important. I think had we in fact decided that, for financial reasons, the bid was better, which it was not—had it been higher—we would have then had to look very hard and get an underwritten offer.

Q19 Mr Newmark: I am trying to understand this. You are saying the fact that it was not underwritten or committed was not really that important.

Sir Winfried Bischoff: It was a factor, but it was not the most important factor.

Mr Newmark: Okay.

António Horta-Osório: Mr Newmark, it is important for you to understand that when you start thinking about the underwriting, you are then comparing the bid more with the IPO process. We also compared the bid with our plan B. We always had a plan B, which was to continue with an IPO. As the chairman said, had NBNK had a fully-funded vehicle, or an underwritten bid—

Q20 Mr Newmark: But that was never going to happen. You knew that when you accepted them as one of the bidders.

António Horta-Osório: No, it can happen. There are examples in the past where you have a fully-funded—

Mr Newmark: I know, but with NBNK specifically—

Q21 Chair: Brooks, just let António reply. You say that it can happen.

António Horta-Osório: It can happen. You could have fully-funded vehicles ahead of transactions that would have given us much more comfort that the money was there in order for the bid to be executed. When you compare the NBNK bid with our plan B, which we always kept on the table exactly because we wanted to have an alternative, you did not have an advantage either between NBNK’s bid, which was not underwritten, and us driving the process of the IPO as a plan B, because both would be dependent on market evolution and a price at a future moment in time. When you go into the comparison with plan B, that becomes a more relevant factor, because we could have certainty of the availability of funds. In this case,
there was no certainty that the funds would be available.

Mr Newmark: Okay, thank you very much for your time.

Q22 Mr Mudie: The whole exercise of choosing the Co-op seems to be very fluid and flexible. There is a suggestion—I think that one of my colleagues is going to push it—about the Co-op not having a bid in before the closing date for the second round, but somehow that was acceptable. It is very complicated. The chairman has referred to five bids from the other competitor. Who was handling this exercise and who did they report to?

Sir Winfried Bischoff: We had one of the members of the group executive committee, Antonio Lorenzo, supported by a team that deals with disposals, run by a man called Rougier, and we had two financial advisors.

Mr Mudie: That is okay. It is the main individual I am after.

Sir Winfried Bischoff: It would have been Antonio Lorenzo.

Q23 Mr Mudie: Who did he report to?

Sir Winfried Bischoff: Antonio Horta-Osório.

Q24 Mr Mudie: He was away for a fair period, was he not, at the end of—

Sir Winfried Bischoff: Six weeks.

Mr Mudie: Did he report to the board? Who reported it to the board?

Sir Winfried Bischoff: If you look at the December bid, the first time round António was not there, and he reported to the board. If you—

Q25 Mr Mudie: Direct?

Sir Winfried Bischoff: He reported to the board. The board was not there all the time but he reported and needed to have approval of the various steps that were taken by the board as a whole, and we discussed it a number of times at the board. It was discussed also before the board at the group executive committee, and we had an interim CEO at that time who he would have reported to directly during that six-week absence.

Q26 Mr Mudie: How many members were on the group executive committee—

Sir Winfried Bischoff: I think at that time there were 10.

Q27 Mr Mudie: Ten. How many are on the board?

Sir Winfried Bischoff: At that time there were 11 on the board.

Q28 Mr Mudie: Eleven on the board and 10 in the group. How many of the group executive are on the board?

Sir Winfried Bischoff: Two.

Q29 Mr Mudie: Two. Did the board unanimously accept the Co-op offer?

Sir Winfried Bischoff: Yes, unanimously.

Q30 Mr Mudie: In January 2012, NBNK sent a memo to Lloyds that, in hindsight, looks fairly accurate in terms of worries over the Co-op bid. Who saw that in Lloyds? At what level was it seen and discussed?

Sir Winfried Bischoff: I can’t, with specificity, say who it was discussed by. It certainly would have been—

Q31 Mr Mudie: You know the document? Yes.

Sir Winfried Bischoff: It certainly would have been discussed by the executive team first and the board would have seen it.

Q32 Mr Mudie: The board would have seen it, or did see it?

Sir Winfried Bischoff: I cannot recollect, quite honestly.

Q33 Mr Mudie: This almost could be written now, so it is a very important document. Did the board see it as an item, discuss it and understand—

Sir Winfried Bischoff: I do not know what document you are referring to but—

Mr Mudie: It is a document that was sent to the board on 27 January 2012. It is only four pages.

Sir Winfried Bischoff: If it was sent to the board, the board will have seen it. I am not aware of the document, but if it was addressed to the board—

Q34 Mr Mudie: And you are chairman of the board. Do you not remember it?

Sir Winfried Bischoff: No, I do not.

Mr Mudie: Do you not remember—

Sir Winfried Bischoff: If you show me the document, I would be able to remember it. I cannot remember a document purely by date.

Mr Mudie: I think I would have remembered this one.

Sir Winfried Bischoff: I would have to have a look at it.

Q35 Mr Mudie: I would be interested in some response that confirmed it was seen by the board and the board just accepted it.

Sir Winfried Bischoff: We can confirm that.

Mr Mudie: Okay. Thank you.

Sir Winfried Bischoff: We can confirm both the receipt and that the board saw it.

Q36 Mr Ruffley: Mr Horta-Osório, the deal that you eventually struck with the Co-op for the Verde business included £1.2 billion to £1.5 billion of capital. Some analysts said that that was very generous—that it gave a core tier 1 ratio of around 20%. Was that act of generosity a key demand—the level of capital—the Co-op asked of you?

António Horta-Osório: The capital required by both offers was very similar. As you are saying correctly, the capital would be around £1.5 billion. The price that we were offered, as we just discussed, for that £1.5 billion was around half. As a board, we were surprised that both offers would be around 50% of book value.
Q37 Mr Ruffley: But was it a key demand of the Co-op?

António Horta-Osório: It was not a key demand. It was in the process of negotiation and, as I just told you, very similar to the level of capital demanded by NBNK, because NBNK wanted to operate with a higher capital ratio—around 12%—which, by coincidence, came more or less to the same level of capital in the TSB bank.

Q38 Mr Ruffley: It was a good capital position that you would be putting either of the bidders in. Deutsche Bank, among other analysts, expected the Co-op “to leverage this capital through new lending.” It has been speculated that that would be very much what Government policy would have liked to see—more lending to the real economy. Did any member of the board, anyone in senior management at Lloyds or you discuss with any civil servant or any Minister the capitalisation point?

António Horta-Osório: No.

Q39 Mr Ruffley: Did you have any discussion of that kind—that this level of capitalisation would lead to higher lending? Did you have that discussion, or any discussion, with anyone at the Bank of England?

António Horta-Osório: No. The capitalisation, as I just told you, came from negotiating the two bids. It was separate criteria that came more or less to the same conclusion by different avenues, if you want.

Q40 Mr Ruffley: And you did not have any discussions along the lines that I have already outlined with the FSA.

António Horta-Osório: No. Our objective, as you might imagine, was to minimise the amount of capital we would have to sell, given we were being offered 50% of whatever capital we would put in the bank.

Q41 Mr Ruffley: In an earlier answer, Sir Win said—I wrote down the words—“No political pressure was applied.” Let me ask a slightly different question. Did you or any member of the board have any discussions with senior civil servants in government, or any Government Minister, about this deal and the capitalisation point?

António Horta-Osório: Mr Ruffley, that is a very broad question.

Mr Ruffley: It is, but it is one permitting of an answer, so give me one.

António Horta-Osório: My answer to you would be 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. What I can assure you is that the board and the executive committee have always acted on the best interests of shareholders, obviously taking into consideration in this process the interest of stakeholders such as the employees and our customers.

Mr Ruffley: But, for sure, that has been debated in the many meetings that I have with civil servants or regulators.

Mr Ruffley: I am not impugning anyone’s integrity. I am just asking some of the questions that you know are being bandied around because it does seem that it was quite a generous deal that was struck from the Co-op’s point of view and we know that—

António Horta-Osório: Mr Ruffley, can I make a point on that?

Q42 Mr Ruffley: I just wanted to say that Co-op Group CEO, Peter Marks, was quoted, in reference to you specifically, that “he had got the shirt off his back”, meaning you. Why do you think he said that?

António Horta-Osório: It was a premature comment. I think, I would like to comment on your point. It looks to me quite interesting that people might say it was a very generous deal and it was like a song. Why was the other bid financially—purely financial—even lower? That is an interesting question to ask, I think.

Mr Ruffley: Sir Win, as Chairman—

Q43 Chair: Excuse me. Why don’t you answer that question for us?

António Horta-Osório: I would like to make two comments, Chairman, given that you are allowing me. I think it is very easy to guess football results on Monday. With the same hindsight, people are now saying we gave a too-generous deal to the Co-op. Using the same hindsight, I should also say that NBNK’s board should be very sorry that I offered 50% for controlling 5% of the UK retail banking market which now, 12 months later, is worth more than double in the market. Lloyds was floating at 40% of book value a year ago and we did this deal for around 50% of book value. Lloyds is today quoting at one times book value. Therefore, with the hindsight of what happen in the market, I am sure the board is very sorry that it is not sitting on a very nice profit.

Q44 Mr Ruffley: Sir Win, wearing your chairman of the board hat, Mr Budeberg, the Chairman of UKFI, who obviously was overseeing the stewardship of this Government stake in your group, said to the Public Accounts Committee that the Verde divestment was “very value destroying” for the UK taxpayer. What do you think the board’s response would be to that statement?

Sir Winfried Bischoff: First of all, I think it is worthwhile stating that I did talk to Mr Budeberg at various times.

Q45 Mr Ruffley: Did you speak about this point, because he said it very publicly?

Sir Winfried Bischoff: No, he did not say that to me.

Mr Ruffley: But it is on the public record.

Sir Winfried Bischoff: Fine. He was kept informed as to what we were doing. He was kept informed of the general bid process. We did not discuss with him either what he may have thought was “value destroying”, or what he thought was the value of one bid as against another bid. He was kept informed and he certainly did not pass on to me the comments that you have just made.

Q46 Mr Ruffley: I did not make them. He made them to the Public Accounts Committee, and I am just
asking you, as chairman of the board, what you make of that statement. It is quite a damning thing for him to say, and he is the steward on behalf of the UK taxpayer for the shareholding in your group. It is quite a big thing for the CEO of UKFI to say to that to the Public Accounts Committee. All I am asking you is what the board thinks of that statement.

Sir Winfried Bischoff: In terms of what you have just said, first of all the board was very much aware, being forced under a mandate from the European Commission to sell at that particular time, that we had to sell at that particular time. That particular time was not a very good time to sell a bank, as I said right at the start. To that extent, it may have been value destroying. Obviously it depends very much on what other bids you get, but the timing was in fact not mandated by us. We would have preferred to have sold, or to have reached agreement with bidders, at a time when the climate for banking sales was better. It was not, and that is what we had to do at the time.

António Horta-Osório: Just on this point, as the chairman said, Mr Budenberg will know better. I think, just to complement what the chairman said, on top of the price itself—obviously when you sell at 50% of book value you are getting a loss—I think Mr Budenberg might have been referring to the fact that this EU-mandated sale was, I recall, a punitive action on Lloyds having been given the state aid intervention. It was destructive in the sense that, as I was explaining, we spent £3 billion merging the systems of HBOS with Lloyds and then we were going to spend another £1.6 billion unwinding part of that. It was destructive in the sense that we have spent money integrating to then spend half that money disintegrating part of the bank because it was an EU punitive action. I think it is value destroying in both senses.

Q47 Chair: You cleared up that potential contradiction between your view and Mr Budenberg’s but, just to be very clear and picking up David’s original question, you fundamentally disagree with Lord Levene’s suggestion that political pressure played a part in this deal.

António Horta-Osório: Absolutely.

Q48 Jesse Norman: Sir Win, what have the total costs been to Lloyds Banking Group of the failure to complete this transaction?

Sir Winfried Bischoff: Whichever way we were going to do the transaction—either through a sale or through an IPO—there were certain costs attached to that. That was £1 billion to dismantle it, and there was likely to be another £600 million that we would have to spend, so £1.6 billion for the disengagement of a part of the business from the broader Lloyds banking business.

Jesse Norman: And that would be the case if it were being IPO’d or if it were being sold to whomever?

Sir Winfried Bischoff: Yes.

Q49 Jesse Norman: And therefore there have been no further costs associated with the failure to sell it to the Co-op.

Sir Winfried Bischoff: There are some small extra costs in relation to that.

António Horta-Osório: Just to be precise for the record, as the chairman says, the total costs forecast at this moment of spinning off totally the TSB bank will be £1.6 billion pre-tax. The costs of doing that to the Co-operative Group, as we accepted publicly several times, would have been £1 billion after tax, so £1.3 billion approximately before tax. The additional cost of going to the IPO will be, as we said publicly as well, between £200 million and £300 million. The costs of the failed bid, as the chairman just said, were minimal because we would have to build the bank in any case. In the case of the Co-operative Group, we would have had to build everything except for a treasury, because the Co-operative Group already had a treasury, and that is the majority of additional costs of £200 million to £300 million of doing the IPO—we have to build the treasury.

Q50 Jesse Norman: So if you had decided not to go down the IPO route, you would have saved £300 million versus the situation where you are now, plus any deal-related costs that you incurred?

António Horta-Osório: Not exactly, because the Co-operative Group had a treasury. NBNK had no bank, no treasury, no clients, no infrastructure—nothing.

Q51 Jesse Norman: Sorry, just to be clear: you said if you sold it, it would cost £1.3 million gross. António Horta-Osório: Sold it to the Co-op.

Jesse Norman: Right. To the Co-op it would have cost you £1.3 billion gross, but going down the IPO it is £1.6 billion. Therefore, it is a £300 million cost, plus the deal costs?

António Horta-Osório: Correct. At the same time, as I just told you, the market price has more than doubled for comparable assets.

Q52 Jesse Norman: Your point is that you have gained because when you do sell you will be able to make something back with the increase in asset value on the IPO?

António Horta-Osório: What we are saying is that, given the market evolution, with the benefit of hindsight, if the market, in a year’s time when we do the IPO, is as it is today, it is likely that those extra costs for the taxpayer will be more than recovered by the price of the IPO. Of course, with hindsight, it is easy to say this.

Q53 Jesse Norman: If it pans out as you currently anticipate, therefore, the taxpayer could be ahead because of the failure of the Co-op bid?

Sir Winfried Bischoff: Yes, fortuitously; this is not by design. That is the way the market has—

Q54 Jesse Norman: We can explore the reasons for that, but this is just to be clear about it. Okay, that is helpful. How much did you pay the advisors on the failed bid?

Sir Winfried Bischoff: Sorry?

Jesse Norman: You were advised by Citibank and JP Morgan.

Sir Winfried Bischoff: Small in relation to the total amount. Do you know what the fees were?

António Horta-Osório: I can tell you that in writing.
Q55 Jesse Norman: Was it tens of millions?
António Horta-Osório: No, it is a small amount. We can tell you in writing. I don’t recall. If it was a big amount, I would recall.

Q56 Jesse Norman: Good. Sir Win, when you received this letter from NBNK on 27 January, which I think you said you would have circulated to the board—
Sir Winfried Bischoff: If I did receive it, I would have circulated it to the board.

Q57 Jesse Norman: Yes, but we know you did receive it because we have it validated from here, and I am sure you will find from your records you did, so let us just assume you did for purposes of discussion. Were that not the case, obviously you can correct the record, but this memo suggests, very trenchantly, that the Co-op bid was fraught with risk: “Outdated IT platform, continued delays and problems with the Britannia integration and the parallel implementation of a group-wide IT centralisation. They are unlikely to be able to finance the Verde transaction at the signing of the sale and purchase agreement. Their attained profits have been relatively modest compared to be able to finance the Verde transaction at the time of a group-wide IT centralisation. They are unlikely to be able to finance the Verde transaction at the signing of the sale and purchase agreement. Their attained profits have been relatively modest compared to the activity. They do not have a CEO. The CEO has quit reportedly on the deal. They only have acting CFO.” This should have been setting off all kinds of alarm bells in your mind at that time, should it not?

Sir Winfried Bischoff: Yes, absolutely.

Jesse Norman: And your people went into it—
Sir Winfried Bischoff: As I said, it would not have been as thorough as perhaps with a publicly listed company but, yes, they in fact gave us access to their information right throughout the process, and I think it is fair to say that, in that process, we became concerned that there might be a shortfall in December 2012, not before.

Q59 Jesse Norman: They set up a room; they co-operated; they put tonnes of information into it.
Sir Winfried Bischoff: Yes, absolutely.

Jesse Norman: This is a shortfall in financing capability.
Sir Winfried Bischoff: No, in capital terms.

Q60 Jesse Norman: So they did give you access to some form of information about the state of their balance sheet?
Sir Winfried Bischoff: Yes.
Bischoff: Yes. The reason why we had doubts, at that moment in time, of their capability, as the chairman says—
Sir Winfried Bischoff: In December 2012.

António Horta-Osório: In December 2012—of executing the transaction was because we were then given the revised plan from the Co-operative Group, given that, as you know, in the last part of the year, you do your budget and you review your three to five-year plan. We were given the combined plan of the Co-operative Bank plus our TSB bank. In the analysis of our teams and our advisers, it was clear to us from that information, indirectly—so not from, as you have said, the P and L and balance sheets—that there was a shortfall of capital. That was when we first had concerns about their capability of closing, as we had said at the time, by March this year.

Q61 Jesse Norman: That would potentially also have imperilled your view of the capability of the Co-op to meet the downstream commitments made in its offer as well?
António Horta-Osório: No, not necessarily, I am sorry, because one thing is the capital capability of acquiring something. The other is their operating profitability and the capacity of making payments throughout—

Q62 Jesse Norman: Let me just record my surprise that in the middle of a bid process with this coming—if it did come—to the board, it would not have made more of an impact on you because, after all, it is posing fundamental questions to a process of due diligence in which you were thoroughly involved at that time. Can I just ask what due diligence you did perform on it, and whether at any point you felt that you were being misled about the Co-op’s financial position?

Sir Winfried Bischoff: The due diligence that we performed was obviously together with the Co-op, and to the extent that the Co-op in fact was able to open its books to us. That was to some extent limited, because it is not a publicly-listed company, so we had to rely on the information that was given to us, and we relied on the view in the market and in rating agency terms, and from the regulator, as to the Co-op. The Co-op after all was—
Q64 Chair: We are seekers after truth here, and we are getting some very interesting replies. None of us has any reason to doubt anything that you have said, but there will be quite a bit of documentation that can support a number of the points that you have made. I think it might be helpful if you could take a look at some of the documentation that was prepared in the context of the due diligence to see what could be put to the Committee in the public domain. A good deal of it will not be capable of being put into the public domain, in which case we might try and think through some arrangement for those papers. Perhaps someone on our behalf can take a look at them and report back to the Committee, but we will put thought to that. I just want to follow up one point very quickly. You said, basically, that you had discovered there might be a hole in the balance sheet of the Co-op in December 2012, to cut a long story short. Correct?

António Horta-Osório: Yes, a shortfall.

Q65 Chair: What did you do about that?

António Horta-Osório: About that we did two things, Chairman. We queried the Co-op about it, obviously, because it was given to us not in the sense of a warning—that is we were not approached by—

Chair: No, you spotted it.

António Horta-Osório: We were not approached by the Co-op Bank or the Co-op Group board.

Q66 Chair: You uncovered it and now I am asking you what you did with that information.

António Horta-Osório: I am explaining the process. Given that we were submitted with a revised plan, including the Co-operative Bank and the TSB bank, in our own analysis of that combined information, for us it was reasonably clear that the assumptions of the plan had changed and there was a shortfall of capital. This was at the end of December 2012. We had as a plan to close the deal by March, as we had said publicly. Therefore what we did immediately was to ask the Co-op about it, formally. As I was explaining to you, they did not come formally to us and say, “We have a problem.” They came to us and said, “This is the new combined plan,” and the Co-operative Group’s answer to us was, “We are handling this. We have several options to handle this and we are revising the plan and the options we have, together with the regulator, in order to address this situation.”

Q67 Chair: I think we had better see any documentation with respect to this exchange as well, because I think that it would be extremely useful. Did you tell UKFI?

Sir Winfried Bischoff: I think we told UKFI. I certainly remember telling UKFI in the beginning of January, but I can’t remember at what particular time.

Q68 Chair: Did it cross your mind that there might have been systemic implications of the hole in their capital accounts?

Sir Winfried Bischoff: No, because they basically, as António has mentioned, were still very keen. We questioned them, obviously, and they said they were still very keen to do the transaction and, secondly, that they had a means of overcoming the shortfall.

Q69 Chair: And you believed them.

Sir Winfried Bischoff: No, we were sceptical at that stage I think it is fair to say.

Q70 Chair: But still you did not think that there were systemic implications.

Sir Winfried Bischoff: No, not at that stage. Again, I think it is worth remembering, Chairman, that the market also basically still—in December and January—took a positive view. The market began to worry about the Co-op at the end of February, and then there came a downgrade. We were aware that there was a shortfall. We did not know, in fact, how the other business might be affected by it systemically.

António Horta-Osório: We were told that several of the options they had, as is now public, were meaningful and were clear, such as selling the insurance company or selling the asset management businesses, each of which could have hundreds of millions of pounds. As the chairman said, we were concerned. We had doubts. We spoke with them in depth. We were reassured, in a sense, that they had options that they were considering, but we were not, as the chairman said, totally reassured. Just to frame this discussion, at the same time we were always developing our own plan of moving towards the IPO because the route was the same, which is important.

Q71 Chair: But a good deal of money could have been saved and a good deal of ink need not have been split if they had been more open with you from the start. It sounds to me that you are saying that they engaged in negotiations with you knowing that their balance sheet was weaker than it appeared to be at the start of the negotiations.

António Horta-Osório: To be very frank, Chairman, I think the extra costs, as we have debated previously, were very small because we had to build the bank in any case in order to do the IPO. Given that we were following the same route to give them more time in order to check whether they would address the difficulties or not looked absolutely the right thing to do at the time. We would have to incur the same costs because we had to build the TSB bank in any case.

Q72 Chair: They were not concealing anything from you at the early stages of the negotiation.

António Horta-Osório: No.

Q73 Mark Garnier: I am going to continue on this point. You reached your heads of agreement on 19 July with Co-op and that was when you announced that you had reached the heads of agreement. Had you done any due diligence on Co-op before that, Sir Win?

Sir Winfried Bischoff: Before the announcement—

Mark Garnier: Before the announcement of the agreement on 19 July 2012.

Sir Winfried Bischoff: Yes, we had done due diligence. We had looked at combined plans—what it would in fact look like, obviously. We had discussed with the FSA because it would have had an impact on our own position. There were discussions with the regulator, and they will have had discussion with the regulator also.
Q74 Mark Garnier: Let me come back to the Chairman’s point: was any wool pulled over your eyes by anybody? The regulator presumably would have had a pretty clear idea of what the balance sheet of Co-op looked like.

Sir Winfried Bischoff: The regulator, to be absolutely clear, did not say, in relation to either the NBNK bid or the Co-op bid, that it was totally free of execution risk.

Q75 Mark Garnier: When you talk about “execution risk”, you mean whether it goes ahead or not. What I am slightly more worried about is the fact that there is this great glaring hole that has emerged in the balance sheet of Co-op, which you had a first warning about in December 2012. However, prior to that, in July 2012, you had obviously had a conversation with a lot of different people, including the regulator. The regulator presumably at that point said, “As far as we are concerned, looking at the balance sheets and what we know about the balance sheet from the point of view of both Lloyds and Co-op, this is a doable deal.”

Sir Winfried Bischoff: They said NBNK would still need to be approved by the FSA. They did not say—

Q76 Mark Garnier: But hey, at that point, given what they—

Sir Winfried Bischoff: They did not tell us, “Don’t do it.”

Q77 Mark Garnier: They did not tell you, “Don’t do it.” They did not tell you that this was going to be a deal that was going to bust Co-op?

Sir Winfried Bischoff: They did say that it needed to be approved, yes.

Q78 Mark Garnier: That it did need to be approved, as opposed to improved? I just want to make sure I have that right.

Sir Winfried Bischoff: No, approved.

Q79 Mark Garnier: Approved, yes. So everybody would have thought that this was looking tickety-boo. Do you think there is a regulatory failure here, by any chance? Given the fact that this had emerged after you had done a lot of due diligence, why was the regulator not doing this, do you think?

Sir Winfried Bischoff: I suspect the regulator may not have been doing this, do you think?

Q80 Mark Garnier: Sure, but it is the same regulator, and they still have the same boxes to tick on liquidity and all that.

António Horta-Osório: As the chairman is saying, they have different regulatory teams. They never tell us anything about other entities. Any specific view we could not have any information from the regulator on the Co-op. That is absolutely standard practice.

Q81 Chair: Yes, but my question to you was: did you ask the regulator to take a look?

Sir Winfried Bischoff: The regulator was having a look at the Co-op, obviously, because it is a regulated entity.

Q82 Chair: But did you make sure you found out they already knew?

António Horta-Osório: As we had these thoughts in December, we shared these thoughts with the regulator, but the July point in time is a different point in time from December. I believe, with the information we had, that in July—you should bear in mind that July was pre the euro crisis in the summer—we had numbers available and the plans available. There was no indication whatsoever of any issue. It was in December, after the revision of the plan, that we had doubts on the combined plan shortfall. We shared those doubts with the regulator, and we were answered on those doubts that they were looking at the matter with the Co-op, but they could not share information with us, which is standard practice.

Q83 Mark Garnier: The reason I am asking these questions is there is a picture emerging of how due diligence is carried out and that a huge amount of credibility is given to bond yields, for example, of what the market is saying. These are almost a smell test of the market. You have the rating agencies that we all hate, as you know. We beat them up regularly here and I am sure they will come back again. We will have another go at them and that will be good. The regulator should be having a good “under the bonnet” look at all of these organisations and they did not seem to pick it up at the time.

On a slightly different thread, presumably as a bank you end up on the interbank market. Typically, given the fact that the interbank markets are not working as well as they should do, what would be the length of lending that you would do on the interbank market? Do you feel comfortable that there is a distinction?

António Horta-Osório: I think the interbank markets are now working much better than they were 18 months ago, so they are working normally now. After the change in liquidity rules and the FLS in the summer of last year, the markets have normalised.

Q84 Mark Garnier: The reason I ask is that I was with one of your competitors this morning and he said that typically three months would be about as long as they would be prepared to lend on the interbank market. Is that—

António Horta-Osório: I think the markets have normalised in the last six to nine months.

Q85 Mark Garnier: To a certain extent where I am heading with this one is the terms of the deal that you came up with, which is that potentially you were going to be underwriting this perpetual bond that was going to be issued by Co-op to pay for the rollover bit. I just want to be clear about this. Is this
underwriting the issuance of the bond, or underwriting the bond in perpetuity?
Sir Winfried Bischoff: Underwriting the issuance of the bond, which would have been sold to the—
Mark Garnier: So once it has gone—
Sir Winfried Bischoff: We would receive cash for it, yes.

Q86 Mark Garnier: Nonetheless, you were taking on quite a lot of risk on this. You had quite a lot of eggs in that one basket. If you had underwritten this deal in order to finance the sale of the thing and the deal did not go through, you would be wearing, what, £400 million-worth of virtual bonds?
António Horta-Osório: £350 million.
Mark Garnier: £350 million. What is £50 million among friends? It is a lot of money to be holding on to, isn’t it? It is quite a big commitment financially that you guys have made, in terms of a lot of different things, and yet there seems to be a huge amount that has fallen down on the due diligence. This is the slightly alarming thing at so many levels.
Sir Winfried Bischoff: I think there is a risk, but we would not have reached this stage of course, of underwriting if the position of the Co-op as an entity that was capable of buying the Verde disposal would not have been approved. It would only have been done on an approved basis. It was only a question as to whether there was sufficient market appetite and, from what we had seen of other issues that the Co-op Group had done, there was sufficient market appetite. But it would not have gone ahead, of course, if it had not been approved by the FSA and if it had not been approved by our Board. This was an agreement in principle.

Q87 Mark Garnier: As a model of due diligence in doing a deal, do you think this was a good example or a bad example of due diligence, looking at it holistically from the regulatory point of view all the way through to just going through the books?
Sir Winfried Bischoff: The iterative process was good. Was it as clear until December to us that there might be a shortfall? No, but there was no withholding of information. The modelling was done entirely appropriately. The Co-op looked in reasonable shape, but obviously, once it had looked at its own position and then come up with a revised plan, that caused us some concern.
António Horta-Osório: Mr Garnier, I think that your points are fair and legitimate. We were surprised in December to see that suddenly there was a shortfall in capital, no doubt. We did not share the view that the economy was worsening. I have said publicly several times that I think this is a long and difficult recovery, but that the UK is slowly recovering. We were surprised. We obviously shared that immediately with our counterparty, the Co-operative Group, and had answers that in a sense made us decide to give them more time, because we had still three months until March, which was reaching the deadline and, as I said to the Chairman, because we had to build the bank in any case.
Of course we were not happy with it, as you can imagine. We shared with the regulator as well. In July, as the chairman said, there was no information whatsoever—and the due diligence was properly done—that there was any problem; so this was in December—six months later. As you say, we would obviously have preferred to have a solution of financing that would not incur so many potential risks for us—you are absolutely right—but you have to bear in mind that this was a punitive action from the European Union.
We had a tight deadline to meet by 13 November this year and, should we not meet that deadline, having shown that we had done all our best efforts to have this deal done, the EU might do it themselves at any cost. We have always acted in the best interests of Lloyds shareholders, as I said at the beginning, taking into consideration the stakeholders such as customers and the employees, but this was not a deal that we wanted to do ourselves. We were mandated to do this as a punitive action and our fiduciary duty was to execute it with the least cost for Lloyds shareholders. That was why we had to take certain risks, such as the one you mention, which is absolutely fair, but we absolutely believe that at every point in time we were acting in the best interests of Lloyds shareholders.

Q88 John Mann: Why did Neville Richardson resign?
António Horta-Osório: I have no information about that; I can’t answer you. He was on the Co-op? You are speaking about a Co-operative Group employee, right?
John Mann: Yes.
António Horta-Osório: We have no idea.

Q89 John Mann: It is just that when he resigned he described his reason as being lukewarm towards this deal, and he was the chief executive of Co-op Financial Services in July 2011, but your answer is sufficient on that. Thank you.
Which Government Ministers did you meet or discuss this issue with by telephone and how often?
Sir Winfried Bischoff: I with none.
António Horta-Osório: As I said in my previous answer to Mr Ruffley, in the normal course of my duties, I have spoken several times with different officials and different Ministers, and, in the course of those discussions, for sure, the Co-operative Group has been raised.

Q90 John Mann: Which particular Ministers?
António Horta-Osório: In the course of my normal meetings, I always meet the Treasury Secretary. I meet civil servants in the Treasury and I also meet sometimes the Chancellor.

Q91 John Mann: The City Minister at the time was Minister Mark Hoban. How often did you discuss this issue with him?
António Horta-Osório: I normally met Mr Hoban every four months, so three times a year.
John Mann: Three times a year.
António Horta-Osério: Yes, and in the course of those discussions for sure I have discussed this with him, as I discussed many other matters.
Q92 John Mann: So three times a year you discussed this with Mr Hoban when he was in post. António Horta-Osório: Not necessarily.

Q93 John Mann: Up to three times a year. António Horta-Osório: Not necessarily.

Q94 John Mann: More than three times a year. António Horta-Osório: I met Mr Hoban three times a year and, in the course of those meetings, I might have discussed this subject. To tell you precisely I would have to look at my notes and the agenda detail.

Q95 John Mann: Obviously. Other than those fixed meetings, have there been any other meetings or discussions with Government Ministers in relation to this deal?
António Horta-Osório: I am sure that, in the course of these two years, I have had phone conversations with Government Ministers that have included discussions about how the Co-operative deal was going, for sure.

Q96 John Mann: How often?
António Horta-Osório: Not very often, but it was normal. I would do that with the most important things about Lloyds. I would either brief or be asked about important matters on Lloyds and I would tell them how the situation would be. I think that is quite normal.

Sir Winfried Bischoff: I do remember a meeting with Mark Hoban at the end of 2011 when he in fact asked us, ahead of the meeting that we had—António was ill at the time—how we were getting on with the Verde disposal process. I did tell him that there were a number of bids and that the board was going to consider it. That is the only time that I can recollect it.

Q97 John Mann: Would any of your other employees or representatives, such as the two financial advisers that you raised, have any meetings or discussions with Government Ministers on this deal—that would include Mr Lorenzo and Mr Rougier?
António Horta-Osório: I think our financial advisers, it is highly unlikely. We may check but I will tell you—
Sir Winfried Bischoff: We can check.
António Horta-Osério: I will tell you no, subject just to checking. In terms of Toby Rougier, our corporate development director, or Antonio Lorenzo, it is possible, like in my case, that at their level they have had discussions with Government Ministers or civil servants. It is possible.

Q98 John Mann: And they would report back in if they meet a Government Minister to discuss this deal. António Horta-Osório: Yes, of course; they would report to me and to the chairman of the board, yes.

Q99 John Mann: So all Government communication of any kind in relation to this deal would be directed to yourself. António Horta-Osório: I think it would be directed either to me or to the chairman, as we just said.

Q100 John Mann: Were there any exchanges of correspondence or e-mails from Government Ministers specifically on this deal?
António Horta-Osório: Not that I can recall.
Sir Winfried Bischoff: Not that I can recall.

Q101 John Mann: Would this be the case with direct representatives of Government Ministers as well—someone acting on their behalf?
António Horta-Osório: Not that I recall. As I told you, what I can recall is it would be more in the sense of briefing or answering questions in the course of normal meetings, not specifically about this deal. I don’t recall any e-mails from Government Ministers or civil servants on this specific deal. I can check, but I don’t recall.

Q102 John Mann: What you are saying is there were a very limited and minimal number of exchanges with Government Ministers—purely in passing—in relation to this deal.
António Horta-Osório: What I would say, Mr Mann, is that I do not have any recollection that my exchanges with Government 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% taxpayer stake.

Q103 John Mann: What view did Government Ministers or their representatives express in relation to this deal and to your decision to go with the Co-op?
António Horta-Osório: 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.

Q104 John Mann: So they expressed their preference for the mutual deal.
António Horta-Osório: No. Given that we thought at the board unanimously that, both on financial grounds and the execution risk, 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—
Chair: Could Sir Win just come in on that point? Sorry to interrupt, John.
Sir Winfried Bischoff: Yes, because I think you mentioned preference. There was no preference expressed to us. In fact, when we told them that we had unanimously decided that it was the Co-op, they said that they were pleased that it had gone that way, but they had no preference whatsoever. There was no preference expressed to us by Government Ministers.

Q105 John Mann: Well, you are saying different things. Mr Horta-Osório, you are saying that their view in preference towards a mutual model was well known and, indeed, is public. When did they first know? What was the date they first knew of your preference for the Co-op as opposed to other bidders?
Sir Winfried Bischoff: It would have been just before 14 December 2011.
Q106 John Mann: Before that, did they express any views in relation to the mutual model and Government policy in relation to it?
António Horta-Osório: Not to me, Mr Mann.
Sir Winfried Bischoff: Nor to me.

Q107 John Mann: To any of your employees or advisers involved.
António Horta-Osório: Not that I am aware of.

Q108 John Mann: And afterwards they did.
António Horta-Osório: As I just told you, when we had made the decision, I was of the clear impression in my conversations that the Government liked the outcome of Verde branches going into the TSB bank. But that is because, as I told you, we had made the decision. It was not a preference; it was an opinion on a decision we had made ourselves on the grounds that I just described to you.

Q109 John Mann: But during that period after December 2011, when the Government were making clear how pleased they were that their policy on the mutual model was being enhanced, you were going through your due diligence.
António Horta-Osório: Yes.

Q110 John Mann: So what impact did the Government view—regularly express to you on their preference for the mutual model in line with Government policy—have over the due diligence process that you carried out after December 2011?
António Horta-Osório: Mr Mann, as I told you, none.
The best evidence I think that it was none was that the board had decided, in March 2012, to readmit NBNK to join again the Co-op and make a second bid. As you know, in March, the NBNK wrote to us and said, “We want to improve our bid and we think it is in the best interests of Lloyds shareholders that we are readmitted into the process”.
The board decided to readmit NBNK into the process because, as I told you before, we thought it was in the best interests of our shareholders. I think that is absolute evidence of the good faith in this process because NBNK were readmitted into the process, given they told us they would improve their offer in March versus what they had presented in December, and also because Co-op took more time in that process than we were led to believe in December. NBNK was readmitted to the process. As you can see, there was no obvious pressure for us, because it would be contrary to what you just asked.

Q111 John Mann: Sure. Two more questions on this. Am I right then to presume that there are no notes of discussions or e-mails from Government Ministers that might in any way embarrass them in the light of events?
António Horta-Osório: I would think so. I would think that you are right in saying that, but I cannot check all my notes one by one. I am absolutely clear, as I told you, that we acted on what we thought in each moment in time was in the best interests of Lloyds shareholders, taking into consideration also stakeholders such as the customers and our employees.

Q112 John Mann: While you are here, because you sent us a letter on PPI, you described mis-selling PPI as unacceptable, but it does appear that you have been trying to avoid paying full and proper compensation. Is that behaviour unacceptable?
António Horta-Osório: Mr Mann, as I have said many times, including in this Committee, PPI was totally unacceptable. We took the lead in breaking ranks in starting to compensate our customers on what became one of the biggest scandals of this country. We did absolutely the right thing. That does not mean, like in real life, that you get 10 out of 10 right. So if we had things wrong, we immediately tried to redress them and, as I wrote to you, we ourselves detected these problems in the beginning of the year and had already taken action before they became public.

Chair: We are not going to prolong that discussion because we are on Verde today. Is there anything else you want to ask, John, on Verde?
John Mann: No, I have the answers. Thank you.
Chair: Great. Thanks very much.

Q113 John Thurso: Can I go back to the question of the regulators just briefly, because I think what you have broadly said to my colleagues is that at no point were the regulators questioning the ability of the Co-op to complete the deal until it was pretty well public knowledge in March 2013. During 2011 and 2012, there was no suggestion from the regulators that the Co-operative may not be able to—
Sir Winfried Bischoff: Could I just say that the regulator always told us that the deal needed to be approved, and they had not approved it, so there were risks attached to both sides—NBNK and the Co-op.

Q114 John Thurso: But that would not be construed as there being a problem; it would be construed as a prudent regulator pointing out that, until the ink is dry, it is not a done deal.
António Horta-Osório: Mr Thurso, to be absolutely fair—and I have had conversations myself with the regulator on this—the regulator made very clear, as the chairman said, that it was not approved and there were hurdles for both bidders to overcome in order to complete the deal. It was very clear to me—I asked it on purpose when we chose the Co-op—that the hurdles of NBNK would be at least the same as the hurdles for the Co-op in terms of difficulty. It was not just that it was not approved, as you said, formally. The regulator made clear for us there would be hurdles for both bids in order to be able to complete the deal.

Q115 John Thurso: We will undoubtedly be talking to the regulator, and a point of interest to us will be how they acted in this. We know from a Telegraph article of 3 March 2012—and we therefore presume it is correct—that the regulator was already making it clear that they might need £3 billion more capital, as well as revamping the board, to ensure that there were people with FSA-approved banking experience. So we know the regulator had concerns. The question we
will be looking at with the regulator is to what extent they had concerns that might have scuppered the deal, and to what extent they were allowing you to just carry on. The question to you is, just to be clear: given that the regulator obviously had not approved it and given they had said there were hurdles, was there nothing that indicated there might be a substantial difficulty with the deal until you found out between December 2012 and March 2013?

António Horta-Osório: That is absolutely correct.

John Thurso: I just want to get that clear on the record.

António Horta-Osório: Yes, that is absolutely correct.

Sir Winfried Bischoff: It wasn’t a show stopper.

Q116 John Thurso: No. Thank you very much. Can I turn to another question about how you discussed this with shareholders? What sort of dialogue did you have with the institutional shareholders during the course of the Verde talks?

António Horta-Osório: Shall I answer?

Sir Winfried Bischoff: Yes, why don’t you, and then I will go.

António Horta-Osório: Mr Thurso, like we meet UKFI, our main shareholder, once a month, and we share with them what we are doing. I meet my biggest shareholders normally every quarter. We have a significant number of shareholders in London, in the UK, in New York, in Boston and also in continental Europe. In the course of those quarterly IMSs that we produce at every quarterly result, I discussed this subject, which was normally raised at every quarter.

Q117 John Thurso: So it would be quite proper and normal and, indeed, part of the principles of the institutional investors committee for you to discuss, in broad terms, the progress—both in terms of the strategy set out and the progress of the deal—as you went along.

António Horta-Osório: Yes.

Q118 John Thurso: Your institutional shareholders would obviously not be aware of the due diligence or anything else, but they would have knowledge of the strategy and would be briefed by you on the main milestones.

António Horta-Osório: Yes, and at every quarterly IMS we would also have one, two or three paragraphs about how the deal would be going and how the costs were evolving. We gave guidance on that. That is absolutely correct.

Q119 John Thurso: Turning to your major shareholder, UKFI, they would obviously have been treated at least as equal in that case.

António Horta-Osório: Yes, that is correct.

Q120 John Thurso: So at what point did UKFI become aware that there may or may not have been a problem in concluding the transaction?

António Horta-Osório: As I was just answering to Mr Mann, I don’t recall exactly but, as the chairman said, it must have been around December, when we found out ourselves.

Sir Winfried Bischoff: December or early January.

António Horta-Osório: Yes.

Q121 John Thurso: Going back from that, what other key concerns might have been expressed to you by the shareholders?

António Horta-Osório: The key concerns to the shareholders were more relating to the forcefulness of this transaction as mandated by the EU, how much it would cost us and how we were going to execute it. So the shareholders were not properly focused; it was not their concern. It was a management matter about bid A or bid B, if that is your question. The shareholders were concerned—

Q122 John Thurso: No, just to help you, I am not interested in discussing bid A versus bid B. I am much more interested in how the shareholders and UKFI interacted with you, not least because UKFI is charged with acting as an institutional shareholder between the Treasury and the companies in which it invests in order for the Treasury not to have to do that job. What I am asking you about is the concerns and dialogues you were having with shareholders and the concerns and dialogues you had with UKFI, and what you discussed with UKFI that may have been an enhanced discussion over what you might have had with other shareholders.

António Horta-Osório: Yes. Institutional shareholders in general were concerned about how much it would cost us to build the bank, what profits would be foregone when the bank was sold and how that would look in terms of the valuation of Lloyds and the risks associated with it. I would say that, with UKFI, the conversation would have been similar—probably deeper given that we met UKFI once a month. Therefore, they have a more normal dialogue with us every month, but very much along the same lines.

Q123 John Thurso: At any time did anybody say to you, “Do you think this thing is going to fly? Are you concerned about it?”

António Horta-Osório: That was one of the risks, absolutely. That is why we have always kept plan B on the table of, “We will build the bank in any case,” because we have always believed that, in order for this spinoff to be effective, we had to build the bank first in-house, transfer the customers into that bank and then float it. That is why we built the bank and that is why you are going to have the TSB bank operating in the high street in two months’ time in the summer.

Q124 John Thurso: I have fully grasped—I think all my colleagues have fully grasped—that actually this was not, “We must do a deal.” This was, “If a deal is right, we will do it but if not we have plan B, which is just as doable, and that is what we are going to do.”

António Horta-Osório: Absolutely.

John Thurso: You were operating on the basis of a comparison between plan B, which as you now say will give you twice the value as it would have done a year ago, there or thereabouts. You are saying, “If we don’t do a deal with anybody on Verde, we have plan B,” which is to float it separately or deal with it separately.”
Sir Winfried Bischoff: That was the intention. Obviously the European Commission would still need to approve a plan B, but it would have wanted us to see that we had made the very best effort that we could to sell to an entity, although plan B was something it was aware of. It has not been approved yet, but it is aware of it.

Q125 John Thurso: I could join the conspiracy theorists—I won’t, but I could—and say that, as plan B is probably the best option, making sure that plan A did not work was the right thing to do. But, listen, we have quite enough on our plate without going there.

Can I go back to talking about UKFI? These concerns—the plan A and plan B discussions, and the reassurance to a major shareholder that there was another route—are all discussions that would have taken place with UKFI.

António Horta-Osório: Yes. UKFI, as our majority shareholder, as you said, is in my opinion very diligent and there are interactions with us on multiple matters, that being one of them.

Q126 John Thurso: This is the same UKFI of which Sir Nicholas Macpherson, the permanent secretary at the Treasury, said, “They are also people of the world who are willing to take the odd instruction consistent with their remit”. So it would be a perfectly valid set of questions for us to be asking UKFI and Sir Nicholas Macpherson whether at that level any conversations, discussions or instructions might have been given in relation to whatever was going on.

António Horta-Osório: I have no knowledge of that.

Sir Winfried Bischoff: Conversations with UKFI, definitely; instructions, definitely not.

John Thurso: Thank you.

Q127 Mr Love: Can I come back to NBNK? Mr Horta-Osório, earlier on in a reply to a question in relation to NBNK, you said they had no treasury, no clients, no licence. They were in effect a shell company. Does that reflect your opinion of the NBNK bid?

António Horta-Osório: That was answering a question, but do you want my opinion?

Mr Love: Yes.

António Horta-Osório: My opinion is that NBNK—as the chairman said and we both publicly said at the time, it was a credible bidder—versus the Co-operative alternative, because the work is relative, had no bank, had no customers, had no IT, and had no underwriting or funding. Therefore, in my view, in order to be superior to the Co-operative’s offer, they should have offered a better price. Compared with our alternative of plan B of an IPO, they should have offered a control premium, and I think it is hard to say that a 50% offer of book value would be a control premium. Therefore, in my opinion, NBNK should have offered a better price. They were a credible bidder. They had the means in order to buy the bank—that was why we took them seriously. As the chairman said, they were allowed to make five bids, but in the end they offered a very low value. In my opinion, given what I told you, they should have offered better value in order for us to have been able to consider the offers differently.

Q128 Mr Love: Was it made clear to them during the bidding process that, because of the problems of execution risk that you have highlighted, it would require a much higher financial bid in order to secure the support of the Lloyds board?

António Horta-Osório: I think our teams made very clear to all the bidders all the information necessary and what they should do, because as you can imagine, it was in the interests of Lloyds and its shareholders to have the best bid.

Sir Winfried Bischoff: Obviously, the bidding process is on the basis that a competitive bid wins, and a better financial bid is likely to win. There is no question but that NBNK will have understood that. It was in a competitive situation, as was the Co-op and as was the third bidder when it dropped out.

Q129 Mr Love: You mentioned earlier the NBNK bid not being underwritten and you suggested that in the past some bids have been fully committed. How important was that as a consideration?

António Horta-Osório: As I said to Mr Ruffley and as the chairman said, I think that consideration was less important in terms of the comparison with the Co-operative bid. But it was more important, in terms of comparing with the alternative plan, which would be the plan B, because when we go to the market, as Mr Thurso said, at the moment it looks very attractive, but we don’t know how the market will be. If there was an underwritten bid versus a plan B, you have to choose between maybe a higher value and more certainty of funds. It is more important versus a float, which is more or less the same thing; less important versus the Co-operative bid, related to the Co-operative bid, as we explained to you, it was financially worse and in terms of execution risk it was also higher.

Q130 Mr Love: How would you respond to the criticism that has been made that you, from a very early stage, prioritised the Co-operative bid and discounted NBNK? How would you respond? This is a criticism that Mark Green has made.

António Horta-Osório: As the chairman said before, I seriously contested that because, as you can see from the process that we submitted to you, NBNK were able to make five bids to us. After the Co-operative was chosen initially in December 2011 by the board, they said they would improve their offer. We readmitted them into the process. Their offer in the end was not substantially better and they lost, as the chairman just said, in terms of the competitive bidding. It was absolutely in the interests of Lloyds shareholders to have the best bid and we chose the best bid. My only conclusion, as I said before, is that NBNK should have offered the better price, which in my view was absolutely compatible with the fact that we were selling 5% of the UK retail market, no legacy issues and a strong bank, fully funded with a loan-to-deposit ratio of 100%. I don’t understand why NBNK decided that it did not deserve a better price or a
control premium, but that is up to them to answer, I think, to you and to their shareholders.

Sir Winfried Bischoff: When there was a delay with the Co-op bid, we were very, very keen to reintroduce NBNK. NBNK wished to be reintroduced into the bidding process—and we did. We had an exclusive arrangement with the Co-op. The Co-op was not able, in terms of time, to meet that exclusive arrangement and therefore we readmitted NBNK. It was in our interests to do so and they had every opportunity between the final time and the time that they were readmitted, as António says, to come up with a better bid.

Q131 Mr Love: This is classic competitive tension, in making sure that you have more than one bidder. Sir Winfried Bischoff: Yes.

Mr Love: Did it produce a response from the Co-operative Group when you readmitted NBNK and, if so, why didn’t it produce a response from NBNK?

António Horta-Osório: I think, as you said, that every competitive pressure creates tension and that improves the quality of the bids in general, I would say, for both.

Q132 Mr Mudie: But could you answer the question? Andrew said: did the reintroduction of the other bank to the bidding process lead the Co-op to increase its bid? Yes or no?

António Horta-Osório: No. The answer on that point is no.

Q133 Chair: We have had a very interesting exchange and we have picked up a lot of information. I think it would be helpful to have quite a bit of it supported in documentation, particularly on the due diligence, on the alleged degree of political involvement and on the exposure of the hole in the Co-op’s accounts and what was done about it, and we can discuss this at staff level outside this hearing. I think you came in with a large chart, Mr Horta-Osório. I am sure there must have been a question that we should have asked in order to elicit this, so perhaps you would like to tell us what it is.

Sir Winfried Bischoff: This is a chart that shows how the trading of Co-op paper in fact took place and how the market value did. We traced this back because there was an assertion that any one of 50 people would have told you that the Co-op was in fact in desperate straits. It may be that those 50 people may have particular knowledge, but neither the market as a whole, nor the rating agencies in fact, as you can see, had that knowledge until we get to March 2013, when you can see even here—perhaps in the beginning of March; 26 February—that there is a blip. Other than that, the Co-op tracked entirely Santander and, in fact, at the beginning, it was better than Lloyds. Here, only in March, it started, and then obviously in May it blew out. So the knowledge of professionals dealing in the market, and buying and selling these securities, was obviously not as great as those other 50 people who seem to have had better knowledge of this.

Chair: Thank you very much indeed for that brief explanation, which we have all appreciated, and thank you for coming to give evidence today. We may need further information; we will see. We have a number of other people and lines of inquiry we want to pursue. Thank you very much indeed.
Wednesday 4 September 2013

Members present:
Mr Andrew Tyrie (Chair)
Mark Garnier
Stewart Hosie
Andrea Leadsom
Mr Andrew Love
John Mann
Mr Pat McFadden
Mr Brooks Newmark
Jesse Norman
Mr David Ruffley
John Thurso

Examination of Witness

Witness: Neville Richardson, former CEO, Britannia Building Society and Co-operative Bank, gave evidence.

Q134 Chair: Thank you very much, Mr Richardson, for coming in to give evidence this afternoon. You are on record as being very sceptical about the Verde deal, to put it mildly. Who within the Co-op Banking Group, or the wider group, was pushing most strongly for the Verde acquisition?

Neville Richardson: Can I give you a little bit of context before I start on the deal and the transaction?

Chair: We have already had quite a bit in your written evidence.

Neville Richardson: It was a deal that was being pushed strongly by the Co-operative Group and by the Co-operative Chief Executive at the time.

Chair: Just give us the names if you would. Who was pushing for this most strongly?

Neville Richardson: When I say “Co-operative Group”, the Co-operative Group has a number of very senior people. Its Chairman, Deputy Chairman and Chief Executive were very keen on the deal. That is, Len Wardle, Paul Flowers and Peter Marks were keen on the deal. I have to say that the deal as such, at another time, was one that I could understand. The problem that I have talked about and would like to talk more about is the timing of the deal and the capability of Co-op Bank to carry out that deal and other major change programmes at a time of many, many changes in the organisation.

Q135 Chair: You have set out your reservations in some detail already. We will go into some of that in a moment. What was the rationale of those seeking to acquire Verde among the Co-op senior management?

Neville Richardson: The Co-op had gone through the merger with Britannia. That had been largely successfully integrated by 2011. It had grown the size of the Co-op branch network from something like 100 branches to well over 300 branches. This came forward as, I think, what was seen as a once-in-a-lifetime opportunity. It had some real attractions for the Co-operative movement in that part of the Verde deal represented the old Scottish branches, the TSB branches, where Co-op was quite weak in terms of presence on the ground. There was a logical, strategic fit that said that, at the right time, this could have transformed the Co-operative Group but, as I said, it was being put forward very much as a once-in-a-lifetime opportunity and perhaps it was with that deal. I have always taken the view that that does not make it an imperative to carry out a transaction if it is the wrong time to carry out that transaction.

Q136 Chair: We might come on to why it was the wrong time in a moment. It has been alleged that the Government was extremely keen for Co-op to acquire Verde. Did Government Ministers encourage this or put pressure on the Co-op, or have other contacts?

Neville Richardson: I saw none of that during my time, but you have to remember that I left in July 2011. At that stage this was nothing more than an indicative bid.

Q137 Chair: If I were to ask you, not having seen the subsequent press coverage, “Could you confirm that, as far as you are aware, there was no ministerial pressure?” you would answer that you can confirm that?

Neville Richardson: At that time, absolutely none that I was aware of.

Chair: Okay. Thank you very much.

Q138 Andrea Leadsom: Good afternoon, Mr Richardson. In your written evidence to us you have said, “The Board and CEO of Co-op Group at that time did not accept my warnings and were determined to press ahead. That is why I stepped down.” Can you tell us what specific reservations you had about the Co-op acquiring the Lloyds branches?

Neville Richardson: I think this is the context that I have to give to you, which is that, at the time of the proposed bid, the Britannia/Co-op deal had only been done two years. A lot of the integration had been done, but there was still work to be done. The Co-op Bank was involved in two other very major change programmes. A phrase that I like—and very much believe to be the case—is that trying to carry out one very major change programme is a challenge. Two major change programmes is asking for trouble and three major change programmes is asking for failure. The bank at that time was carrying out two major change programmes.

Q139 Andrea Leadsom: Which are you referring to?

Neville Richardson: The first was IT transformation. IT transformation had started before the Britannia CFS merger and was the replacement of poor IT systems, something that I think no other UK clearing bank has ever done. It was a massive change, but it was necessary. The second programme was the sale of the life and savings business. At the point of merger, discussions were held in the board and strategic reviews as to whether the bank should continue in
insurance areas. The conclusion that we came to was it did not need to and that it probably was not core to carry on insurance businesses.

The life and savings business was facing retail distribution review changes. It was facing changes in the market that meant that it would cost a very significant amount to stay as is. It was decided and concluded—and I led this—that the life and savings business should be sold, which would produce about £200 million more capital for the business. Those were two very major strategic change programmes happening in the bank.

Q140 Andrea Leadsom: Were you worried about the success of these programmes?
Neville Richardson: I would always worry about those. They are such big programmes that there is no guarantee of success.

Q141 Andrea Leadsom: Have they now been successfully completed?
Neville Richardson: The life and savings business has now been sold. I finalised the deal before I left, but it took two years of regulatory approvals to get it finally done. The IT transformation was suspended as part of the Verde transaction and has now been abandoned altogether.

The context I am giving you is that there were two very major change programmes happening. Together with that, the Co-op Group introduced something called Project Unity, which was to take many major areas of the bank and put them under the control of Co-op Group as a cost saving exercise. This was putting financial services under the control of people who are not financial services people. It was causing very major disruption at the time that we were trying to settle in other programmes. I was very, very much against the disruption that that was likely to cause and said at the time that I believed that that, combined with the other two programmes and with Project Verde, would have disastrous consequences for the organisation.

Q142 Andrea Leadsom: It sounds like there was some real strife then with your senior colleagues. Can you tell us how they reacted to your warnings, and whether they accepted any of your concerns? Did you have any allegiance from other senior colleagues?
Neville Richardson: The way that I would normally deal with things and the way that I dealt with this was through attempting to persuade, attempting to use my experience and knowledge, to explain to people that this was going to be disastrous if all these programmes were done at the same time.

Q143 Andrea Leadsom: Yes, but did anyone believe you?
Neville Richardson: I believe that some of them did. I think some of the executives did.
Andrea Leadsom: Can you give us any names of colleagues that agreed?
Neville Richardson: As a whole, I believe that all the executives believed that this was a major problem that we were going to have.
Andrea Leadsom: The executives of which entity?

Neville Richardson: CFS.
Andrea Leadsom: The main board members of CFS agreed with you?
Neville Richardson: Yes. The executive members, and there were those among the non-executives who also agreed that this was going to cause difficulties.

Q144 Andrea Leadsom: Essentially the whole board of CFS and some of the non-executive members, also of CFS, agreed with you, but the Co-op Group overruled you?
Neville Richardson: The executive team and some of the non-executives, because the board comprised executive and non-executive members, and, as I have said, the executives could see the problems that this was creating and some of the non-executives, the more experienced financial services—
Andrea Leadsom: Now are you talking about CFS or the Co-op Group?
Neville Richardson: CFS.
Andrea Leadsom: Some of the non-executive members of the board of CFS thought it was a good idea, but others didn’t. None of the executive members of the CFS board thought it was a good idea, but it was the CFS Group board then that overruled you. Is that right?
Neville Richardson: CFS Group and Co-op Group, yes.

Q145 Andrea Leadsom: Did anyone else in the Co-op Group board support your views, or was it a complete disagreement?
Neville Richardson: I am not aware of anyone who did.

Q146 Andrea Leadsom: There was no agreement from the Co-operative Group board that this was a problem?
Neville Richardson: That is right and, just to be clear here, I am talking specifically about taking on Project Unity. This was the third of the major programmes. At that stage, Project Verde was at an indicative bid stage. It was an indicative bid, which means that very little resource was being allocated to it. But you can gather from what I am saying that, if I was very unhappy at taking on three major programmes, a fourth on top of that, to my mind, was going to be absolutely disastrous.

Q147 Andrea Leadsom: Just to be clear, the evidence you have just given is about Project Unity, not about Project Verde?
Neville Richardson: It is specific to Project Unity and the combination of programmes that the business was trying to cover.
Andrea Leadsom: Yes, but, specifically, this inquiry is about Project Verde.
Neville Richardson: Yes.

Q148 Andrea Leadsom: You have said that you resigned because your warnings about Project Verde were not heeded. Can I ask you those same questions? Who in CFS, executive or non-executive members, agreed with you that Project Verde would be a disaster and who in the Co-operative Group agreed with you?
Neville Richardson: Can I clarify? I did not resign. I left the organisation because the board did not accept my view about the combination of programmes of which Verde was one. This was not a matter of principle purely about Verde. It was that the business was incapable of coping with all the significant change that was happening in the organisation at the time. This was not a principle about one particular programme. It was an absolute, pragmatic view that the business was incapable of coping with all this change at the same time.

Q149 Andrea Leadsom: Your resignation was a result of pre-dating project overload, not a result of Project Verde?

Neville Richardson: Not in isolation, but I have to say quite unequivocally that, if I had known that Verde was going to be as all-consuming as it became, I would not have been for it at all, because the disastrous consequences that I warned of, with the other programmes and Verde coming down the line, were just being multiplied by Verde and the distraction that Verde was creating.

Q150 Andrea Leadsom: But, to be clear, you are not saying your resignation was Verde. It was a combination of the other programmes and this was the final straw?

Neville Richardson: Also, just to be clear, I did not resign. I brought matters to an absolute head and we mutually agreed that I would leave the organisation, but it was—

Q151 Andrea Leadsom: Most people would see that as resigning, but okay. Just one last question. Did anybody else from the CFS board, either executive or non-executive, decide to also fall on their sword or leave mutually or whatever, resign?

Neville Richardson: In the period between me leaving and the current—

Andrea Leadsom: For the same reason obviously.

Neville Richardson: For very similar reasons. Five of the eight executive team members left and something like 15 of the 30 people below left. That is an awful lot of experience to lose over that period of time. There were different reasons for different people, but it is important that people realise that the management team was being denuded of experience and resources.

Q152 Andrea Leadsom: What was the Co-operative Group’s reaction to that? Did they try to keep people? Did they let people go? How did they respond to such a massive loss of experienced staff?

Neville Richardson: You are talking about a time after my time. Quite a number of people did try to persuade me to stay. Quite a number of members of the Co-operative Bank board, who were also on Co-operative Group, spoke to me and asked me to stay. They did not want to lose me. I understand that that may have been the case with some of the other colleagues who left. They were not people that the bank or the group wanted to lose.

Q153 Chair: Was there any financial benefit to you in leaving by mutual agreement rather than resigning?

Neville Richardson: I don’t believe so. That wasn’t something that crossed my mind.

Q154 Chair: On the points that you have made about the positions of the respective parties on these boards and their attitude—and you have been pretty trenchant in giving that—will the minutes of the respective boards support what you have said?

Neville Richardson: The minutes and board papers will point to the fact that, throughout 2011, I was talking about management stretch and that is I suppose a shorthand version of “We’re trying to do too much”. That was before Project Unity and before Project Verde. The minutes will say that quite clearly. The minutes will not say that I pointed out that there would be disastrous consequences, because that was done over a very short period of time and was done outside of a board meeting with the Chairman, the Deputy Chairman and the Group Chief Executive.

Q155 Chair: The answer to my question is no, the board minutes will not support the evidence you have just given us?

Neville Richardson: The board minutes will not but there is substantial evidence—it is absolutely clear what I was saying and who I was saying it to at the time.

Chair: Documentary evidence in the firm?

Neville Richardson: I have contemporaneous transcripts of what I said when I said it and that is absolutely clear.

Q156 Chair: What about the position of the other people on the board, which you have just been describing to Andrea Leadsom, the respective board positions?

Neville Richardson: I don’t know whether the minutes would reflect that—I will have to tell you how quickly all this happened. It happened in a very short period of time. Project Unity had been coming around for quite some time. Project Verde had been a possibility for a few months. I brought this to a head at a point where it was decided that Unity was going to be implemented immediately and Verde was at the indicative bid stage. It was something that I felt so strongly about that I was not going to stand for it.

Q157 Jesse Norman: We are focusing on July 2011 then, Mr Richardson, which is when your disagreement about these projects with the management comes to a head. By the way, was there a gagging clause in your separation agreement?

Neville Richardson: It is normal to have confidentiality agreements and I have those, yes.

Jesse Norman: You are not in breach of any of that stuff in talking to us or making transcripts available of meetings you have had?

Neville Richardson: You have invited me here today and parliamentary privilege means that I can talk openly to you in a way that I have been unable to for the last two years.

Jesse Norman: You could let us have copies of the scripts that you prepared for your conversations in July—

Neville Richardson: Subject to legal clearance, I will.
Q158 Jesse Norman: I must say I am staggered that your concerns were sufficiently clear in your own mind and sufficiently important that you found it necessary to write a script. You have said here you had telephone conversations with Paul Flowers, who was the CFS Chair and Group Deputy Chair, and Rodney Baker-Bates, who was the CFS Deputy Chair, and then on 11 July you had a face-to-face meeting with Peter Marks. For those meetings you had transcripts to make sure there was a consistent message about your concern?  
Neville Richardson: Yes, there was. I wanted to see all three of them on the morning of 11 July but Paul Flowers was flying off to Europe for a meeting and so, because I couldn’t see all three together, I arranged a telephone conference call on Sunday, 10 July and then spoke to Peter Marks face-to-face on the morning of 11 July.  

Q159 Jesse Norman: From your point of view, the fact that the Chief Executive was in the process of having severe concerns registered at board level ought to have been an earthquake to the board of the CFS and, indeed, to the board of the Co-op, should it not?  
Neville Richardson: I didn’t take this lightly. This was very, very serious. For a Chief Executive to take the steps that I took, I think, is incredibly serious.  

Q160 Jesse Norman: There is an interview with Len Wardle on the Co-operative website, dating from 19 July 2012. I don’t know if you have seen that?  
Neville Richardson: I don’t think so, no.  

Q161 Jesse Norman: This is at the point when they are going live with the formal bid for Verde and he is asked a question, “Any deal of this size and complexity must carry with it a degree of risk. How does the board satisfy themselves that these risks can be properly managed?” He answers, “I make no apologies that we took such a long time to come to a conclusion on this deal, almost a year really, and, therefore, we have gone into the deal in finite detail.” I think he means “in infinite detail”, “The audit committee looked at all the due diligence to satisfy itself it was sound. The risk committee looked at all the risks, stress testing, economic scenarios for the future, a very detailed process. Totally unlike how they were handled in the past.”—that is ironic—“when they took on HBOS. Considerable time and effort—”. He does not mention the fact that his Chief Executive has quit over the issue because he could see a year earlier that the bank was wildly overloaded in the commitments it was making.  
Neville Richardson: I think also the comments you have just made there relate to the due diligence on a project, and my concern was more significantly about the impact that this was having on business as usual.  

Q162 Jesse Norman: Just to be clear, do you share my amazement that he should have been able to make those remarks given the history of the experience that you had had?  
Neville Richardson: I am very surprised, but I want to just clarify that my real concern was that, when you run a bank, it is all about running it on a weekly, a daily, an hourly basis. To take resource away from that may mean you can achieve the project, so you can look at the project and say, “We’ve done it properly”, but that leaves a bank vulnerable to not being run properly.  

Q163 Jesse Norman: Your point was they should never have got started with the Verde proposal because the bank was already being stretched in so many different ways?  
Neville Richardson: Yes. I was willing to go with an indicative bid, which means you are having a look at it, it takes very little to resource and it is not a problem. I would certainly not have been in favour of diverting significant resource from the bank because I thought that was dangerous for the bank.  

Q164 Jesse Norman: Did you think the board of the Co-op Banking Group had the capacity to manage an expanded network as a result of Verde, given all the other problems we knew: stress on management, other commitments, failure of IT systems, capital shortfall, and so on? Do you think they had the capacity to do that?  
Neville Richardson: This was one of my concerns. One of my concerns was not just at the management, but at the board level. You have to remember, this was increasing the size of the bank from 100 branches to 1,000 branches over the space of less than three years.  

Q165 Jesse Norman: Cutting through it, you thought they were not competent to manage that process from a board level, let alone from a management level?  
Neville Richardson: They needed more experienced resource on the board to cope with that.  

Q166 Jesse Norman: Thank you. Andrew Bailey of the PRA, the Bank of England, came before us and said that he raised his concerns first with the Co-op about their status in July 2011. Do you remember that? Was that about the time you were talking to them?  
Neville Richardson: I only recall one conversation with Andrew Bailey, remembering that I left the organisation around about 18 July. I have read the transcript. I don’t know which conversation he is talking about, but I know that he came to the board of Co-op Bank for a regular visit. It was on 12 July. I believe, and he came for dinner with the board and made some remarks before the board. At that stage—  

Q167 Jesse Norman: This is the day after you have had a face-to-face meeting with Peter Marks, scripted by you, at which you tell Peter Marks that the bank is incapable of running all these deals?  
Neville Richardson: Yes.  
Jesse Norman: Andrew Bailey turns up. You have dinner with him?  
Neville Richardson: Yes. He didn’t turn up. It was pre-arranged because it was a board off-site and he was asked to come as a guest to that—  
Jesse Norman: Did you discuss it with Andrew over dinner, “By the way we think the bank is vastly overstretched and shouldn’t be doing this”?
Neville Richardson: No. I wasn’t in a position to discuss it directly with Andrew.

Jesse Norman: Did Peter Marks raise it with him?

Neville Richardson: I don’t know. I don’t know. But you asked me the question, and the question was, “Did Andrew Bailey raise any concerns?” Yes, I recall that he did. In a session that he had with the board before dinner he raised the question of whether Co-op Bank/Co-op Group was capable of taking on Verde. Remember, this was at outline bid stage, so he was commenting before there was any real clarity as to what the bid might look like and he—

Q168 Jesse Norman: He is tacitly backing your position. He is saying, “You shouldn’t be in the business of launching this bid given how overstretched you are”?

Neville Richardson: I recall that the specific comment he made at that dinner was that he felt that Co-op may need a partner if it was going to go ahead with this. I think it was an off-the-top-of-the-head remark, but he mentioned Rabobank. We had no conversations with them, which is why I think it was an off-the-top-of-the-head remark from him, but he said that he felt that was the case.

Q169 Jesse Norman: This would be a partner that helps the bank with the management of the new branches, but would also supply new capital?

Neville Richardson: When the possibility of Verde was first put to Co-op Bank, it was put to Peter Marks and it was put to me by Credit Suisse. I said no at that stage, even to looking at an indicative bid, although I was later willing to look at that. There were three reasons that I said no: capital, liquidity and management stretch. This is only me thinking—I think Andrew Bailey was being more specific to capital and liquidity—but I don’t know.

Q170 Jesse Norman: You will recall in his testimony to us he mentions all those three things.

Neville Richardson: Yes.

Jesse Norman: They are also tracked by the NBNK memo that was sent in the context of the bid to the Lloyds board. A couple more questions if I may, Chairman, because we are on quite a rich seam here.

Q171 Jesse Norman: How would you evaluate Peter Marks’ performance in regard to the discussions that we have just considered?

Neville Richardson: All these things are about judgment. I was making a judgment call to take what I think was a massive decision, which effectively ended my executive career, to go and say, “We cannot cope with all this at the same time”. This was a massive decision for me to take. It was a judgment call about which I might have been wrong. If I had been wrong, then I had effectively left my executive career, which was very successful at that point, and was not going to walk back into any executive career. Hindsight tells me that that was a good judgment call. As far as Peter Marks is concerned, which is what you asked me—

Neville Richardson: The IT transformation write-off would not have happened had I still been there. If you ask the question of why these things happened after I had gone, but did you raise these concerns as potential issues that could emerge?

Neville Richardson: No. The IT transformation write-off would not have happened had I still been there. If the bank had been managed on a proper basis, if the bank had been managed and not had its resources diverted to Verde, and many key people diverted to Verde, its operating profit position would have been better than it was. Its loans would have been better managed than they were. Loans have to be managed on a daily basis. They have to be managed on a frequent basis. That diversion of resource is exactly what I was talking about when I warned about the
consequences of taking on too many projects at one time.

Q175 John Mann: But you were not quantifying your fears in any way?
Neville Richardson: It was almost impossible to do that. It was impossible to do that apart from I used the word “disastrous”. I used the words “collapse of the banking system”. These were pretty dramatic words that I used at that time.

Q176 John Mann: Mr Andrew Bailey is suggesting to us that the main issue was around the Britannia assets. Is he right in that?
Neville Richardson: No, he is not and, by reference to the report and accounts and the research I can do just looking at the websites of the Co-operative Group, you can see that, of the losses that have been reported over the last 18 months, only about one third relate to Britannia.

Q177 John Mann: When he had these meetings and this dinner—and you are obviously better placed than anyone to answer questions in relation to Britannia and Britannia assets—what specifically did he raise with you about Britannia?
Neville Richardson: Absolutely nothing. At that point, the merger had happened two years ago.
John Mann: He did not ask any questions?
Neville Richardson: None whatsoever.
John Mann: None?
Neville Richardson: There was no issue about the Britannia assets.

Q178 John Mann: The internal models that the Co-op was using in relation to capital, were they sufficient?
Neville Richardson: They were approved by the boards and by the regulator. They were sufficient.

Q179 John Mann: In your view, they were sufficient?
Neville Richardson: In my view and the regulator’s view, they were sufficient.

Q180 John Mann: You seem to be a little vague on whether you resigned. Was anyone trying to push you out?
Neville Richardson: If I could give you the explanation of what happened. I took things to a head on 10 and 11 July. This was a serious move on my part and I had thought about it very long and hard. We had a board meeting on 12 July in which I tried to persuade the board not to carry on with Project Unity. I wanted the board to suspend Project Unity. If I had known the depth of the work required on Verde, I would have been against that as well. The board did not take the warnings that I gave, and Project Unity was announced on the Thursday of that week, so around 14 July. Project Unity was announced to all the staff on that date. I thought about it very long and hard over that weekend and went see Peter Marks on the Monday morning, 18 July, and said, “Look, I have made this judgment call that I think it is impossible to run the bank in a proper way and carry out all these projects. You and the board have taken the view that you think it is. I think my position is untenable, I am not prepared just to sit back and try to make this thing work, because I have made it so clear that I think it is untenable,” and we agreed that it was in the interests of the bank that I left.

Q181 John Mann: You take a very different view from Andrew Bailey on the relative significance of the problems of the Britannia in the whole picture, but you accept that there were problems with the Britannia. When were you first aware of those problems?
Neville Richardson: No, I don’t take that point at all. Can I just take you back through the sequence? Britannia was a good organisation. It was a strong organisation. It was approached by Co-op Bank, not the other way round. It was approached by Co-op Bank to look at a possible merger. Co-op Bank then carried out due diligence on Britannia over a period of 15 months—it had 15 months to complete the deal. It carried out very extensive due diligence. Whatever it came up with was for the Co-op Bank to see, so any loans that had been written by Britannia and any issues were open and transparent to Co-op Bank. For the two years after that, while I was still there, no unexpected issues whatsoever from Britannia arose. For the year and a half after that, after I had left—so this is outside my influence—no issues arose. Accounts were audited year after year after year. Boards were carrying out their governance structures and reviewing loans month after month after month, throughout the whole of that process, and no issues whatsoever arose. So something different happened.

Q182 John Mann: Your position on that is very clear. One final question and that is on the future of co-operative banking. Are we seeing now the end of co-operative banking in this country?
Neville Richardson: I sincerely hope not. I am a very big supporter of the mutual model. I think the mutual model as a whole, and co-operative banking in particular, provides something that others do not provide. I think it provides competition on the high street. If you look in the Sunday newspapers at the best buy, invariably mutuals and the Co-operative are strongly featured in that. I think it would be a very sad day if the Co-op Bank or other mutuals did not exist.

Q183 Mr Love: First, can I draw the attention of the Committee to my designation as a Labour and Co-operative Member of Parliament? Can I take you back, Mr Richardson, to one of your answers to an earlier question, when you indicated that five executive members and 15 senior management personnel left after the Verde process had started? That rather links the two together. Do you have any evidence to suggest that management stretch or Verde or a combination of those things were the reasons why any of those people left?
Neville Richardson: Verde and Unity. I bring Unity into it as well because Unity was changing people’s roles and so a number of people who were in senior positions had their roles changed in such a way as
they found it unacceptable to stay in the organisation. Their reporting lines changed and they just found it unacceptable to stay. It wasn’t—

Mr Love: But was that linked in any way to Verde or to the concerns you had about management stretch, with all the things they were being asked to do, and Verde making that impossible?

Neville Richardson: I would be guessing if I gave the answer to that because I wasn’t there at the time, but it is highly unusual to lose that level of experience and expertise in such a short space of time. I would find it very difficult had I been chief executive to continue running the organisation at that point. I should also say that the business was running at that point with a temporary chief executive, a temporary chief finance officer and a temporary chief risk officer. This was an organisation trying to do the biggest transaction of its life—Verde—running with a depleted executive team, a depleted management team and temporary people in all the senior roles.

Q184 Mr Love: You have commented on this earlier, but I would like to get some more specific information from you in relation to the widespread reports in the press, in particular that the current problems faced by the Co-operative Banking Group were a direct result of the loan portfolio that they inherited from Britannia. Perhaps you would contradict what the press has been commenting on regularly?

Neville Richardson: First, it is not all the press. One or two newspapers have been making these sorts of comments. Others have carried out the research that I have and looked on the websites and the report and accounts. The figures that are reported to relate to losses and significant items over the past two sets of reports from the Co-op Bank add up to £1.6 billion. Of that, the amounts attributed to Britannia are about one third. But I would also contend very strongly that, of those that are attributed to Britannia, much has come about because of the way in which the businesses have been run and, very importantly, because of regulatory change in the way that provisions are being required. The regulator in December 2012 imposed on banks and building societies a new way of carrying out provisions and they decided to start adjusting the level of provisions that they were holding. There is an imposition by the regulator that appears, to my mind, to have substantially increased the reported losses of banks and building societies in general.

Q186 Mr Love: That may be something that we will take up with the regulator when we see him. You commented in your written evidence to us on the results announced on 29 August, where you highlighted non-core loan losses of £680 million and you indicated that it was clear from the published information that the Co-operative Financial Services originated loans were part of this figure. You said earlier the only resource that you had was published information. Can you give us any information on how that £680 million figures breaks down between Co-op Financial Services and Britannia?

Neville Richardson: I can give you part of the information that is publicly available and that is to say the £680 million I don’t immediately recognise because the loss was £709 million in total. The amount that related to loan impairments was £496 million. Of the £496 million, £350 million related to non-core. So at that point we are down to a figure significantly less than happens at Britannia. Non-core had been designated, according to the Co-op’s own results, as being the ex-Britannia commercial loans and intermediary lending, but it is very clear from the 31 December accounts that non-core business also included significant amounts of loan write-offs relating to Co-op Bank issued before the merger. I don’t have an exact figure for you, but I can say that, of the total loss provisions and significant items of £747 million, my belief is that significantly less than £300 million was generated by Britannia assets.

Q187 Mr Love: Perhaps, rather than bore the Committee by throwing figures around, we could ask that perhaps, Mr Richardson, you could write to us on how you find these figures and the sources from which you have them.

Neville Richardson: Yes.

Mr Love: That would be very, very helpful.

Q188 Chair: Before you move off that, if I may just interject with one point. You have already supplied us with some figures. I just want to as a point of fact clarify this. This says, “Britannia’s gross assets £37 billion were analysed”. Analysed by whom?

Neville Richardson: It is in the public domain. At that time, under the Basel requirements, it was—

Chair: This is a Pillar 3 disclosure, is it?

Neville Richardson: It was Pillar 2 at the time but it became Pillar 3, yes.

Chair: All these figures that you have in here are derived directly from the accounts by you?

Neville Richardson: Yes.

Chair: You have put this table together?

Neville Richardson: I have put that table together. It is very straightforward. It was a publicly available document. In fact, I should emphasise that virtually every figure that I have mentioned in my written statement—and I apologise that there are a lot of figures in my written statement—I have derived very largely from the Co-op Bank and the Co-op Group website.
Chair: Thank you. Sorry to interrupt, Andrew. It was clarification.

Q189 Mr Love: Yes, that is helpful. Can I take you on to the issue of commercial property and commercial investment more generally? There has been a lot of comment over a long period about the fact that many financial organisations got into this. Can you tell me whether you were the originator of the idea of moving into this area and why you took that decision as part of the Britannia organisation?

Neville Richardson: No. In fact Britannia has been in commercial lending for a substantial amount of time. I believe it was from prior to 1990—way before my time—that Britannia was a commercial lender, but can I just draw a distinction because—

Q190 Mr Love: Did that go from a very small base prior to the 2000s, because I think you will find from other financial services organisations that they had exposure to commercial property but it was very much smaller than it built up to be prior to 2007?

Neville Richardson: It increased over that period of time but so did the balance sheet. Looking at the balance sheet as a whole, I always look at the balance sheet as a balance of risks. The largest individual part of the lending was standard retail mortgages, which represented over 30% of the balance sheet. Those had a loan to value of 37%. That was probably the least risky lending anybody did in the country at the point. It had some loans that were of higher risk. It had £2 billion of commercial rented property, which represented only 5% of the balance sheet.

I just wanted to clarify what we mean by commercial lending because, to some people, commercial lending was speculative. It was lending to property developers who didn’t have a property in mind or they just had the land. The lending that Britannia did throughout my time was underwritten in two ways: first, by the rental stream that came from whoever the tenant of the property was. If we lend to a borrower because he is buying an office block, we want to know who the tenant of the office block is, what the length of lease is buying an office block, we want to know who the tenant of the office block is, what the length of lease is. The second piece of underwriting was the value of the property itself. We never lent speculatively in that period of time. We were not developers in that way at all. Every one of those loans, as far as I am aware, was loaned on the security of an underlying tenant and an underlying property value. That is very different from what you will see in many organisations.

Q191 Mr Love: There was a lot of comment at the time when commercial property and commercial loans generally had gone up prior to the credit crunch and there was particularly a lot of comment about whether mutual organisations which had been in retail and mortgage-type activity had the expertise. Did you assure yourself, as the managing director of Britannia, that you had the commercial expertise to enter in the way that you did into this marketplace?

Neville Richardson: Just to go back, we didn’t enter it during my time. We continued it during my time and, yes, we did have the expertise. We had people, crucially, who had been around in the early 1990s seeing the aftermath of the previous crisis. They had seen what problems can occur. They were an experienced team. My guess is we had somewhere between 30 and 40 people working on this activity, which in fact is a very big team with a lot of combined experience.

Q192 Mr Love: You have commented in your written statement about the Co-op’s £1.7 billion exposure to property and construction. What was your assessment at the time of the merger about the riskiness of that portfolio and, if you felt it was risky, did you draw it to the attention of the board?

Neville Richardson: Yes. I have talked a lot about the due diligence that Co-op did on Britannia. I quite right that I also point out that Britannia did due diligence on Co-op and when we looked at that loan book, yes, we did see risks in it. I would expect to see risks in any loan book. The view that one of our experienced non-executive directors had was that perhaps it would have needed additional provisions of something like £100 million against it. My view is the reason why that would be an understated figure—so I suspect losses have been higher than that in the period since—gets back to my fundamental concern that, because the eye had been taken off the ball because of Verde, the loan books have not been managed properly in the last two years, as has the rest of the business.

Q193 Mr Ruffley: On this point about the impairments predominantly arising after you left—that is the sense I am getting from your evidence, Mr Richardson—could you just say something about the blame you seem to be putting on the regulator for asking for more extensive provisions for potential future losses as compared with write-downs that you would have seen and discussed when you were there?

Neville Richardson: I think I would come back to the view that I just expressed, which is something happened that suddenly required banks and building societies to make additional provisions at the end of 2012. My understanding is that the regulator took a different view and a harsher view on commercial provisioning, such that they were asking organisations to provide on what I think they believed to be an economic basis rather than an accounting basis. An accounting basis is you make provision when you see something wrong. An economic basis is you assume that certain economic circumstances will arise over the next few years and you make provisions on that basis, but can I just support my view that provisioning is not necessarily the same as a loss?

In 2012 provisions raised by Co-op Bank amounted to nearly £500 million, I think. They already had provisions sitting in their accounts of something over, I believe, £200 million or £300 million. They had hundreds of millions of provisions. The actual write-offs—so this is a position where you recognise that you do have a bad debt as opposed to trying to make a provision—from the report and accounts was about £50 million. There was provisioning being built up, being built up, being built up, and actual write-offs
seemed to be quite small. Then in December 2012 it
seems that the regulator came in and said, “We would
like a harsher method of provisioning. We would like
you to regard things as impaired at an earlier stage
than you have previously been doing that”. I am not
saying that the regulator was right or wrong to have a
judgment call. The thing that surprises me is to bring
it in in one go; so to bring it in as an immediate effect.

Q194 Mr Ruffley: Let us just go to your written
evidence where you talk about Britannia having an
£8.6 billion specialist residential mortgage loan
portfolio acquired through intermediaries. The Co-op
interim for the first half of 2013, which we have most
recently seen, shows that more than £1 billion of the
£7 billion optimum (Britannia) portfolio is impaired
with more than a quarter having a loan to value of
over 100%. Do you agree with that?

Neville Richardson: I don’t know. I haven’t seen
those figures.

Mr Ruffley: What do you mean you don’t know?

Neville Richardson: Sorry, I haven’t necessarily seen
those figures but it doesn’t surprise me.

Mr Ruffley: But this is the optimum portfolio that is
your baby, from Britannia.

Neville Richardson: The £8.6 billion is a figure that I
recognise, and I recognise that there would be
significant figures—

Q195 Mr Ruffley: You are a numbers man and you
have given us quite a lot of details and reiterated that
in your oral evidence today, but the Co-op interim
accounts for the first half of 2013 show that more than
£1 billion of the £7 billion optimum portfolio is
impaired. I am asking you, do you agree with that or not?

Neville Richardson: I am assuming that they must
have the right figures but can I just draw your
attention to—

Mr Ruffley: So that is a yes?

Neville Richardson: Can I just draw your attention to
what—

Mr Ruffley: Sorry, is that a yes? You accept that
figure in the Co-op interim report?

Neville Richardson: I will check that figure afterwards and confirm to you whether I accept it or not.

Q196 Mr Ruffley: Who was responsible at Britannia
for the strategy of pursuing growth through specialist
mortgage business?

Neville Richardson: The board approved all the
strategy of Britannia and the board was in approval of
this, but can I—

Q197 Mr Ruffley: Hang on; I want to stick on that.
Who on the Britannia board had knowledge of this
specialist mortgage business?

Neville Richardson: Quite a number of members of the
board. We had a very experienced board at Britannia.

Mr Ruffley: In sub-prime?

Neville Richardson: It was not sub-prime. The
definition you are applying—there are one or two things I need to—

Mr Ruffley: Hang on, specialist mortgages of the
kind of business that General Motors Acceptance
Corporation were flogging to you. There is no sub-
prime in that?

Neville Richardson: I need to clarify some of the
comments that you are making.

Mr Ruffley: No, I am asking a question. I am not
making comments. You are saying there was no sub-
prime on the Britannia loan book?

Neville Richardson: I am saying there were no
significant problems with the—

Mr Ruffley: No, no, sorry, there was no sub-prime.
Is that what you are saying?

Neville Richardson: Not at all. No, there was some
sub-prime.

Q198 Mr Ruffley: There was some sub-prime. Let’s
just go back to the optimum portfolio. What
proportion was originated by Platform, which was a
Britannia entity? That is a yes. What proportion was
originated by Platform and what proportion was
flogged to you by General Motors Acceptance
Corporation?

Neville Richardson: The amount from General
Motors was only purchased subject to extensive due
diligence—

Mr Ruffley: No, that isn’t the question. I want to
know what proportion—

Chair: Let him just—

Mr Ruffley: No, with respect, he needs to answer the
question I am asking, not make a statement.

Chair: I would be very grateful if you could just
finish that sentence and then answer Mr Ruffley’s
question.

Neville Richardson: Yes.

Mr Ruffley: You have probably forgotten it now.
What proportion of the optimum portfolio was
originated—

Chair: David, just let Mr Richardson say what he
wanted to say and then we will come on to this
question.

Neville Richardson: There is a presumption behind
your question that the GMAC loans are not
necessarily good loans.

Mr Ruffley: There was no presumption. I asked you
what proportion of the optimum portfolio—

Chair: You must let Mr Richardson just finish what
he wants to say about GMAC—

Mr Ruffley: Try answering the question, please.

Chair: and we will come back to your question,
David.

Neville Richardson: Whenever we purchased loans
from GMAC we underwrote them ourselves. That is
what I am trying to say. In other words, the
underwriting criteria that GMAC used were somewhat
irrelevant to us because we went in and did due
diligence and looked at them as though we had
originated them ourselves, and if they were not to the
quality that we expected in that due diligence, we
would reject them and not take them on board. That
has not been the case for other people who purchased
GMAC loans. They often just took them as stated. We
did not. The quality of those loans from GMAC was
not significantly different from the quality of loans we
were originating ourselves.
Q199 Mr Ruffley: Before I get to my final question, I am going to have another go. What proportion of the optimum portfolio was originated by Platform and what proportion from GMAC? Can you answer that?
Neville Richardson: My guess would be about two thirds to three quarters from Platform and the remainder from GMAC, but I don’t have the figure readily to hand.

Q200 Mr Ruffley: Bradford & Bingley explained to the predecessors on this Committee when they looked at Bradford & Bingley’s failure: “Underwriting criteria written into their GMAC contract meant that when credit conditions deteriorated there was no ability to change the underwriting criteria for the loans”. Did Britannia have a similar—
Neville Richardson: This is what I am trying to explain to you.
Mr Ruffley: It didn’t?
Neville Richardson: No, it did.
Mr Ruffley: It did, right.
Neville Richardson: Bradford & Bingley were very different from Britannia. Britannia, when it bought loans from GMAC, three things. One is what I just explained, which is that it carried out due diligence. We carried out our own due diligence on those loans. The second is we had no forward purchase agreements. Bradford & Bingley had agreed in advance that it was going to take loans from GMAC, regardless of whether they wanted them or not. We did not. We bought GMAC loans on a portfolio-by-portfolio basis. The third and absolutely critical point is that we in Britannia had extensive warranties, so if the loans proved not to be what we thought they were going to be, we put those loans back to GMAC. That was a massively different position from the one which Bradford & Bingley accepted.

Q201 Mr Ruffley: My final question is, given the Co-op accounts show that more than £1 billion of the £7 billion optimum portfolio is impaired, you can’t account for that, can you?
Neville Richardson: I would like to explain to you what I was trying to explain before, which is about what impaired means. Impaired does not mean bad debt. If we look at some of the aspects of the accounts, impaired is a title that is given on the credit card and loans accounts to accounts that are one penny one day overdue. If anybody around this table has ever had a loan in that situation, you talk to the customer, you give the customer the ability to repay, they do repay and it is not a bad debt. The evidence of what I have said is that, in the period since the merger between Britannia and Co-operative Financial Services, the actual bad debts arising on that portfolio, despite the level of impairment you have talked about, have been absolutely minimal. That has been a good book and, over the years, earned Britannia members profits of well over £100 million.

Q202 Mr Ruffley: It all went wrong after you left. Is that what you are saying? You would like that to be the conclusion from your evidence?
Neville Richardson: It is absolutely clear that, when I left, the business was in good shape. There were no issues arising. Nothing was coming forward from regulators or auditors that suggested that there were any issues, nor was there at the half year after I had left or the full year or the following half year.

Q203 Mr Ruffley: Absolutely the final question. Therefore, it is completely mystifying to you, is it, as to why Andrew Bailey came in front of this Committee a few weeks ago and said, in reply to Mr Norman, that Britannia assets were something that troubled him? You cannot understand why the senior banking regulator, currently, said that to this Committee? You have no idea why he said it?
Neville Richardson: I have no idea why he would say that, given the figures that I have in front of me.
Mr Ruffley: Thank you.

Q204 Chair: Just to be clear, I think I understand you to say, in effect, that, far from being a weakness, having GMAC on your balance sheet, given your ability to sift out the good from the bad GMAC, the wheat from the chaff, and your unique skills of managing it as a firm, even though we are talking about non-conforming loans, self-certification, buy-to-let and so on, represents a source of strength on the balance sheet overall and not weakness?
Neville Richardson: It was certainly a source of profit and a very good return on capital. The answer to your question is yes.

Q205 Chair: In that case, given the crucial role that this very large proportion of loans on your balance sheet played and the importance of it in the overall presentation of your view of the performance of Britannia, why did you make no reference to this at all in your evidence?
Neville Richardson: Because it is within the figures that I have mentioned and, from my point of view, these loans were never worse performing than the Britannia-generated loans. It wasn’t an issue because of the underwriting that we had carried out ourselves to satisfy ourselves on those loans.

Q206 Chair: But if this is such a strong point, given that this is what is likely to have been raised—and indeed has been raised given that this was a very similar problem with Bradford & Bingley—might it not have been a good idea to spell this out in your evidence?
Neville Richardson: I think, with hindsight and given the questions that I have just had, I would have been delighted to spell it out.

Q207 Chair: You certainly bought a lot, didn’t you, of GMAC?
Neville Richardson: Over the years we did buy a significant amount, as I have just said, but still that led to us being on track. There was an awful lot to do, but it was on track. In terms of the life and savings business, again that was taking a lot of resource to sell and to put together as a package that could be separated from the rest of the business, but the sale process was going well. It is my fundamental belief, backed up by the facts of the results in the accounts and everything around it at the time, that CFS at the stage that I left was meeting all the targets that had been set for the merger. This was set up as being a merger creating a new force in banking and at that point it was doing that.

Q208 Stewart Hosie: Mr Richardson, you have gone on at some length, rightly I think, to describe your concerns that four major projects, including Project Verde and Project Unity, leading to the management stretch was a fundamental reason for many of the problems. To what extent are the current difficulties rooted in the acquisition of Britannia in the first place?

Neville Richardson: I do not think that is a major problem at all and I go back to my earlier comment that, after the Co-op approached Britannia, the Co-op carried out extensive due diligence. The sort of loans that we have just been talking about were generated in 2008 and prior; so 2007 going back probably over the previous five, six, seven years. That means that, by the time that suddenly the shock hit in 2012, these loans had been on the books for between six and 10 years. It defies credibility to say that loans suddenly become bad after six to 10 years and I will just explain why I say that. Experience in lending, and particularly in the sort of lending we have just been talking about, the residential intermediary lending, tells you that, if a loan is likely to go bad, it goes bad very quickly. For instance, whenever we bought GMAC loans, we insisted that the first or second payments had already been made, so the existence of the ability to pay was in place. Trying to claim that issues that arise now in the Co-op relate to loans issued six to 10 years ago that had been subject to six to 10 audits simply does not make sense.

Q209 Stewart Hosie: I am not making the point that it is in relation to the loans. I am taking the lead from your evidence, of what you have said earlier today, that in large measure this was down to Co-op trying to do three major projects in advance of Verde. The question I have is, even if Project Verde had not come along, is it not the case that the new bank, Co-op and Britannia combined, would still have lacked the management capacity to deal with the three substantial changes that you spoke about earlier?

Neville Richardson: No. The business as usual was succeeding very well. In fact, at the point at which I left the organisation in mid-2011, the business was profitable. It had good liquidity. It was meeting all its capital requirements and it had good ratings. The business, as business as usual, at that point was performing well. It was achieving the £50 million per annum synergy targets—so the cost saving targets that we had set at the time of the merger—and was performing well. It was a good organisation. In terms of the IT transformation, that was a big stretch, a very big stretch, because it takes hundreds of people to work on that sort of programme, but external quality assurance was telling us that we were on track. There was an awful lot to do, but it was on track. So a very great deal.

Chair: So a very great deal.

Neville Richardson: I am happy to follow that up to see if that was accurate.

Chair: I think it might be helpful. I think the area that we have just been exploring is extremely important for our inquiry.

Q210 Stewart Hosie: The entire reason for the difficulties is the pressure that was added to the management team as a direct consequence of the Project Verde acquisition?

Neville Richardson: Verde and Unity.

Stewart Hosie: Verde and Unity?

Neville Richardson: Yes.

Q211 Stewart Hosie: Let us go back to the Co-op Britannia acquisition in the first place. There was a deal of market turmoil immediately prior to that. Was there any pressure from the FSA for the Co-op to acquire Britannia?

Neville Richardson: No. In fact, quite the contrary. If you recall, at that time, the markets were incredibly tough. When we first approached the regulators—we jointly approached the regulator, CFS and Britannia—they were, I believe correctly, sceptical about the transaction. Could this combined entity have sufficient capital? Could it cope with the stresses? You have to cast your mind back to 2008 and how tough things were at that time. The regulators were keen to make sure that any merger that was announced, if it was being announced as good news, which this was, had sufficient capital backing. We had to go through significant amounts of numbers and detail with the regulators to confirm that this was a deal worth doing and a proper deal.

Just to add one point, the regulator at the time was looking at the adequacy of capital in banks. They were going through a process of insisting that some banks got more capital from other sources and many of the listed banks went ahead and raised additional capital at that point. If the FSA, as it was at that time, had felt that this deal, which they were very closely involved with, did not have sufficient capital, they would not have let it go through.

Q212 Stewart Hosie: Let me ask that question a slightly different way. Clearly, there were discussions with the FSA. They raised issues about capital and liquidity; quite right, too. The capital adequacy debate was raging at the time. Could Britannia have survived on its own, given the liabilities on its balance sheet at that point, if it had not had the merger with Co-op?

Neville Richardson: Yes, it could. In fact, my recollection is the way the regulator looked at the merger was it looked at the two separate entities first and then looked at the merged entity. My recollection
is that there were no issues to do with the capital adequacy of either of the organisations.

Q213 Stewart Hosie: Good. You told this Committee in February 2011, “Following its merger with Britannia, Co-op is now a bigger and stronger organisation.” Notwithstanding what happened since Unity and Verde, do you still stand behind that or, in practice, was it a bigger but weaker and riskier organisation?

Neville Richardson: No. It was a good, strong organisation. It was putting together two organisations that had different strengths. Britannia, in many respects, I would have said, was the best mutual in Britain at the time. Its attention to members, its attention to customers and its attention to employees was tremendous. It had a great name in mortgages and in savings, but a very narrow product range. The Co-op had a tremendous name in current accounts. It also had a good name in corporate and it had other activities that went with it, and it was part of the bigger Co-operative Group. Putting the two organisations together, to me, made perfect sense at the time, as it did to the Co-op, as it did to my board, and it still makes perfect sense to me today. I think it is very sad, what has happened to the organisation.

Q214 Stewart Hosie: Just one final question. In your written evidence, you state that CFS may have been a less prudent organisation than Britannia in the years preceding the merger. “The level of provisions charged to P&L by Co-op was higher than those made by Britannia on a proportionate total asset basis”. To what extent could that be a reflection of under-provisioning by Britannia historically, rather than the adoption of a more prudent approach?

Neville Richardson: There was never any suggestion of under-provisioning by Britannia historically, rather than the adoption of a more prudent approach?

Neville Richardson: There was never any suggestion of under-provisioning by Britannia. In terms of the audits and all those sorts of things, they were all clean. In terms of the level of overdue debts, they were very low. It was a well-managed organisation and, had there been some horrendous issue arising, I am sure that the Co-op due diligence would have picked that up or it would have arisen before December 2012. It is such a long time in banking terms. If you look at the collapses that have happened with the listed banks, so many of those have happened very soon after the loans were written. It just does not happen that loans subject to so much due diligence, subject to so many audits, suddenly fail for no reason at all and were claimed to be problems at the start. That does not make sense.

Q215 Stewart Hosie: The bit of this jigsaw I am struggling to fit in is that Britannia is functioning notwithstanding the difficulties. Co-op is functioning notwithstanding the economic circumstances. The merger is fundamentally good. You then give the most stringent warnings that the addition of two projects, Unity and Verde, will effectively crash the bank, and nobody listens to you. What more should you have done? Should you have been public and said something more clearly? Should you have been more strident internally? To get to this point now, where Verde has failed, where Co-op is struggling, what more should you have done to make your view heard at that point, in and around the middle of 2011?

Neville Richardson: I have thought about that an awful lot. Could I have done anything differently? In some respects, the people that I was talking to were people who were not financial services people—people who had a very successful background in retail—and financial services and banking is very, very different from retail. I am not at any stage accusing anybody of being reckless or ignoring my warnings in order to be reckless. What I am saying is I think they did not understand the consequences. I tried to make those very clear. I have thought about exactly what you have said—should I have gone public at the time?—and I go back to an answer I gave earlier. This was about a judgment call that I was making. It was my judgment that putting all these projects together was going to lead to disaster. I may have been wrong. If I had gone public at that stage and said, “This business is heading for disaster”, it would have had severe consequences for the business. That was my judgment, and if my judgment had been wrong, I would have caused as a big a problem as they have today.

Q216 Chair: Just to be clear, your position remains that the Britannia merger offered a unique opportunity to create a new and strongly capitalised force in financial services?

Neville Richardson: Yes.

Q217 Chair: The PRA, it seems, thinks that this entity now needs £1.5 billion of capital. The regulator has told us that the main issue was the Britannia assets. You will understand that we feel there is some gap between your interpretation and the fact that all this capital is required and the regulator is saying that the main issue is Britannia assets?

Neville Richardson: I can assure you very clearly, as I have done in my written statement, that more of the problems that the Co-op Bank has faced came from sources other than Britannia than from Britannia. Can I just talk a little bit about the £1.5 billion? In addition to the regulators changing the rules on provisioning in December 2012, they also brought in more stringent requirements for capital in February-March 2013. £1.5 billion is on a new basis. It is on a different basis.

Chair: A basis that will have hit Britannia assets more than the other assets. That must be the case for your argument to be sustained.

Neville Richardson: It could well be the case.

Chair: You think that that is likely to be the case?

Neville Richardson: It could well be the case.

Q218 Chair: We will find out. I have to tell you now, although I have not discussed this with my colleagues, that we might want to have further discussions with you and take further evidence, as that reveals itself. Perhaps I might also ask you now a couple of other points. We have had a letter that has been put into the public domain from a Mr Roger Gorvin who is a long-retired former main board executive of Co-op. He says, “It was known that Britannia was a rescue operation because Britannia had got into trouble with
some large-scale Icelandic investments.” Is that not true?

**Neville Richardson:** Not at all. I am struggling to cast my mind back, but I do not remember.

Q219 **Chair:** Fine, if you think it is not true. You have given the Committee a clear steer. Mr Gorvin also says, “It should be remembered that Mr Richardson made it a condition of his support for the merger that he became chief executive of the merged entity.” Is that correct?

**Neville Richardson:** That is not true at all. The approach that was taken was that David Anderson, who was the chief executive of the Co-op Bank, said that he was going to step down and the Co-op Bank and Co-op Group went through a very thorough process, including psychometric tests, a series of interviews—

**Chair:** Okay, fine. You have given us a very clear steer on both those points.

Q220 **Mr Newmark:** I just want to focus on what happened after you left because it raised some questions with me and was problematic with a lot of people in the financial services sector, as well as constituents. My first question is, what was your severance at the time when you resigned?

**Neville Richardson:** My severance?

**Mr Newmark:** Severance, yes. When you resigned you received a certain amount of money. How much was it, just so I am clear on that?

**Neville Richardson:** The amount that I received over and above the pay for the year and all those various things, I received a final severance payment of £500,000 before tax, which is £280,000 after tax.

Q221 **Mr Newmark:** On top of what else, though, before that? Your base pay and everything else, what was that, all-in?

**Neville Richardson:** Beyond the amount that I was paid for 2011, which was a contractual year, I received £1.39 million, which represented £380,000 as pay for the year’s notice. I was on a one-year contract. The Co-op Bank held me to certain obligations within that contract. That one year’s notice would have applied the same both ways around, and I was paid the one year’s notice.

Q222 **Mr Newmark:** Can I ask, just to be clear: your pension, on top of that, was how much; on top of the £1.3 million?

**Neville Richardson:** That was nothing to do with the severance.

**Mr Newmark:** I just want to understand how much, all-in, you received when you left.

**Neville Richardson:** But it was not all-in. In January of 2011, the Co-op Group took a different approach to the way in which it was making pension provisions. It approached me and said that it was taking a different approach and gave me a number of options. Bear in mind this is seven months before I left. I had no indication or no intention—

**Mr Newmark:** I know, but what is the number? I am trying to get whole—

**Neville Richardson:** I am trying to give the background, because you lumped it in with me leaving and it is nothing to do with that.

**Mr Newmark:** Go ahead, please.

**Neville Richardson:** Yes. The Co-op Bank approached me and they gave me various options. One of those options was to take the pension entitlement I had in cash and pay tax and employer’s national insurance on it. I took that option in April. I took the sum of £2.1 million and paid 63% tax and national insurance on it.

**Mr Newmark:** Okay. I am sure the Exchequer was very happy with that. But when you add in all those numbers, £1.3 million plus the bonus plus the £2.1 million, it comes to a large figure. I know that, in the financial services sector—because I was in there—maybe in the grand scheme of things that was not a big number, but to most people out there that is a big number. Then they see you leave and the problems that seem subsequently to emerge. I am just curious. Why you were paid such a relatively large amount of money—assume it is a rhetorical question—is because you were the senior guy at the firm, responsibility sits with that individual and the buck stops at the top. I have been listening to your answers, which are sort of a slight self-justification explanation for what went on and a lot of ducking and diving as to why you were not responsible, some of which I buy and some of it that I find a little problematic, but at the end of the day you are paid a lot of money, so when something happens, ultimately, responsibility does lie with you. When there is catastrophic failure, which there was at this institution, you have to take some sense of responsibility for that. I just get no sense of that listening to you answering any of these questions. Do you take any responsibility for what went on?

**Neville Richardson:** You have asked me a number of questions in that explanation. As regards the pension payment and, although you said it should not be lumped in, you sort of lumped it in. That pension was earned over many, many, many years of my career and so was nothing to do with what happened in 2011.

Q223 **Mr Newmark:** No. The point that I was making was the fact that you are the top guy. Responsibility sits with you and all of us here have constituents who write to us the whole time not understanding this. Now, I understand this. I was not in your business, I was in private equity, but there are large numbers there. But to the vast majority of ordinary people out there, what you received—because you had a responsible position you received a large bonus over a number of years, plus a large salary relative to mere mortals out there. Given that responsibility sits with you, you may not have been totally to blame for everything but you must share some of the blame because you were the top guy.

**Neville Richardson:** I will make it absolutely clear. You have mentioned ducking and diving there and if you think that is the case, then please ask questions again because—

**Mr Newmark:** No. Just like Mr Ruffley, just like everybody, I am trying to understand—

**Neville Richardson:** Let me answer your question. One of my personal values is about taking personal
responsibility. I think anybody who has ever worked with me and anybody who knows me knows me as somebody of the highest integrity and somebody who will take personal responsibility. In the Co-op Bank, I took tremendous personal responsibility because I was the one who stood up and said, “This is not going to work. This is not going to work. This is going to lead to disastrous consequences”.

I could have taken a far easier line. The easier line that some were encouraging me to take was to go with it. If I had done that—and the numbers, I agree, are big numbers—I would have earned a lot more by staying in the Co-operative Group, keeping my head down and not saying anything. If I was in this for the money, that is what I would have done. Because of my absolute belief in taking personal responsibility, because of the integrity that I believe that I have built up over my entire working career, I took probably the toughest decision of my life and that decision was to tell the board members that this was not going to work, and effectively ruled me out of an executive career for the rest of my life.

Q224 Mr Newmark: Again, I can tell that the whole experience was painful for you and I understand that and I recognise once again that you did take a big decision in resigning, but we are here as representatives of the public and there often is a disconnect between understanding the granularity with which you have now had the opportunity to go into matters with us—but I just need to move on to the next question, because you were paid a lot of money. You decided, effectively, in your words, to resign; fall on your sword, say, “I’ve had enough”, and walk away. It was a lot of money to the public out there and you were the top guy when things went under. This is where I have a problem.

Neville Richardson: I am sorry. You said I was the top guy when things—

Mr Newmark: Effectively while the catastrophic failure was taking place—

Neville Richardson: No, I do not agree with that. The catastrophic failure arose because the people around did not take heed of my warning. If they had done that, this would not have come to the issues that we have today.

Q225 Mr Newmark: I guess therein lies the difference. We are trying to get to the bottom of that. It is almost a Gordon Brown-esque argument. The ground, effectively, for what happened was prepared. When the failure happened with the bank, the organisation was an impaired organisation—not impaired in the one pence overdraft thing, but impaired in more of a macro sense—because—

Neville Richardson: No, I refute that. The organisation was not an impaired organisation. At that point it was a good organisation and continued to report good results for the following 18 months.

Q226 Mr Newmark: Therefore, what you are saying to me is there was nothing wrong with the organisation up until the day that you stepped down. Just to be clear here, there was nothing wrong with the organisation. You left with your head held high. Next question was, having been chief executive of an organisation that quickly unravelled, in my view, you then went on to another financial services business, which is M & S Bank, which you subsequently came, because of public pressure, to resign from. Do you think that individuals such as yourself—I will not even say “you”, but individuals such as yourself—who have been paid a lot of money to be chief executives of companies that subsequently are seen to fail should immediately go into another financial services business or that perhaps they should pause, have a cooling off period, because there may be an issue with being, effectively, fit and proper to go on to another financial services business? I am not saying you are not a fit and proper person, because I can tell that you are and I know you have a huge moral code. I feel that from you. But, still, you are chief executive and bad things did happen. Do you think you should have gone on to M & S Bank as a non-exec officer?

Neville Richardson: Again, let us be clear. You mentioned the point of “immediately problems occurred”, but they did not. The Co-op Group would not have been raising funds in the market in the latter part of 2012 if it thought there were major problems around. That would not have been right. The issues arose 18 months after I left. That is a long time for a bank to incur problems.

I joined the board of Marks & Spencer Bank in January 2012, so it was nearly six months after I had left. There were no issues coming forward from Co-op Bank whatsoever. The regulators clearly had to approve my appointment and were happy to do so. I felt, in my time at M & S Bank, that I was contributing well to its board. My reason for stepping down was not in any way that I felt there were any issues to do with Britannia or CFS or Co-op that should reflect on them. It was to do with commentary that people were making in the media suggesting that I was not fit to carry out that role. That is not the view that M & S Bank took, but I chose to step down because I thought it was unfair on what is a very good organisation—M & S Bank—to have to deal with the media on a subject that was not of their own doing.

Q227 Mr McFadden: We have been going around this now for about an hour and a half and I want to try and get to the heart of the point that you are making. As the Chairman asked you a few minutes ago, Mr Bailey from the PRA said a big chunk of the Co-op’s problems—I’m paraphrasing, not quoting—were down to the inheritance from the Britannia takeover. You have made it the central point of your evidence to us, both in writing and today, that you fundamentally disagree with that. Is that correct?

Neville Richardson: I do disagree with it because I have taken my evidence from the report and accounts that I see. If Mr Bailey is aware of something different from what is in the report and accounts, I am not aware of that.

Q228 Mr McFadden: I will just clarify. You absolutely refute that the lion’s share of the Co-op’s problems as has been publicised in recent months are down to bad loans from the Britannia period?

Neville Richardson: I do.
Q229 Mr McFadden: All right. You would say then, that when it comes to this £1.5 billion, which has caused such a nervous breakdown in the Co-op Bank and serious consequences for investors, that £1.5 billion shortfall is essentially down to two things: first, the overload that you predicted of all these different change projects and, secondly, the actions of the regulators themselves. Is that a fair summary of your view?

Neville Richardson: I am not naive enough to say there are no other causes. For instance, loans do go bad over a period of time. There are also other factors that have come into play, such as the requirement for the Co-op Bank to pay redress on PPI mis-selling that it carried out before the Britannia merger, and that has made a hole of several hundred million pounds in these accounts. There are other factors, but the straight answer to your question, “Do I think those are the principal causes?” is yes, I do.

Q230 Mr McFadden: On the one hand, the regulator is saying it is Britannia and you are saying, at least in some part, it is not Britannia; is it the regulator?

Neville Richardson: I am saying the regulator has had a significant influence on that £1.5 billion black hole.

Q231 Mr McFadden: Obviously, we will have to try and get to the bottom of these two very different versions of events. You have made great play of this Project Unity. Would you say that the bank was seriously impaired by what amounts to an internal takeover by the rest of the Co-op Group?

Neville Richardson: I think it was, for two reasons. One is that there is something very different about financial services that people need to understand. The requirement for attention to detail, the requirement for attention to records and so on, is very different in financial services from in retail. For the finance people in a bank to report to people who do not have financial services experience, is, to my mind, dangerous. That is the philosophical part of it. In addition, Project Unity was requiring people to reapply for their own jobs. It was changing the structures, it was changing their positions, at a time when I think they should have been concentrating 100% on running the bank. It was just the wrong time.

Q232 Mr McFadden: Can I take you forward then to the restructuring of the Co-op itself that is coming about as a result of all this? Obviously, there are many investors who are very unhappy at the concept of what we have come to know as a haircut or perhaps a bail-in. Do you believe that the broader Co-op Group should bear a greater responsibility for the turnaround of the bank in the rescue package?

Neville Richardson: I do not know what the Co-op Group is capable of putting in. There may be restrictions on what it is capable of putting in. Certainly, from what I read, it is putting in what it can afford to put in, but I don’t know. My honest answer to your question is it should put in what it can afford to put in.

Q233 Mr McFadden: I will just ask you finally about where this leaves mutual. You said in your written evidence to us, “If the Rochdale pioneers had been at Thursday’s results announcement”—the latest £1.5 billion—“I think they would say that their successors have not lived up to the example they set.” Britannia and the Co-op was supposed to be the super-mutual; as you said, a new force in banking. This could end up—and it looks very much like it will—with the main mutual force that people know in banking, the Co-op Bank, no longer being a mutual because its shares are listed. Where does this leave mutuals in the financial services sector?

Neville Richardson: Let me try and make two separate issues here and that is the bail-in you talk about. If I had still been around, first, I believe many of these issues would not have arisen. Verde would not have been on the cards, the distraction of management would not have happened and the business would have been in better shape. But if I ask, “Is that bail-in necessary?” I think it is a question to ask the regulators. The changes that were imposed on provisioning and on determination of the so-called black hole in UK banking—£27 billion in total—was it necessary to impose that in one go over the period December 2012 to March 2013? What would have been the alternative if it had been imposed over a longer time, specifically for the Co-op Bank? When I am saying that Britannia was not the major part to blame, if I look at the figures that gave rise to significant losses—items such as the IT write-off, PPI, Project Verde costs—they add up to very significant figures, but they are all one-offs, in my opinion. Would it have been possible for the regulator to say, “Because they are one-offs, we will give you time to put the capital right”? So, “We will give you time to put your capital into proper position, rather than list the company”.

Q234 Mr McFadden: But you accept that when a financial institution gets into trouble, it is a desirable policy objective for the taxpayer not to be continually on the hook, as they were for RBS, Lloyds and so on?

Neville Richardson: Absolutely, and I am purely talking about the timing here. I am saying, would it have been possible for the regulator to impose these rules over a longer period of time? If that had been the case, would it have then been necessary to list the bank? You also asked me about the future of mutuals. I believe mutuals have a very strong future in this country. I think they add an awful lot to the economy. They add a massive amount to competition because they have a very clear focus. In the building society sector, the customer owns the business. I always say to people, “One of the very clear things that I understand with a mutual is that the next person who walks in through the door owns the business. They are not a profit opportunity.” That is a very different way of looking at things. I hope, and I believe, that the mutual sector will have a very long and successful future in this country.
Chair: In various ways, we have gaps between your evidence, the evidence of the PRA, and the evidence we have had from Lloyds, and it is those gaps that this Committee will now want to fill in the months ahead. We are very grateful to you for your evidence today. We may want to hear from you again when we have heard from others. Thank you very much for coming.

Neville Richardson: Thank you.
Tuesday 22 October 2013

Members present:

Mr Andrew Tyrie (Chair)  Mr Brooks Newmark
Mark Garnier  Jesse Norman
Stewart Hosie  Mr David Ruffley
Andrea Leadsom  John Thurso
John Mann
Mr Pat McFadden

Examination of Witness

Witness: Peter Marks, former Chief Executive, The Co-operative Group, gave evidence.

Q235 Chair: Thank you very much for coming in this morning to discuss the Co-op, Mr Marks. I think you would agree that the Co-op, both as a group and as a bank, was strong seven or eight years ago and both are now very weak. How much of that is down to you?

Peter Marks: I have spent 45 years of my life working for the Co-op, starting at the bottom and becoming chief executive. Over the last five years, the retail arm has doubled profits, quadrupled dividend, made record levels of capital investment, transformed its brand and strengthened its values. So it is harsh to say that the group as a whole is weakened. Absolutely, the bank is weakened and that is a tragedy. It is a tragedy for me particularly, but for the group as well. That is what I would say. In terms of my role—

Q236 Chair: Before we leave the group, are you saying that overall, therefore, you think that the group is still strong or that it is weak now?

Peter Marks: It depends what you mean by strong or weak. The bank has weakened the group, because the group is the sole owner of the bank, and I accept that, but the food business, the funerals business, the pharmacy business, legal services and all of its eight other substantial businesses are in stronger positions now than they were in 2007, when I took over.

Q237 Chair: The bank represents about 40% of shareholders’ funds?

Peter Marks: Yes, I believe it is that kind of figure.

Q238 Chair: And was that figure a bit higher prior to the crash?

Peter Marks: I am sorry, Chairman, I cannot remember that.

Q239 Chair: But we are talking about a little less than half, are we not? So what you are saying is that a good half of the Co-op has been wrecked by the other half?

Peter Marks: You could look at it that way.

Q240 Chair: Is there any other way you can look at it? You cannot say that the good half has wrecked the bad half.

Peter Marks: I am not sure that the bad half has wrecked the good half. I still think there is a good future for its food business, its funeral business and so on and so forth.

Q241 Chair: Okay. Now let’s turn to those weaknesses in the banking half—or slightly less than half. What responsibility do you bear for the demise of that part of the Co-op?

Peter Marks: I wonder if I could at this stage help the Committee by explaining the governance. I think that may be helpful. The group is governed by 20 non-executive directors who are elected democratically. Neither I nor any of the executive team were members of that board. The board is made up of 15 people, roughly a third executive, a third non-executive of which I was one, and a third independent professional non-executives. My official role with the bank was that of non-executive director. But I share responsibility, as a non-executive director, clearly for the demise of the bank.

Q242 Chair: But are you saying that you don’t have responsibility because somehow the board of the Co-op as a whole, of which you were chief executive, does not really have any direct influence on the bank?

Peter Marks: No. The board has a number of non-executives to represent the shareholder, which is the group. I was one of those non-executive directors. But the bank was ring-fenced by regulation. So it had its own board and its own chief executive and executive committee.

Q243 Chair: May we come back to the question I asked? I want us to be clear. Perhaps I will ask it in a slightly different way. What do you think are the key mistakes that have more or less destroyed this banking arm of the Co-op? Why don’t we just run through where the losses are? It is Britannia; it is the IT failures; it is PPI. There are also quite a lot of self-certified mortgages and other specialist mortgages and some further commercial real estate lending to come which we don’t yet know the scale of losses for. Correct? Are there any other major heads which we should include?

Peter Marks: I don’t think so.

Q244 Chair: Well let’s just go through these. Which of these—they could arguably be called mistakes, and you may say that they weren’t mistakes by all means if that is your view—which of these decisions, and behind each of those losses lie decisions, do you feel you bear responsibility for?

Peter Marks: If we take Britannia, I agree with the evidence that was provided to the Committee by
Andrew Bailey when he said that the large amount of losses were due to the Britannia book. So if we go back to 2009 when we made the decision to merge with Britannia, I was on the board and I voted for that as a non-executive director. It was a friendly transaction: two mutuals coming together. We hired consultants—advisers—to do proper due diligence. It was a lengthy process and fair value was attached to the assets of the business. We accepted the advice that we were given.

Q245 Chair: How much scrutiny of that deal took place at group level?
Peter Marks: The scrutiny was largely at bank level, because that is where the banking expertise was, particularly among the professional, non-executive directors.

Q246 Chair: But the risk lay with the group, didn’t it? And it still does.
Peter Marks: Yes.

Q247 Chair: I am surprised that you hesitate about that. What I find perplexing in all your answers is the idea that, somehow, the group was over there and did not really matter so much and all the mistakes happened down in this banking group when, in fact, this is the holding company: the heart of the group. You were chief executive of it, and now you tell us that the group did not even look at this deal very carefully.

Peter Marks: I know that it sounds complex and different, but that is how the group is governed. The bank is a separate entity—it always has been. The group supervises its ownership of the bank by having non-executive directors on the bank board.

Q248 Chair: You are describing a severe structural weakness, or failing, at the heart of the Co-op, aren’t you?
Peter Marks: You could interpret it that way.

Q249 Chair: I am asking whether you interpret it that way.
Peter Marks: There are areas of governance within the Co-operative that absolutely need to change.

Q250 Chair: Why didn’t you change them?
Peter Marks: I was not a member of the board. On many occasions, I had conversations with the board in which I said, for instance, that I believed they were doing too many things. How many businesses try to be a major bank, a major food retailer, a major pharmacist, a major funeral services provider and so on?

Peter Marks: Not about the bank specifically; I was warning them that they needed to focus on fewer businesses. They were stretching their capital, and still do, over too many businesses.

Q251 Chair: So you were warning them the whole time?

Q252 Chair: You were chief executive for six years?
Peter Marks: Yes.

Q253 Chair: So you were in a position to do something about it. Are you saying that you were only a nominal chief executive and the real decisions were taken somewhere else?
Peter Marks: No. The chief executive in a cooperative is very different from a chief executive in a plc. In a plc, you will find the chief executive, and his executive team, on the board. In the Co-operative movement, that is not the case. You have 20 people, elected democratically. Therefore, the chief executive’s role is to try to persuade the board with regard to strategy. We were focusing very much on bringing new life to the retail arm, which, as I said earlier, I believe we did successfully. When I took over in 2007, the food business was declining. It had a 4% market share while all the other food retailers were growing their businesses. We needed to change that and we did.

Q254 Chair: I am still trying to come back to the question whether you, as chief executive, feel a sense of responsibility for this clear, serious structural weakness at the heart of the Co-op that you now say is responsible for the failure.
Peter Marks: I am not sure, Chairman, that you can attach the problems that emanate in the bank purely to the governance of the Co-operative.

Q255 Chair: I am only following what you just said to me. When I asked you about where the sources of these mistakes lay, you replied by saying that you felt the need to talk about the governance. You then described a weakness in the governance. I now ask you whether you feel you bear responsibility for allowing that to remain.
Peter Marks: I don’t believe that I could have changed the whole governance of the Co-operative movement, which was established in 1860. It is a democratic organisation, and its whole ethos is democracy.

Q256 Chair: But you could have flagged up to them, “This is an unsustainable business model. We have to do something about this. We can’t have this organisation run by a plastering contractor, a farmer, a telecoms engineer, a computer technician, a nurse, a Methodist minister”—who, incidentally, also chaired the bank—“and two horticulturists.”
Peter Marks: That was the nature of the beast, Chairman. As chief executive, of course I could comment on the way that the Co-op has been developed, its history and so on, but there is no way I could have had the power to say, “You need to stop electing members democratically to the board.” That was a fundamental principle of the whole cooperative ethos.

Q257 Chair: You were on the board of the bank. When the bank engaged heavily in PPI selling, did that come before the bank board? Did you find that that issue was discussed?
Peter Marks: No.

Q258 Chair: Not at all?
Peter Marks: I don’t recall it, Chairman.
Q259 Chair: It has done a bit of damage to the image of an organisation that prides itself on ethical conduct, don’t you think? It has been fined over £200 million for mis-selling. You have been telling your customers that you aim to “be an ethical leader...To build a better society by excelling in everything we do.”

Peter Marks: Chairman, I accept that its reputation as an ethical bank has been damaged by PPI mis-selling. I do not think the Co-op has ever claimed to be perfectly ethical. I do believe very strongly that it tried to be more ethical than other organisations, and that is largely because it does not profit-maximise. For instance, it tries to provide banking for socially excluded people, not at any profit. That is just an example of what it does. It also turns down about £2 billion worth of business a year that does not represent the kind of business that it wants to do.

Q260 Chair: Before I hand over to one of my colleagues, I want to come back to the question I asked earlier. What share of responsibility, if any, do you feel for the major mistakes that appear to have been made in the banking arm that have more or less destroyed it, or gravely weakened it, and weakened considerably the group as a whole? We agreed on the list, pretty much. You have had a moment to think about it. You have probably had years to think about it. Are you clear in your mind whether you are really responsible for those mistakes?

Peter Marks: As a non-executive director of the bank, of course I share responsibility. Should we have made the Britannia merger? It was a pretty big decision. It was a billion-pound decision. We agreed on the list, pretty much. You have had a moment to think about it. You have probably had years to think about it. Are you clear in your mind whether you are really responsible for those mistakes?

Q261 Chair: So it is the professional advisers’ fault?

Peter Marks: You can never—

Q262 Chair: Who were your advisers?

Peter Marks: KPMG.

Q263 Chair: Who on the banking board was really running that deal?

Peter Marks: The chief executive of the bank, David Anderson.

Q264 Chair: So you think that he was responsible?

Peter Marks: Partly.

Q265 Chair: He is the key figure who carries the can on that issue? Or are we going to have another one of these discussions that we have had with so many banks, where somehow nobody feels individually responsible for anything?

Peter Marks: I think we all have to take some degree of responsibility. Chairman, including me, but—

Q266 Chair: I am asking you who was primarily responsible. You have said it was not you, so who was it, Mr Marks?

Peter Marks: The architects of the Britannia merger deal were David Anderson and Neville Richardson. David Anderson was the chief executive of the bank and Neville Richardson was the chief executive of Britannia building society.

Chair: Okay. We have the answer to the question—unless there is a very important rider you want to add.

Peter Marks: I just want to say that I do not want to sit here and say, “It’s not me.” I was a non-executive director of the bank.

Q267 Chair: We have heard what you said on that but you have now given us an answer to the one. What about the IT failures—who was responsible for those? Who was driving that?

Peter Marks: Again, that was driven by the chief executive of the bank.

Q268 Chair: Mr Anderson?

Peter Marks: It started under Mr Anderson. When Neville Richardson took over, he continued it.

Q269 Chair: What about this heap of impaired self-certified mortgage lending and other lending that we are still grappling with, which has gone sour? What is it—£7 billion out of £20-something billion?

Peter Marks: Again, that largely arises out of the Britannia book, which Mr Bailey has talked about. I agree with him.

Q270 Andrea Leadsom: Good morning, Mr Marks. It would seem to most people listening to this evidence that, effectively, you are saying, “It’s not my fault—I was just voted on to the board.” What any normal person would rely upon, namely that the chief executive of the holding company—the group—would be accountable, you are therefore effectively saying is not the case because the Co-operative movement is different from other structures in the banking sector. Is that right?

Peter Marks: Yes. The banking arm of the business was ring-fenced by regulation. I was approved by the FSA as a non-executive director.

Q271 Andrea Leadsom: Bearing in mind that most people would have thought that the chief executive of the Co-operative Group would have known what was going on in the bank and would have been protecting the group’s investment in the bank, would you not agree that at some point, as the chief executive, you should have made clear—before it all went horribly wrong—that actually you were not in a position to be in authority over what went on in the banking arm?

Peter Marks: I think that was patently clear to the group board and everybody else within the organisation.

Q272 Andrea Leadsom: But we are only hearing about this for the first time on the Treasury Committee, so I think you can probably count on the fact that there will be many bondholders and other investors in the Co-operative Group who also relied on the fact that the group knew what was going on and that the chief executive was accountable for that. Effectively, you are saying that that is not the case.

Peter Marks: 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.
Q273 Andrea Leadsom: Okay, so effectively then it was a case of “buyer beware” for all those bondholders who now feel very bitter about the whole thing: they should have found out that you couldn’t be accountable because you weren’t regulated by the FSA to be responsible for the banking arm. How do you think that somebody in your position should have made it clear to the public that actually the bank could effectively bring down the group and there would be nothing you could do about it?

Peter Marks: It is difficult to answer that question. All I can tell you is what the governance structure of the group was and what my role was in that. The bondholders, I would have thought, would see the bank almost as a separate entity. I am not sure that the bondholders would rely on the fact that the bank was owned by the group. But I don’t know—I am not a bondholder, so it is difficult for me.

Q274 Andrea Leadsom: The Co-operative movement, as you put it, elects members to its board who may or may not have any experience relevant to the business that they are trying to run. With the benefit of hindsight, would you say that that needs to change in the 21st century?

Peter Marks: Yes, I think it does need to change.

Q275 Andrea Leadsom: So that would be your strong advice to the Co-operative movement—that they should change their governance structures in the wake of your experience?

Peter Marks: Absolutely, yes.

Q276 Andrea Leadsom: Thank you. I would like to come on to one other point, namely political involvement in the decision to award the bid for the Lloyds bank branches to the Co-op. Specifically, Lord Forsyth, who was a member of the NBNK board, has said that he was certainly aware that political pressure was applied during the process of the deal. He further said: “how on earth did we get to the situation that everyone can now see is inexplicable?” In that, he is referring to the fact that the Co-op went ahead, rather than NBNK. So tell us whether, in your experience, any political pressure was brought to bear to encourage the Co-op to bid for the Lloyds branches.

Peter Marks: None that I am aware of.

Q277 Andrea Leadsom: Absolutely not?

Peter Marks: Not that I am aware of.

Q278 Jesse Norman: In July 2011, Neville Richardson approaches various members of the Co-operative Financial Services board with his concerns about overstretch across a series of businesses. He then meets various members, and he has testified to us that he did so using a script, because he was sufficiently concerned about the legal implications of the things he was saying. Would you talk us through what happened from your perspective at that time?

Peter Marks: Yes. There is no doubt that Neville Richardson expressed concern about management stretch, both to me and to the bank board. It is something that we discussed in the bank board and at the management level. 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.

Q279 Jesse Norman: Right. So you considered his concerns, then dismissed them, essentially? You disagreed with them?

Peter Marks: Yes.

Q280 Jesse Norman: Shortly thereafter, he ends up leaving the institution?

Peter Marks: Yes.

Q281 Jesse Norman: Why was that?

Peter Marks: I can only assume why he left. He decided that he wanted to leave.

Q282 Jesse Norman: What did he tell you about why he wanted to go?

Peter Marks: Actually, he didn’t. I do not recall him saying: “I’m leaving because of…” He tendered his resignation after a number of discussions with me and the board, but I do not recall him specifically saying: “I am leaving because of x, y and z”.

Q283 Jesse Norman: He met Paul Flowers, who is the CFS chair and group deputy chair, and Rodney Baker Bates, who was the CFS deputy chair, before he met you, didn’t he?

Peter Marks: I don’t recall, but if he says that, I don’t disagree with him.

Q284 Jesse Norman: His testimony says that he did that. At that point—in 2011—you had been chief executive of the institution for four years. So he came to you because you were the boss. He had had a series of discussions with these other folk and he comes to you for a final showdown to say: “Are you paying attention to these serious concerns that I am bringing to your attention about Verde and Unity, and can I please appeal to you to take some action on it?”

Peter Marks: Yes.

Jesse Norman: And you turned him down.

Peter Marks: We disagreed.

Q285 Jesse Norman: Fine. At almost exactly the same time, Andrew Bailey comes to visit you from the Prudential Regulation Authority, or as it then was, the FSA, does he not? It was in Mr Richardson’s testimony that it was in the same week.

Peter Marks: I can’t remember that meeting at all. He didn’t come to see me. Andrew Bailey never came to see me at all.

Q286 Jesse Norman: Were you aware of the concerns that he had expressed on grounds of overstretched management capability, capital and information systems at exactly that time to the Co-operative?

Peter Marks: Are we talking about Project Verde?

Jesse Norman: I’m just talking about the time he visited. He visited in July 2011.

Peter Marks: He certainly came to see the board and talked about what we needed to do. If I may refer to
his comments, he said the board was told about five areas of the business they had to deal with: capital, liquidity risk management, integration, governance and management. He went on to add that Verde would have brought the Co-op three things: capital—because Lloyds were putting capital in—management and IT systems. All would have been of benefit to the Co-op. I absolutely agree with that and the other two were being dealt with as well. On risk management, the board of the bank, following that conversation, appointed a new head of risk.

Q287 Jesse Norman: So the chief executive has presented his concerns; they have gone up the tree within Co-operative Financial Services. He has come to you as a court of final appeal. You have disagreed with him. He has resigned. The institution then goes spectacularly bust; and you are telling us you don’t feel a strong degree of personal responsibility for that?

Peter Marks: I don’t think that management stretch was the cause of the bank’s problems. It was a capital problem, and I don’t think that not pursuing Verde or not pursuing Project Unity were things that created the problem. In fact, Project Unity, which was very simply the bank and the retail businesses working together to save costs and cross-sell products—that project delivered around £70 million on the bottom line in the first 18 months of its life. That doesn’t seem to me to say that there is a management stretch problem.

Q288 Jesse Norman: But I don’t understand that, because you have already testified to this hearing that you warned the Co-operative board—the group board—about the dangers of doing too much.

Peter Marks: That was not to do with the bank, Mr Norman. That was to do with the fact that it was not just being a bank, but a food retailer, a farmer, and so on and so forth. That was a strategic issue surrounding the whole group. What Mr Richardson was talking about was management stretch within the bank, and 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.

Q289 Jesse Norman: Mr Richardson has testified to us that you were one of the driving forces, if not the driving force, behind the decision to bid for Verde.

Peter Marks: Yes.

Q290 Jesse Norman: Why was that?

Peter Marks: The rationale, for me and for the bank board, and the group board, was clear. 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 FSA; and a management team to strengthen the Co-op management team. It gave the Co-op access to the Lloyds IT systems, which was very important, saving capital but also de-risking execution. It meant that we did not have to migrate customers’ information from one system to another, which is where the risk is. I think, also, not discounting what the Chairman said about the ethical issue, it was a great opportunity for the consumer, for the bank to be a real competitor.

Q291 Jesse Norman: Okay, so this is a deal, then, that is really being driven by the Co-operative Group rather than by Co-operative Financial Services. Is that right?

Peter Marks: Both. Very much so, yes.

Q292 Jesse Norman: And it is a deal which is going to take you from 100 branches to 1,000 branches?

Peter Marks: Yes.

Q293 Jesse Norman: So do you now accept, then, that as the driving force you were not really acting as a non-executive director of Co-operative Financial Services—that you were in fact the architect of this, and it was a catastrophic misjudgement?

Peter Marks: No, I don’t accept that. I don’t think our—

Q294 Jesse Norman: Well, you were the driving force. You must accept that.

Peter Marks: Yes. Look—

Q295 Jesse Norman: The group was in the vanguard, was in the driving seat. You were pushing it forward. It was not merely a Co-operative Financial Services deal; we know that’s true.

Peter Marks: Yes.

Q296 Jesse Norman: So then the question is, why wasn’t it a catastrophic misjudgement?

Peter Marks: Because I don’t think that our examination of this opportunity was at the heart of what’s happened to the bank. What has happened to the bank is that it hasn’t got sufficient capital. This acquisition would have brought capital into the bank, as Mr Bailey has said; I absolutely agree with him.

Q297 Jesse Norman: And you had taken steps to assure yourself, in that driving role, that the due diligence that had been done was satisfactory and that the institution had the capability and the capacity to manage the network if the transaction was successful?

Peter Marks: Absolutely. It took us two years to consider this acquisition.

Q298 Chair: You have said you were the driving force behind this financial acquisition—banking acquisition. What qualifications did you have to be on the board of a bank?

Peter Marks: I worked very closely with the chief executive of the bank and his team, so—

Q299 Chair: We’ll come on to that in a moment. What qualifications did you have to be the driving force behind a huge deal of this type?
Peter Marks: Well, I was the group chief executive and I had negotiated deals of this nature before. We acquired Somerfield, which is a major food business, in 2008 and successfully integrated it, so—

Chair: This is a banking deal.

Peter Marks: Yes, I accept that.

Q300 Chair: I’ll have a third go. I’m just asking you: what qualifications do you have to examine, scrutinise and ensure thorough due diligence of a banking deal?

Peter Marks: I don’t think I needed it, Chairman, because the chief executive of the bank was actually running the process. I was—

Q301 Chair: So you were relying on the chief executive for that?

Peter Marks: Yes, and his team.

Q302 Chair: You weren’t doing the work yourself?

Peter Marks: No.

Q303 Chair: You were relying on someone else to do it?

Peter Marks: Yes.

Q304 Chair: Did Neville Richardson have a reporting requirement to the group?

Peter Marks: He reported to the chairman of the bank initially, but in 2010, I think it was, when the group board wanted to institute Project Unity in order for this to be a success, it was felt he reported to me, and he was made deputy group chief executive. But it was important that he was running the bank, not me. I was very careful not to interfere with the running of the bank, and the FSA as was made it very clear that my influence, because I am not a banker, was limited to Project Unity.

Q305 Chair: I’m just trying to get clear where the driving force behind this lay. You have said that you were the driving force behind it, but at the same time, what you have just said—correct me if I have misunderstood or you want to qualify it in some way—is that actually the responsibility for this lay not with you, not least because you were not qualified to take that responsibility, but with Neville Richardson.

Peter Marks: No, Neville Richardson had gone by then, so—

Q306 Chair: Lay with the chief executive.

Peter Marks: Yes, and look—

Q307 Chair: Throughout the period that you were dealing with the bank?

Peter Marks: The way the Co-op works—this is not a dictatorship. On numerous occasions, I said to the management team and the board, “I’m retiring”—

Q308 Chair: I am trying to get to the issue of who, if anybody, is carrying individual responsibility for the deal.

Peter Marks: It was joint responsibility.

Chair: We have heard that before.

Peter Marks: Well, I’m sorry, Chairman—

Q309 Chair: Everybody collectively moving forward together and nobody actually responsible for running it. Did you take a look at the recommendations of the Banking Commission?

Peter Marks: I believe I did, but—

Chair: Sorry, was that a yes or a no?

Peter Marks: I don’t recall looking at them in detail, Chairman, but—

Chair: Well, have you looked at them at all?

Peter Marks: Yes.

Q310 Chair: What is probably the prime recommendation of the Parliamentary Commission on Banking Standards?

Peter Marks: I can’t remember; I’m sorry, Chairman.

Q311 Chair: It is that individual responsibility should be taken for actions in banks, and you are saying that there was no individual responsibility for these decisions—that they were always jointly owned. Is that correct?

Peter Marks: Yes.

Q312 Chair: Did you have a lot of informal chats with the chief executives under you of the bank at this time?

Peter Marks: I had lots of formal and informal chats, yes.

Q313 Chair: Did you ever vote against a policy on the bank board?

Peter Marks: I don’t recall, Chairman, that I voted against a policy.

Q314 Chair: Did you ever vote against anything on the bank board?

Peter Marks: I don’t remember voting against. There were lots of things that we discussed. I certainly remember challenging and querying. I don’t actually remember.

Q315 John Mann: Good morning. First, I want to clear my mind and clarify a couple of facts. You were group chief executive and you oversaw the integration of Somerfield—you mentioned that a minute ago—and the integration of Britannia. The integration of Britannia was overseen by the CEO of the bank.

Peter Marks: No. The integration of Britannia was overseen by the CEO of the bank.

Q316 John Mann: So you oversaw Somerfield but not Britannia?

Peter Marks: Correct.

Q317 John Mann: A strange structure then.

Peter Marks: It is a strange structure but none the less true.

Q318 John Mann: You chaired the risk committee of the group?

Peter Marks: No—oh, I’m sorry—the group risk committee. Yes.

Q319 John Mann: So you were looking at all issues related to risk. When your retirement was announced on 7 August, you were not quite as hesitant in what
you said to the media. Let me quote your words on Project Verde. “Having done the deal it now feels like the right time to hand it over to my team.” That does not have the ambiguity that you just gave to the Chairman of this Committee.

You went on to say, “Just look at the state the banking industry is in. The Co-op brand is back on track and in renaissance and what a time to do it.” That was referring to the deal. “Mutualism is back in vogue, with what has happened in the plc world.” You also said in relation to your time there, “It has been full on for the last six years. I am now running one of the biggest businesses in the UK.” Your group chairman said of you, “Peter was the architect of the current strategy to ensure that we developed real scale in our key businesses.” So then you were at the heart of it. Aren’t the facts of the matter rather simple? You and others were totally out of your depth in expanding the size of the Co-op so quickly. It is that attempt to grow so rapidly when you were all out of your depth that has led to the Co-op’s current catastrophe.

Peter Marks: I reject that completely. The strategy, as I said earlier, was to build scale in our businesses. When you look at the food business and what we achieved over the five years that I was in charge, integrating Somerfield, in the depths of arguably the worst economic recession in living memory, and giving the Co-op food business a real future, I am actually very proud of what we achieved in the retail businesses.

Q320 John Mann: It sounds to me—I may be wrong—that two American hedge funds, Aurelius and Silver Point, are about to take over the strategic direction of the group. That is what seems to be happening today, unless I am wrong. That is what was reported yesterday. So we have a membership organisation that, in your words, saw a massive opportunity because of what happened in the banking world, and you rushed into it. I put it to you that you were out of your depth; you got it wrong. You critically didn’t assess the risk, which was your role in the group, and we have a catastrophe here. Is there or is there not a catastrophe currently facing the group?

Peter Marks: Not borne out—first, the hedge funds are not controlling the group; they are controlling the bank. We took two years to look at Project Verde. That is not rushing into something, by any means. At the end of the day we pulled out; we did not go ahead. Santander pulled out of the RBS deal after a similar period of time.

Q321 John Mann: But when you did you blamed the regulators.

Peter Marks: No, I am not blaming the regulator.

Q322 John Mann: Well, that’s what the group’s statement said at the time you pulled out. You blamed the regulators. Are you trying to say that the group didn’t make a disastrous error with Britannia?

Peter Marks: In hindsight, with a crystal ball, we should have—
Q330 Chair: Too difficult, that question. You have said that this was a tragedy, but isn’t that word usually used to describe events that are uncontrollable? Is it not the truth that this set of events was controllable, and that you were, as chief executive of the group, in control?

Peter Marks: I am not sure it was controllable. I think the bank is a victim of the financial crash—the financial crisis—and the deepest and longest recession.

Q331 Chair: An innocent victim?

Peter Marks: Well—yes.

Q332 Chair: Okay. It was an innocent victim. The other question that I have tried to raise with you right from the start concerns what individual responsibility you feel that you bear for this. Do you feel that you should take some individual direct responsibility?

Peter Marks: To some extent. You have to break it down. Are we talking about Britannia, Verde, or the capital issue?

Q333 Chair: You were in charge of most of these decisions.

Peter Marks: I was not in charge of the bank when the Britannia deal was done, but I was a non-executive director. I absolutely voted for it, but I was not the architect of the Britannia deal.

Q334 Chair: On self-responsibility, the Co-operative Group’s values and principles state: “We take responsibility for, and answer to our actions.” Do you really feel that what you are giving us in evidence today is consistent with those values?

Peter Marks: Yes, I do. I have always taken responsibility for actions. If you were to say to me, for instance, “Do you take absolute responsibility for the Somerfield deal?” I would have said, “Absolutely yes.” But I cannot take responsibility for something that I am not in full control of, which was the bank.

Q335 Mark Garnier: Mr Marks, I want to come on to Lloyds, but before I do, I am struggling to reconcile a couple of statements that you made, particularly to Mr Norman. On the one hand, you say that you were very worried about the stretch of the group in terms of going into lots of different businesses, but then you are okay with the Project Verde deal. So you are saying that one of those parts of the business worried you in terms of the stretch, and yet you enlarge the business into a 1,000-branch bank. How do you reconcile those two actions?

Peter Marks: As I said earlier, the net effect of the Verde deal was positive to the bank—positive in terms of stretching the managerial resources of the group as a whole.

Q336 Mark Garnier: But negative in terms of stretching the managerial resources of the group as a whole?

Peter Marks: We were bringing in management and capital, so I would argue that the stretch was being, to some extent, helped by the Verde deal.

Q337 Mark Garnier: Had the bank completely integrated Britannia?

Peter Marks: Pretty much.

Q338 Mark Garnier: You say pretty much, so the answer is no, it had not completely integrated Britannia.

Peter Marks: Again, when is integration ever full? If you take the fact that we still have—

Q339 Mark Garnier: That is a slightly alarming rhetorical question that you are asking. It would have been obvious.

Peter Marks: What I mean by that is that you may say that it is not integrated until all of the branches have a blue Co-op fascia, but that might not have been necessary or required.

Q340 Mark Garnier: Integrated is when you have integrated systems that allow the free flow of information and management skills around the institution. That is fully integrated.

Peter Marks: Yes. That had not been fully completed.

Q341 Mark Garnier: Which is quite an important point. The management of Britannia and Co-op bank had not been fully integrated, which is really important for a financial institution—I do not want to stray too much into the regulatory side, because one of my colleagues will follow up on that—and you went off and did another deal, which would not help and would confuse that integration process by bringing in an extra element.

Peter Marks: The good thing about it was that we were going to use the Lloyds systems.

Q342 Mark Garnier: So it was backward integration into someone else’s system—

Peter Marks: Yes, which would have helped integration significantly, both between Britannia and Co-op and ultimately with the Lloyds branches as well.

Q343 Mark Garnier: Had a lot of due diligence been done on the systems of the Verde branches?

Peter Marks: An enormous amount of due diligence.

Q344 Mark Garnier: For example, what do you think of this statement that I heard from someone who did a bit of due diligence on the Verde branches? They said that there was still a computer programme within the IT systems that converted pounds, shillings and pence into decimal currency.

Peter Marks: I didn’t know that. I wasn’t aware of that and I have not heard that.

Q345 Mark Garnier: I think it is well known that the big banks’ IT systems go back to punch-card systems in the 1950s and 1960s. These are antiquated systems.

Peter Marks: But if the systems that Lloyds is running are adequate for a bank the size of Lloyds, I am pretty sure that they would have been adequate for the size of bank that we were talking about.
Q346 Mark Garnier: Really?
Peter Marks: I believe so.

Q347 Mark Garnier: How much due diligence did you do?
Peter Marks: An enormous amount.

Q348 Mark Garnier: Can we turn to what Lloyds did and did not know? Mr Horta-Osório, when he came before us, told us that Lloyds first identified the capital shortfall in Co-op back in December 2012 and approached Co-op—he did not specify which part of Co-op—to discuss their concerns about your ability to complete the deal. What discussions took place at that stage in 2012?
Peter Marks: There were lots of discussions by the team that were running the process with Lloyds.

Q349 Mark Garnier: This would have been a strategic discussion, rather than an ongoing one.
Peter Marks: I honestly do not recall that particular conversation. I would have to know the date and time.

Q350 Mark Garnier: Shall I read to you what António Horta-Osório said to us? I will cut out the waffle. He said: "in our own analysis of that combined information, for us it was reasonably clear that the assumptions of the plan had changed and there was a shortfall of capital. This was at the end of December 2012…what we did immediately was to ask the Co-op about it, formally…they did not come formally to us and say, 'We have a problem.' They came to us and said, 'This is the new combined plan,' and the Co-operative Group’s answer to us was, 'We are handling this. We have several options to handle this and we are revising the plan and the options we have, together with the regulator, in order to address this situation.' That sounds like a pretty important flag that was being waved by Lloyds Group.

Peter Marks: Can I say, in answer to that, that capital was an issue that the board discussed on numerous occasions? We needed a stronger bank, and we accepted that. However, in March 2013, just after the year end and having provided for a number of issues in the year-end accounts, our core tier 1 capital ratio was over 9%, which did not indicate a bank with a capital problem. That figure was not the best in the market, but it did not indicate a bank under capital stress.

Q351 Mark Garnier: This is a bank in the process of integrating two organisations—the Britannia and the Co-op—is it not?
Peter Marks: Yes. We had within the bank a project team named Project Pennine that was looking at ways of raising capital. We had agreed to sell the life and savings business to Royal London. We had agreed to sell the insurance business. We had agreed to wind down corporate lending, because that requires significant capital. So the bank was looking at a lot of things to improve its capital position.

Q352 Mark Garnier: Which Co-op directors, either from the group or the bank, were party to the significant discussions with Lloyds? If you genuinely do not know whether there were any significant discussions.
Peter Marks: Barry Tootell, who was the chief executive of the bank and who I believe will be here next week, was the main person supervising the day-to-day running of the process.

Q353 Mark Garnier: Did he raise this? I want to clarify, because you just said that you were not aware of any specific significant flag-waving by Lloyds in December 2012.
Peter Marks: When I say that I cannot remember it, that does not mean to say that it did not exist. We had lots of conversations.

Q354 Mark Garnier: No, sure, but this is a major concern on the part of Lloyds. You are painting a picture where this is a very important deal for the Co-op in order to strengthen the balance sheet of the bank, you are doing a whole lot of different bits and pieces, you are integrating Britannia, you are doing an awful lot of stuff, and key to it all is the Project Verde transaction going ahead. Lloyds raises it to the Co-op organisation in December 2012, according to the chief executive and the chairman of the Lloyds Group, and you were not aware of it.
Peter Marks: I could have been aware of it, but you know, it is some time ago, Mr Garnier, so—
Mark Garnier: It wasn’t that long ago.
Peter Marks: I don’t know when it was.
Mark Garnier: December 2012.
Peter Marks: December 2012—well, that is some time ago. And bearing in mind that we had—
Mark Garnier: Is it? It is within a year.
Peter Marks: All I can say is that we had lots of conversations with Lloyds—

Q355 Mark Garnier: But this would be the most significant conversation. This is Lloyds saying that they are not too sure about it. Lloyds have said to us that this is the point at which it is looking as if the wheels are coming off the whole deal, and they have come back to you to flag that up and ask what you have to say about it.
Chair: You cannot recall that at all?
Peter Marks: No, I can’t.
Mark Garnier: This is a major, major conversation.

Q356 Chair: Extraordinary. Not at all? You were the driving force but you cannot remember it?
Peter Marks: There were lots of conversations, Chairman, and I cannot remember every one.

Q357 Mark Garnier: Do you think that in a year’s time you will remember this hearing before the Treasury Committee?
Peter Marks: Yes.

Q358 Mark Garnier: It is this sort of level of importance. You will remember this in a year’s time, so why do you not remember, from less than a year ago, that the deal that you were one of the driving forces behind was about to crash?
Peter Marks: Well, it wasn’t.
Q359 Mark Garnier: According to Lloyds it was looking pretty iffy.
Peter Marks: It wasn’t about to crash.

Q360 Mark Garnier: So the person you are about to do a transaction with flags up that they are worried that there is a problem, and you do not recall that conversation.
Peter Marks: I am sure that we will have said to him at the time that we were addressing the capital issues.

Q361 Mark Garnier: Do you think that somebody has been pulling the wool over your eyes internally at the Co-op?
Peter Marks: No, not at all.

Q362 Mark Garnier: So you take responsibility for the fact that there was a conversation that you should have known about that you did not know about.
Peter Marks: I honestly cannot remember the conversation. There were lots going on, you know?

Q363 Chair: Do you remember the point at which Lloyds got nervous about this? Can you remember the general point, even if you cannot remember the specific conversation?
Peter Marks: I do not remember a day or a week or a month that said that Lloyds were getting nervous. We were all concerned about whether we could do the deal, all of us.

Q364 Mr Ruffley: I hope, Mr Marks, that your selective amnesia will not continue during my questioning. You have painted a picture that you were not FSA approved—those were the words you used earlier in your testimony. You have given the impression that really the bank was not something you got too closely involved with because of the governance structure, despite the fact that you were group chief executive.
In evidence to the Committee, Neville Richardson said: “During 2010 I became increasingly concerned at Co-op Group’s aim to fully integrate’ Co-op funeral services “within Co-op Group from a management and administrative point of view (Project Unity).” He said that he made his concerns known about the disruption and distraction to the CFS business as a result of the strategy. He continued that Project Unity was “not taking into account the risks which would be created in the bank.” What do you say to that?
Peter Marks: Project Unity was not designed to fully integrate the management and the systems of the bank—
Mr Ruffley: Hang on, I just want to stop you there. This is testimony that Mr Richardson has given to the Committee, and I have just read it out. I read it out because it throws into question your argument that you were not particularly hands on with the bank.
Peter Marks: May I explain what Project Unity was?
Q365 Mr Ruffley: No, I have just told you what Richardson said. What do you think it was?
Peter Marks: Yes, well, I am just about to tell you. This was about the bank collaborating with the retail businesses to share services such as HR, procurement and the like to save costs, and to cross-sell products—for instance, selling insurance products through our chain of supermarkets and so on.

Q366 Mr Ruffley: So it wasn’t management?
Peter Marks: No.

Q367 Mr Ruffley: And it wasn’t administration? It might be administration with sharing services, but management it was not.
Peter Marks: No.

Q368 Mr Ruffley: So there is a clear conflict of testimony between what you are saying. Is it not the case that in January 2011, according to Mr Richardson, “in recognition of my contribution to the group and as part of Project Unity I was appointed Deputy CEO Co-op Group”? So, from the beginning of 2011, you had as your deputy group CEO a man who was running the financial services business.
Peter Marks: Yes.

Q369 Mr Ruffley: So you would be quite intimately connected on a day-to-day basis with what was going on in the bank, would you not, Mr Marks?
Peter Marks: More intimate than it was before, absolutely.

Q370 Mr Ruffley: Going back to the testimony that Andrew Bailey gave us in July, he said that at the tail end of 2011, he told the board of Co-op bank that it was not clear to the regulator that “the Co-op Banking Group had the ability to transform itself successfully and sustainably into an organisation on a scale that would result from acquiring” the Verde assets. How did you react to those views expressed by Mr Bailey?
Peter Marks: I agreed with his points that we needed to address—

Q371 Mr Ruffley: What did you do about it? How did you address his concerns?
Peter Marks: He talked about five concerns—
Mr Ruffley: Yes, we’ve done that. We don’t need to repeat it. What did you do about it?
Peter Marks: We appointed a head of risk, which was addressing one of his other concerns. That head of risk was reviewing and implementing a whole new risk architecture for the bank. That was four out of five. The other one that he was talking about was governance. That was more of a long-term issue for the group.

Q372 Mr Ruffley: What does that mean? What did you do about governance in response to Mr Bailey? What did you actually do? You. What was your advice? What positions did you take about fixing the governance problems that Mr Bailey identified?
Peter Marks: I believe that—
Mr Ruffley: What did you do, Mr Marks?
Peter Marks: In terms of governance—
Mr Ruffley: I just asked that.
Peter Marks: I did not do anything about governance.
Q373 Mr Ruffley: Right. So what did you actually do in relation to Andrew Bailey’s statement of five areas of weakness?

Peter Marks: We pursued the Verde deal, which would have delivered three of them.

Q374 Mr Ruffley: Right. Andrew Bailey expressed his doubts. He asked Co-op bank to make his concerns clear to Lloyds Banking Group. How did you do this—informing Lloyds Banking Group? When and how did you do it?

Peter Marks: It was done by the chief executive of the bank.

Q375 Mr Ruffley: By Mr Richardson?

Peter Marks: No, by his successor, Barry Tootell.

Q376 Mr Ruffley: In December 2011, because Mr Richardson had gone by then.

Peter Marks: Yes.

Q377 Mr Ruffley: In their evidence to the Treasury Committee in June this year, the chairman and chief executive of Lloyds told us that they became aware of a combined Co-op-TSB capital shortfall in December 2012. When was that capital shortfall relayed to Lloyds by you—any time before 2012?

Peter Marks: No.

Mr Ruffley: No, it was not.

Peter Marks: Sorry, but it was not apparent that we had a capital shortfall. The capital shortfall—the £1.5 billion that has been talked about—was only apparent at the beginning of this year. As I said earlier, we had a core tier 1 capital ratio of over 9% at the year end, so how was there a capital shortfall?

Q378 Mr Ruffley: At the end of 2012, António Horta-Osório told us that you told them in December 2012: “We are handling this. We have several options to handle this and we are revising the plan and the options we have, together with the regulator, in order to address this situation.” That is what the chief executive of Lloyds said that Co-op told Lloyds in December 2012. Is that correct?

Peter Marks: Yes, which goes back to what I was saying earlier—that we knew we needed to strengthen our capital. We had a project team working on that—selling the insurance business, selling the life and savings business, winding down corporate lending, and so on.

Q379 Mr Ruffley: Just to be clear, there were no alarm bells ringing at the tail end of 2011 coming, as far as you were concerned, from the regulator.

Peter Marks: No—other than I had a conversation with Mr Bailey about the Verde deal. He said that he would support it, but he wanted the deal to happen from a position of strength, and by that he meant capital.

Q380 Mr Ruffley: Those answers are quite interesting. You say in an unintentionally comical—in the light of events announced this morning—valediction in Management Today, Mr Marks, that you worked your way up from the bottom: “Bloody hard work and determination has got me where I am.” Where are you at the moment, Mr Marks?

Peter Marks: Feeling very sad.

Q381 Jesse Norman: I want to come back with one quick question, if I may, Mr Marks. You have said that you were the driving force behind the Verde deal, and of course the Verde deal was, when it was announced, a deal between Lloyds and the Co-operative Group, not Co-operative Financial Services or the Co-operative Banking Group.

Peter Marks: No, actually the deal was between the bank and Lloyds, but, because it is such an important strategic deal, the group, as the shareholder, clearly was very interested in it.

Q382 Jesse Norman: I understand. You felt responsible, you were driving the thing through, it was a group deal as much as it was a bank deal.

Peter Marks: Yes.

Q383 Jesse Norman: Thanks. That is helpful. Given that it was a group deal as much as a bank deal, and given that you were the driving force, do you not think there was a danger that you were acting as a shadow director of Co-operative Financial Services, although you do not have an FSA clearance? Therefore, do you think that that might make you vulnerable to some form of criminal proceedings?

Peter Marks: I was a director of the bank.

Q384 Jesse Norman: Is there a danger that you might have been acting as a shadow executive director, although not FSA-cleared?

Peter Marks: No, because I was working very closely with the chief executive of the bank and his team. When you describe me as the driving force, I think you need to remember that the group board unanimously voted to look at this deal; the bank board unanimously voted to look at this deal. I was acting on behalf of the group board, but I was not acting alone. This was not in a Peter Marks plc; it was a joint effort between the bank team and the retail team.

Q385 Jesse Norman: You have assented to the description of yourself as a driving force. You have accepted, agreed, that this was as much a group deal as a bank deal. You have already testified that Co-op’s corporate culture was so unquestioning that it was highly unlikely that there was going to be any genuine pushback from either the CFS board or the Co-operative Group board, so it does not seem unreasonable to put the question.

Peter Marks: Sorry, I do not understand what you mean by there was not likely to be any pushback from the bank board. The bank board—

Q386 Jesse Norman: You suggested to us that you never voted against any bank board decisions.

Peter Marks: I did not say that. I said that I could not remember voting against any decision, but I may well have done.

Q387 Jesse Norman: Votes were regularly held, were they, on the bank board?
**Peter Marks:** Yes, of course.

**Q388 Jesse Norman:** So you did not proceed on a consensual basis; you proceeded on a put-it-to-the-vote basis?

**Peter Marks:** Yes, sometimes. But sometimes it was consensual.

**Q389 Jesse Norman:** Would you allow us to see board minutes testifying and supporting that position?

**Peter Marks:** I am not in a position—

**Q390 Jesse Norman:** Or would you encourage the Co-op to allow us to see them?

**Peter Marks:** Yes, of course.

**Q391 Mr Ruffley:** Mr Marks, it is normal practice for the regulators to interrogate a departing chief executive. I am thinking of when Mr Richardson departed as chief executive of Co-op Financial Services. Did you or any of your colleagues at group level have any discussions with Mr Bailey or any of Mr Bailey’s fellow regulators about the reasons for Mr Richardson’s departure?

**Peter Marks:** No.

**Q392 Mr Ruffley:** Did you think that odd?

**Peter Marks:** What? That the regulator did not speak to us about it?

**Mr Ruffley:** Yes.

**Peter Marks:** No, I do not think so because—

**Q393 Mr Ruffley:** It did not register, and you did not want to offer any thoughts to the regulator to set their mind at rest as to why this man seemed to depart in a rather peremptory fashion?

**Peter Marks:** If we had been asked, I am sure we would have commented, but we were not asked.

**Q394 Chair:** What would you have said?

**Peter Marks:** I think I would have said that Mr Richardson was in disagreement with his board, his management team and me about two important projects, Project Unity and Project Verde. Whether anything else was in Mr Richardson’s mind at the time he resigned, I do not know, but that is what I would have said to the regulator.

**Q395 Chair:** So you would have warned the regulator?

**Peter Marks:** Warned them?

**Chair:** That there was a difference of view on the board about a very important deal affecting the bank’s future.

**Peter Marks:** Of course. If asked, we would have said that Mr Richardson did not agree with those two projects.

**Q396 Chair:** But you did not think it was your duty to tell the regulator or offer to tell the regulator?

**Peter Marks:** No, not really.

**Q397 Stewart Hosie:** Mr Marks, on 24 April this year, the Co-op Group announced that it had withdrawn its bid for Project Verde. Why was the bid withdrawn, and whose decision was it?

**Peter Marks:** It was a collective decision within the management team.

**Q398 Stewart Hosie:** Is that the group or the bank?

**Peter Marks:** Both. The steering group that was looking at this project was a combination of the bank’s executive and the group’s executive, which I chaired. It was a difficult decision. We got the final business case after lots of due diligence, looking at risk and so on and so forth. The business case was projected over five years and the team had used the Treasury model on the prospects for interest rates and GDP growth over the next five years. The economics of the deal just did not work.

**Q399 Stewart Hosie:** Okay. Let me come back to that in a moment, because the announcement from the Co-op Group’s withdrawal said, “This decision reflects the impact of the current economic environment,” which you have suggested, “the worsened outlook for economic growth,” which you have also suggested, “and the increasing regulatory requirements on the financial services sector in general.” Can you please tell us which of the specific regulatory requirements led you to conclude that that was part of the bundle of problems that meant you could not progress with the deal?

**Peter Marks:** The regulator was asking all banks to carry significantly more buffer capital. At the time that we announced that, we did not know what the number was from the regulator, but we knew that it was going to be a significant increase on what the buffer capital was. That was what was meant by that statement.

**Q400 Stewart Hosie:** But you have said on several occasions today that the deal would have brought capital along with systems and management expertise. You have been able to remember that you had 9% tier 1 capital, which you said was not the best but certainly not the worst at that time. So how was it the case that capital was suddenly an issue by the time you got to 24 April when it had not been until then? Indeed, you had been saying how well the bank had been doing generally with 9% tier 1 capital sitting there.

**Peter Marks:** The problem was that if the combined bank was not making much profit over a five-year period, capital was not building up when it needed to. The profitability of the combined bank was not good enough to build capital over a period of time.

**Q401 Stewart Hosie:** Okay. Let’s take a step back from that April date. On 21 March, the Co-op announced losses of £600 million at the bank. It was not even making a small profit. It was making a substantial loss. Did senior Co-op executives, either from the group or the bank, discuss at that stage the possibility of withdrawing from Project Verde?

**Peter Marks:** Yes. I’m sure we did.

**Q402 Stewart Hosie:** And the conclusion at that point was?
Peter Marks: We were almost at the stage—this was March this year—of getting the final business case together, so no decision was made, but clearly it did not help.

Q403 Stewart Hosie: Okay, so your business plan going forward to build capital required substantial profit. By the time you reached mid to late April, it was clear that the joint group was not going to make that profit in order to pack the balance sheet. But in the period between 21 March and 24 April, which is only a month, you did an interview with the Manchester Evening News in which you were bullish about the deal going ahead. That was still the case in late March. It is almost as if those on the steering group were in complete denial for a prolonged period that this was ever going to work. Having announced the losses in March, which presumably people knew about significantly before then, why was this deal even live until 24 April?

Peter Marks: Even after March, the core tier 1 capital ratio was 9.2%. Even after the losses at the year end, the capital position was not dire. That said, of course it dented our enthusiasm and we were clearly having second thoughts. However, in terms of announcing it to the media, who were asking us pretty much constantly, it was not right to tell them where we were until we made our decision, because we knew that we would be completing the process and making a final decision within a few weeks. In any case, it was a decision for the bank board and the group board. They had to be apprised of all the facts. It was right to have a look at this deal, but it was also right to pull out of the deal as we did.

Q404 Stewart Hosie: Okay. I understand why someone would like to assess and appraise the deal and have a look at it in that sense, and I understand why it would be right to come to a decision at the end of the appraisal, whatever the decision, but this was not having a look. This was gung-ho, all guns blazing. You were saying that you were going to beef up the bank and get this capital and systems and management expertise in from Lloyds via Project Verde. This was not just an appraisal. This was all systems go to make it deliver until suddenly at the very last moment you and others found out that you simply could not manage to do it.

Peter Marks: That’s true. That’s absolutely true. We absolutely believed that this was the right thing to do for the bank. I repeat—and I agree with Andrew Bailey—that it brought significant benefits to the bank. A number of colleagues—not just me—thought that there was as much risk in not doing this deal as there was in doing it. The bank was small, it was weak, and, yes of course, the deal would have brought risk, but it was also going to bring significant benefits for the bank.

Stewart Hosie: Well, it is smaller now, weaker now and it isn’t independent any more, because it is being run by two hedge funds.

Q405 Mr McFadden: I want to clarify your group role on some of the issues raised about the bank. Mr Ruffley asked you about Andrew Bailey’s warnings on five areas, delivered in late 2011. As group CEO, you sat on the group audit and risk committee and chaired the group risk management committee.

Peter Marks: I was not on the audit and risk committee.

Mr McFadden: You were not on the audit and risk committee?

Peter Marks: No.

Mr McFadden: Not on the group audit and risk committee?

Peter Marks: No.

Q406 Mr McFadden: Okay. Can you tell us the difference between the group audit and risk committee and the group risk management committee?

Peter Marks: The audit committee was essentially the audit committee. The risk committee looked at general risks to the group: health and safety and risks of that nature, not necessarily financial.

Q407 Mr McFadden: But the group is running a bank, which potentially exposes it to big risk. In what way did the group risk management committee consider Andrew Bailey’s warning about five areas that had to be improved in the bank?

Peter Marks: As I said earlier—I am sorry to repeat it—Andrew Bailey’s comments were taken very seriously and taken on board.

Q408 Mr McFadden: So you knew about them at the time and knew exactly what the issues were?

Peter Marks: Yes, but three out of five were dealt with by the acquisition of Verde. Of the other two, we appointed a new head of risk, who was doing a very good job in improving the structure of the bank. As for governance, I am not absolutely sure what Andrew Bailey had in mind in terms of governance. Governance was always a difficult one to change because of the nature of the Co-operative structure.

Q409 Mr McFadden: You said to me a minute ago that you were not on the group audit and risk committee. Did you ever attend it?

Peter Marks: No.

Mr McFadden: You never attended it?

Peter Marks: No, I was not asked to attend it.

Q410 Mr McFadden: Looking at the loan impairments and the balance sheet, we have talked a lot about the core tier 1 capital ratio—

Peter Marks: Sorry, can I just correct myself? I have just remembered that I did attend the audit and risk committee on a number of occasions, but only for specific issues. So if there was a specific issue on which they wanted my input—I can’t remember which ones they were—occasionally I was asked to attend the committee meeting.

Q411 Mr McFadden: So you did attend on a number of occasions. Can you remember the issues of bank risk ever being discussed there?

Peter Marks: No, I wasn’t party to that.

Q412 Mr McFadden: Going to the balance sheet, you have talked about the core tier 1 capital ratio and
how healthy the position seemed until late in the day. Can you tell us what the Co-op Bank’s balance sheet says are the total impairments and significant items from 2012?

Peter Marks: I can’t remember that number, I’m sorry.

Q413  Mr McFadden: It was £859 million. This is at a time when you were saying that you thought things were healthy, because of the core tier 1 capital ratio, but even last year £859 million of impairments and losses were identified on the balance sheet. Doesn’t that ring alarm bells?

Peter Marks: Of course it does, but wouldn’t that show on the core tier 1 capital ratio? I specifically spoke to KPMG, the bank’s auditors, after the year end and said to them: “Are there any going concern issues?” and I was assured that there weren’t. If the bank was in such a parlous state, you would have thought that the bank’s auditors would have said that there was a going concern issue here. They didn’t, and that was in February or March of this year.

Q414  Mr McFadden: So this £1.6 billion hole appears from nowhere?

Peter Marks: Well, I can tell you what my thoughts are on that. Clearly—[Interruption.]

Chair: Sorry—try to ignore the bell if you can.

Peter Marks: In terms of crystallising and providing for potential losses in the Britannia loan book or in the loan book generally, normally 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. So what we are seeing now is assumptions about the loan book based on judgment. There has been acceleration of provisioning. The other part of the £1.5 billion, bearing in mind that I had left by the time this came out was, I believe, the regulator saying that all banks needed to keep more capital. We don’t, we, that all the big banks have been raising capital to satisfy that requirement. 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 wouldn’t be subject to what appears to be the acceleration of, first, the provisioning for risk in a loan book and secondly, building up for capital.

Q415  Mr McFadden: Are you saying that the regulator has shifted the goalposts?

Peter Marks: Yes. I am not criticising the regulator. I think he has shifted the goalposts because of what has happened over the last few years. I do not in any way blame the regulator. What I am saying is that the goalposts have well and truly been shifted.

Q416  Mr McFadden: Let me ask you about the position of the Co-op bank today. Do you believe it is possible to have an ethical hedge fund?

Peter Marks: No. If I could qualify that: hedge funds are there to maximise profit; that is their sole purpose in life. To be truly ethical, you cannot do that—but that’s an opinion.

Q417  Mr McFadden: So there is a fundamental clash between the model of the bank that is appearing and its principles and traditions for the last 150 years?

Peter Marks: I think so, yes.

Q418  Mr McFadden: Your successor said in a message last night that the group retained control of the bank. That is not true is it?

Peter Marks: Because I now do not have the information available and I have left the business, I honestly don’t know what the circumstances are.

Q419  Mr McFadden: Let me put it another way. The reported stake that the group will have in the bank after this restructuring is around 30%. That does not represent control, does it?

Peter Marks: No it doesn’t.

Q420  Mr McFadden: The way that the bank proposes to deal with the ethical question I put to you is to write all these values into its core mission and so on. Do you believe that that is worth much, given that ethical conduct statements are pretty easy to find in the City among major banks?

Peter Marks: That is true and from a banking perspective I think the ethical initiative, if I am reading accurately what is being said, does not apply any more, or is not there. That is not to say that the group cannot be ethical, because it can. Without the bank it can focus on its other businesses and be very ethical and values-driven in those businesses.

Q421  Mr McFadden: Can it still be called the Co-op bank if it is no longer a co-op?

Peter Marks: Again, that is difficult for me to answer. In terms of branding, I suppose it can, but it is not a co-op, is it? It is difficult for me to answer that question without further information.

Q422  Mr McFadden: What is your reflection on where we have ended up with this? This is the country’s biggest mutual and people believed that the Co-operative bank was different.

Peter Marks: I think it is tragic. I have worked for the Co-op for all my working life and it is very sad, in terms of that bank. However, I think there is a degree of inevitability, because it was trying to stretch its capital across too many businesses. I do not know of any other business that tries to be a major bank, a major food retailer, a major funeral services provider, a pharmacy chain, a motor group, a legal services business, a security business and a property business. With limited capital resource, how can you do that in today’s world? I think this crisis, if you call it that, will be beneficial to the Co-op in making it focus on what it is good at.

Q423  Mr McFadden: Isn’t the conclusion that it was inevitable a bit dismal? Surely we should not conclude that mutuals cannot survive in the financial services world. They do here, albeit on a smaller scale than before, and they do in other countries.

Peter Marks: Mr McFadden, I think the Co-op could survive in financial services if it focused on financial services. What I am saying is that it is very difficult
to see how it can focus on financial services, food and everything else. If it wanted to be a serious financial services business, it could sell all of its other businesses and put all of that capital into being a bank. These are things that we discussed in the group boardroom on many occasions. The problem with the governance of the group is that, because you have all these constituencies around the table, 20 of them, with emotional ties to various businesses, it is very difficult to get them to make big strategic decisions such as, for instance, selling farms—that is another business I didn’t mention: it is Britain’s biggest farmer—and focusing on core businesses, or one core business. If I failed in anything, I failed to get the group to consider that.

Q424 Chair: If we go looking for the documentary evidence of your attempt to do that, will we find it?  
Peter Marks: I doubt it. These were strategic discussions.

Q425 Chair: So there is no written record at group level of you giving the devastating critique that you have given us of the business model of the group of which you were chief executive.  
Peter Marks: I am sure that if you asked my colleagues whether I talked about these issues with the group board, they would say that I did, but I do not think that you will find a board minute that says that we discussed this.

Q426 Chair: So there was never an agenda discussion on the evidence that you just gave us that you had stretched the capital over too many businesses.  
Peter Marks: I do not think that there will be.

Q427 Chair: Why should we accept that that is what you did if you cannot provide any documentary evidence and you do not think it is worth us trying to look for it? You were chief executive of this operation.  
Peter Marks: Yes I was.

Q428 Chair: And you have just told us that the group had a fundamentally unsound business model for the whole of the period you were running it.  
Peter Marks: It had been run like that for more than 150 years. For me to come in and say, “By the way, you should sell off this and that”—” Let me give you an example, one of which there will be documentary evidence. I suggested that it should sell its farms business, which is worth £100 million at today’s prices, I think, or was then. That was rejected.

Q429 Chair: But you never once made the point at board level, as chief executive, in a way that will be recorded, that the capital was stretched over too many businesses?  
Peter Marks: As I said, Chairman, I had many conversations with the board about strategy.  
Chair: I am talking about board meetings here. I am not talking about friendly chats in the corridor. Organisations are run at meetings with minutes.  
Peter Marks: Yes, I appreciate that. We didn’t discuss those things at regular board meetings.

Q430 Chair: Okay. Would you think it was an unfair inference of ours, in the light of the evidence you are giving us now, that you are placing much greater emphasis on your concerns about that business model than you did at the time?  
Peter Marks: It is difficult, because you have to understand the nature of the Co-op. I felt it was—  
Chair: But is it an unfair inference of ours to conclude that?  
Peter Marks: Yes, I think it is.

Q431 Mr Newmark: You have talked about what a good food man you are—you managed to integrate the Somerfield acquisition, and so on—and how your skill set lies in food and food retail, but not really in financial services. Yet you seemed to be very gung-ho about expanding the financial service business, while at the same time acknowledging that you did not have the competency to do the analysis that was needed in order to understand what you were buying. Have I got that right?  
Peter Marks: No. I think I had the competence to understand the nature of what we were doing in the deal. In terms of the technicalities, I was working with a very experienced team in the chief executive of the bank and his executives.

Q432 Mr Newmark: You had your differences with Mr Richardson, who did have the expertise. That was his background.  
Peter Marks: It was also the background of his successor, Barry Tootell. It wasn’t as if we didn’t have a chief executive who wasn’t a banker. We did.

Q433 Mr Newmark: But, as chief executive, in your desire to be slightly gung-ho in expanding the financial services business, you were leading the charge in many ways in that, even though you had no background in it.  
Peter Marks: Well, hang on. There was the group board and the bank board, and the bank board had lots of professional bankers, including executives on the board. It wasn’t just Peter Marks; it was the bank board.

Q434 Mr Newmark: I know, but you were the chief executive. The buck stops at the top. That is what leadership is about.  
Peter Marks: But I don’t think “gung-ho” is the appropriate phrase. If we were gung-ho we would have done the deal at any price, like RBS and ABN AMRO. We actually pulled out of the deal. I ask the Committee to bear that in mind. Although we looked at it, and we looked at in great detail, and we wanted to do it, because we thought it was the right thing for the bank to do, in the final analysis we had the discipline to say, “We have to walk away from this because we can’t do it,” just as Santander did with the RBS deal.

Q435 Mr Newmark: But if I focus on Britannia and the other acquisitions, there would seem to have been a heavy reliance on KPMG’s analysis. You said that they gave you a clean audit and that everything seemed to be all right, when it wasn’t.
Peter Marks: I think that to say it wasn’t is maybe—
It was at the time, and what has happened is that the
economy has gone south—

Q436 Mr Newmark: You can’t blame the economy
for it. There are huge impaired assets on the balance
sheet, no?
Peter Marks: Yes, and those impairments are because
of loans that were made by Britannia building society.

Q437 Mr Newmark: Who did the audit for you on
that, though?
Peter Marks: KPMG.

Q438 Mr Newmark: Who scrutinised the balance
sheet? Did KPMG screw up?
Peter Marks: Well, there was a team of people
engaged within the bank to supervise the due
diligence. It was very thorough. They had the
assistance of advisers, who were quality, very
experienced advisers, in this case particularly.

Q439 Mr Newmark: The responsibility has to lie
with somebody. I am trying again to get to the bottom
of this. Either there is the competency internally in
your organisation and you are the guy, as the head of
that organisation, who takes responsibility for it, or
you are saying that you outsourced the decision
making to an organisation such as KPMG; you relied
on their audit and KPMG failed you dramatically.
Peter Marks: You can’t outsource decision making; I
absolutely accept that. I was a non-executive director
at the time. I voted in favour of—

Q440 Mr Newmark: You can’t say, “I’m a non-
executive director.” You were the group CEO; you
were the main guy.
Peter Marks: But I wasn’t responsible—

Q441 Mr Newmark: You are in complete denial. I
don’t understand this denial. On the one hand, you
want to take responsibility for the strategic direction
of the business, yet you keep putting your hat on this
thing called “non-exec” as though being non-exec
abrogates any responsibility.
Peter Marks: What I am trying to do is explain the
truth. That is what you want me to do. I was not in
control of the bank at the time that the Britannia
building society deal was done. I was a non-executive
director. I did not have absolute control of the bank.
However, absolutely, I share responsibility with the
rest of my board colleagues for the decision to merge
with Britannia building society. I absolutely share that
responsibility. But to say that I was the group chief
executive and the architect of the Britannia building
society deal is wrong, and if I said that I would be
telling you a lie, because it is not fact, it is not true.
My role as group chief executive was limited.

Q442 Mr Newmark: But at the end of the day, you
were chief executive. That is why you had that title.
It says it on the tin—chief executive—for a reason.
You were the leader. You can’t just say, “I was one
of many.”

Peter Marks: No, I am sorry. That is wrong. I was the
leader of the trading group. My role was all of the
other businesses—eight businesses—100,000
people—

Q443 Mr Newmark: But not financial services?
Peter Marks: Not financial services.

Q444 Mr Newmark: Even though, as we heard
erlier, you very much wanted to drive the expansion
of that particular business of yours.
Peter Marks: I agreed with the bank board and the
group board that we needed scale in the bank. Yes, I
was absolutely in favour.

Q445 Mr Newmark: Again, you say you agreed.
What competency do you have to agree, given that
you have no financial services expertise to make that
judgment?
Peter Marks: Because I was a non-executive director,
and also in my capacity as group chief executive I had
to look after the interests of the shareholder, which
was the group.

Q446 Mr Newmark: Let me go back. I’m not really
focusing on you; I want to focus on KPMG, because
KPMG is a blue-chip organisation and it seems to me
that they gave you bad advice. Do you think they gave
you bad advice? They did the audit. They said that the
balance sheet looked pretty good to them. Yet they
were wrong.
Peter Marks: Yes.

Q447 Mr Newmark: So is there any liability you
would throw back at KPMG for screwing things up
for you? You might not be here today if they had done
a better job.
Peter Marks: Yes. Is there any liability? I don’t know.
Is there legal liability? I don’t know.

Q448 Mr Newmark: But this was a dramatic event
in your organisation. Surely you must have looked at
that and said, “We got advice from these guys who
were in fact completely wrong in scrutinising the
balance sheet of a business that we ended up taking
on.”
Peter Marks: Yes.

Q449 Mr Newmark: So you are saying that they
screwed up but there is no—
Peter Marks: I didn’t say there was no liability. All I
am saying is that we took their advice.

Q450 Mr Newmark: But are you guys, someone
internally, saying that we should do something about
this, that we should hold KPMG to account?
Peter Marks: I am not there any more so I don’t
know.

Q451 Mr Newmark: But before you left, there was
no follow-up when the proverbial whatever hit the fan.
You guys did not say, “Wow! We had this clean bill
of health from this blue-chip accounting firm yet they
were dramatically wrong. We must follow up on this.
This was bad advice.”
Peter Marks: I have no doubt that those conversations will be happening now.
Mr Newmark: I think I will leave it at that, Mr Chairman.
Chair: Two colleagues want to come in with quick questions. I emphasise the word “quick”.

Q452 Mr Ruffley: Pursuant to the Chairman’s queries about the written records of what you were saying at the group’s board meetings, I want to put this to you. In written evidence to this Committee, Mr Richardson said: “I have full contemporaneous transcripts”—of the meeting on 11 July 2011, which he says he had face to face with you—“in which I told them amongst other things that ‘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.’” He has told this Committee that that is a transcript of what he told you. Is Mr Richardson telling the truth, or are you?

Peter Marks: I’m not sure there is a discrepancy between what I am saying and what Mr Richardson is saying. I am agreeing that he raised issues about management stretch and the number of projects. That was discussed by the board, of which I was a director, and the board and management team felt that, despite management stretch, we should proceed with Project Unity—which, I repeat, significantly delivered additional profit, which the bank needed—and also Project Verde, because it was such a great opportunity for the bank. So I am not saying that Neville Richardson did not say he was concerned about management stretch. I am saying that that was discussed in the boardroom.

Q453 Mr Ruffley: Did he warn you that there were breaches, possibly, of directors’ duties?

Peter Marks: No, I don’t believe that.

Q454 Mr Ruffley: So you do not think the transcript is accurate?

Peter Marks: I don’t remember that comment.

Q455 Jesse Norman: That is obviously a fundamental point. You would not mind if Neville Richardson shared his transcripts with the Committee?

Peter Marks: Not at all.

Q456 Jesse Norman: Thank you. I want to follow up one final thing. You have said on several occasions that the point of the Verde transaction was to remedy three of the five problems that the FSA had identified with the Co-op and its financial services in particular. May I remind you of what Andrew Bailey actually said in testimony to this Committee? “Towards the end of 2011”—December 2011—“we made it clear to them”—the Co-op—“that—and I will use these words carefully—it was not clear to us that the Co-op 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. Then we set out five things, the five areas that they would have to deal with” to be able to make the Verde acquisition. He listed: “Capital, liquidity-risk management, integration, governance and management.”

First, that is a massive indictment of the way in which the bank has been set up—it is roughly everything that could have gone wrong: capital, liquidity-risk management, integration, governance and management—from the FSA. It seems that that is true. Secondly, these are things that you would have to have sorted out in order to be able to make the Verde acquisition, not as a result. He is clear that you will not be able to solve the problems that he has identified through the Verde acquisition. That is going to be insufficient.

Peter Marks: But he also said, “Verde would have brought to Co-op three things: capital, because Lloyds was putting capital in; management; and IT systems, all three of which would have been of benefit to Co-op.” He also said to me personally in a conversation that he was in favour of us trying to do the Verde deal, but he wanted it to be done from a position of strength, and by that he meant capital. There was never a time when the regulator said, “You should drop this because you can’t do it.”

Q457 Jesse Norman: But he did ask you to pass on to the concerns they had indicated to Lloyds.

Peter Marks: Which was done.

Q458 Chair: You just said that you had conversations with Andrew Bailey about all this. Earlier you told us that you didn’t know what Andrew Bailey meant by governance, among the list of five concerns. Did you ask him?

Peter Marks: I think specifically—

Chair: Did you ask him?

Peter Marks: I can’t remember asking him, Chairman.

Q459 Chair: But if the regulator comes to you and says that there are five major things wrong with an outfit of which you are group chief executive, don’t you think it is a good idea to ask him what he means by each of those five things?

Peter Marks: We got four of them sorted out.

Q460 Chair: But you forgot to ask him about the fifth.

Peter Marks: I seem to remember him talking about the bank, the make-up of the bank board, the fact that the chairman was a lay person, and perhaps that we should have a different structure within the bank board. But it did not appear to me that that was his main—

Q461 Chair: You did know what he meant by governance, then?

Peter Marks: Yes, but I don’t believe that was his main issue.

Q462 Chair: With great respect, why did you tell us you didn’t know what he meant by governance earlier this morning?

Peter Marks: “Governance” is a nebulous word, isn’t it? I wasn’t absolutely sure—
Q463 John Thurso: May I get a tiny bit of clarity on the governance structure? The Co-op itself—the main structure, the mutual—is by virtue of being a mutual owned by all its members.

Peter Marks: Yes.

Q464 John Thurso: The members elect the 20 members of the board. It is an entirely democratic operation, which results in whatever choice democracy chooses to throw up.

Peter Marks: Yes.

Q465 John Thurso: So there is no filter for the particular skills of the people who arrive on the board. They are the people who put themselves forward and get elected. The interesting thing is that unlike a plc, you, the chief executive, your finance director, your operations directors and your division chiefs do not sit on the board.

Peter Marks: No.

Q466 John Thurso: So there is presumably an executive committee?

Peter Marks: Yes.

Q467 John Thurso: And you chaired that executive committee?

Peter Marks: Yes.

Q468 John Thurso: The executive committee is like a Government, and the board is like a Parliament. So you have to work out how to run the thing and take it to the Parliament to try to get the decisions through?

Peter Marks: Yes.

Q469 John Thurso: And that is both the strength and the weakness of the mutual model?

Peter Marks: Yes.

Q470 John Thurso: So far, I completely understand. Was the bank a completely mutual bank, or was it owned by the mutual?

Peter Marks: It was owned by the mutual.

Q471 John Thurso: So it actually had share capital?

Peter Marks: Yes, it did.

Q472 John Thurso: So right from day one it was never a mutual bank; it was a bank owned by a mutual.

Peter Marks: Yes.

Q473 John Thurso: That is a pretty fundamental difference. Therefore, it had a different board structure of a third, a third, a third. It was one third executives, one third selected from the Co-op board to represent the Co-op, and one third of skilled, professional non-execs, whom you would presumably be relying on.

Peter Marks: Yes.

Q474 John Thurso: There is a raft of questions around those non-execs. They are probably the same questions the Banking Commission asked non-execs of all the other banks, and I suspect they fell into exactly the same traps and were equally incompetent and all the other things that we discovered when we did that. I don’t want to discuss that with you today. I just wanted to get the model straight, and I have got that now. Thank you.

May I look at what that means for the future of mutuals or mutually owned organisations? To what extent do you think the difficulties that the Co-op bank has experienced and the position it is now in come from its adherence to the mutual model, or from the fact that really it was behaving like any other bank but with a poor governance structure?

Peter Marks: I don’t think that its problems arose out of the fact that it is a mutual, other than that it could not raise capital as easily as other banks. For instance, if the regulator says, “You need another £1 billion buffer capital,” if you are a plc you either sell businesses or go to the market. The mutual model does not allow that, and I think that that has been a major problem with why the bank is where it is. If it needed to raise capital, it could have gone out to the equity markets if it was a plc. I’m sorry, I do not think I have answered your question properly.

Q475 John Thurso: Really, I am trying to get at this. Richard Pym, the new chairman of the Co-operative group, has stated: “The Co-operative Bank has an important role in providing a viable alternative to the traditional banks.” The question is therefore around the fact that it was behaving like a traditional bank, it was structured like a traditional bank but without the checks and balances or capital-raising ability, so, as an equity bank owned by a mutual, it was in an extraordinarily weak position. When Mr Pym states that there is “an important role in providing a viable alternative”, one must ask a very big question about that. Do you believe that the mutual model remains viable, looking ahead?

Peter Marks: I think it is going to be very difficult for a mutual to compete in the banking market that the Co-op bank was trying to compete in, which was high-volume, low-margin business. The 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. So it is going to be difficult going forwards for a mutual to be a really serious competitor in the retail banking market.

Q476 John Thurso: The mutuals have played a vital and wonderful role in our society over the years. The building societies, particularly when they were locally based, were outstanding institutions. I, for one, always regretted their passing. But they were not banks. They took savings and gave loans—they provided that vital service. To be clear, the distinction I think I hear you making—correct me if I am wrong—is that there is nothing wrong with that model, but there is a great deal wrong when those mutuals try to get into all the low-margin, high-volume aspects of modern high street banking with all the concomitant problems and regulation.

Peter Marks: That would be my opinion.

Q477 Chair: I want to clarify one point about your role, Mr Marks. Were you not chairman of group risk management?
Peter Marks: Yes.

Q478 Chair: In that capacity, were you at all aware of the main risks that have now been brought to us as the major weaknesses—the commercial real estate exposure, the high loan-to-value ratios, and what they would call in America sub-prime mortgages?
Peter Marks: Yes.

Q479 Chair: What did you do, or what action was in train, to mitigate those risks?
Peter Marks: As I said earlier, we were building up capital in the bank. Clearly, the Co-operative was not pursuing the kind of areas you mentioned. It had acquired them via Britannia, largely. It had to manage those risks going forward. But there was not much we could do about what was already in the loan book.

Q480 Chair: So it was a very, very difficult inheritance that you had had from this big mistake with this deal?
Peter Marks: Yes.

Q481 Chair: Was sufficient information coming to you at group level to enable you to form those judgments on the group risk committee? Was this being withheld or just not provided?
Peter Marks: No, it was not being withheld.

Q482 Chair: So everything you needed to know to perform your job effectively as chairman of group risk management was being supplied to you?
Peter Marks: Yes.

Q483 Chair: Mr Marks, you have told us today that you were the victim of an economic crisis. You are not prepared to agree that Britannia was a large error as a deal. You say that the Co-op bank board was separate from the group but you were chief executive of the group driving the Verde deal forward at the same time. You also accept that you effectively set aside the advice of the bank chief executive on both Projects Unity and Verde even though you have agreed that you weren’t qualified to run banks. Looking at all of that in summary, do you now feel that you made very big mistakes in the course of your period as chief executive?
Peter Marks: If we talk about Verde—
Chair: If you concentrate on the heart of the question, which in a sense is the same question that I put to you right at the beginning, Mr Marks. We have moved forward a little on all these points. I am trying to get a scale of the acknowledgment of the mistakes.
Peter Marks: Of course, I acknowledge that Britannia has turned out to be not a good deal for the bank. I absolutely accept that. I don’t accept that it was a mistake to give a lot of consideration to Project Verde. I think Project Verde would have transformed the bank. I think it would have given a real competitor in the banking market. The Independent Banking Commission said that to be a true competitor you needed 6% or 7% market share of current accounts. That is what this would have given us, together with the things that Andrew Bailey talked about. So I think it was a project that was well worth pursuing. By the way, I really need to say that on many occasions I said to the board and to the management team that because I would not be around post-Verde if it happened, I had to be really confident that everybody was supportive of what we were doing. That included the bank executive and the retail-arm executive. 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. So, yes, I was in favour of Verde. Absolutely, I was. But I also was absolutely aware that it needed to be a collective decision and not Peter Marks, gung ho. I really need to get that point across. So far as Project Unity was concerned, again that is not a mistake. That has turned out to be highly beneficial, delivering £70 million or £80 million—I can’t remember the exact figure but I am sure we can give you that—of savings by combining back-office services. Why wouldn’t we cross-sell products? Tesco sells insurance products in its supermarkets. Why shouldn’t the bank sell its financial services products in the other retail chain? That is all Project Unity was trying to deliver. It did deliver it, which does not suggest that it got in the way of management stretch. I also think that management stretch has not created the problem in the bank. It is a capital problem. The operations of the bank—dealing with customers and satisfying customers—have, as I understand it, been absolutely fine. The capital issue was driven by the Britannia loan book, essentially, and by the requirement for significant buffer capital in the new world.

Q484 Chair: Mr Marks, large numbers of people have lost money out there—I am not just talking about the bondholders, but very many other people as well—as a consequence of all these decisions. I am sure that this has not been an easy morning for you. Frankly, I do not think that it has been an easy morning for any of us, but I hope you understand that it was necessary that we go through this.
Peter Marks: Of course.

Q485 Chair: Is there anything that you want to add before I bring the sitting to a close?
Peter Marks: All I would reiterate is that I spent my life—45 years—working for the Co-op. I believe in its values and it is a tragedy what has happened: for the group, for the movement and for me personally. We did, however, achieve a lot of success in the retail business and to say that it is completely defunct is an exaggeration. The group still has a very good future, due to a lot of the work that we did.
Chair: Thank you very much for giving evidence today.
Tuesday 29 October 2013

Members present:

Mark Garnier                        Mr Brooks Newmark
Stewart Hosie                      Jesse Norman
Mr Andrew Love                     Mr David Ruffley
John Mann                          John Thurso
Mr Pat McFadden

Witness: Barry Tootell, former Chief Executive, Co-operative Banking Group, gave evidence.

Q486 Chair: Good morning, Mr Tootell. Thank you very much for coming to give evidence this morning.  
Barry Tootell: Good morning.

Q487 Chair: You were chief financial officer of the Co-op Banking Group, from 2008 to 2011, and then chief executive. Is that right?  
Barry Tootell: Indeed.  
Chair: You were in a key position of responsibility for the whole of the period that we are looking at?  
Barry Tootell: Yes.

Q488 Chair: Would you consider Project Verde to have been yours; that is, something that you primarily had responsibility for?  
Barry Tootell: Given the significance of the Verde opportunity, it was, quite rightly, something that the group had a major hand in. The group board, together with the bank board, had concluded that it wished to pursue the opportunity that was represented by Verde.

Q489 Chair: Mr Marks tells us that this was a matter primarily for the bank and not for the group board. Who is right?  
Barry Tootell: Mr Marks said it was primarily for the bank to decide whether it was able to complete the transaction. I think Mr Marks also said that he was a driving force behind it as he had the full support of the group board to consider the opportunity.

Q490 Chair: Where does primary responsibility lie for handling Project Verde?  
Barry Tootell: 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. So primarily the bank, but if the bank wished to pursue the transaction it would have had to have sought approval from the group board.

Q491 Chair: We know the legal position here. We are trying to establish which individuals were driving the attempt to do this deal. Were you one of those?  
Barry Tootell: I was, yes.

Q492 Chair: Were you uneasy about the deal?  
Barry Tootell: I was concerned at various stages about the economic viability of the transaction, culminating in April 2013 when 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. As the group chief executive—given the key strategic importance of this initiative for the group—Peter Marks was also the key driving force behind us exploring the opportunity.

Q493 Chair: So you were uneasy about it at various points?  
Barry Tootell: Rightly so. Given the size of the transaction, it would be—

Q494 Chair: When did you first become uneasy?  
Barry Tootell: At the end of 2011, beginning 2012, we were going through the consideration of our indicative offer to Lloyds. We were very clear that we had to make this economically viable and we were doing a lot of analysis to make sure that it did do just that, and then, during 2012, we continued to have a debate with Lloyds about the do-ability of the transaction. That is not to say I was concerned and wished to pull the plug on the transaction, but it was quite right that I was concerned that it was the right thing for the group to do and I was challenging of our ability to do just that.

Q495 Chair: Did you discuss your uneasiness with Neville Richardson?  
Barry Tootell: No, I did not. Neville had left the business in July 2011.

Q496 Chair: But you said you first had concerns towards the end of 2011. You never discussed it with him?  
Barry Tootell: No. Could I just clarify, Chair?  
Chair: He never had any influence over your views on this?  
Barry Tootell: Absolutely not, no.

But to clarify what I mean there by “concern”: concern that it was the right transaction for us to do; concern that we approach it with appropriate diligence to make sure it was the right transaction. That was not a concern that we could not do the transaction in 2011. It was merely a duty of care and detailed diligence over our capability. Concerns did emerge in 2012 about the economics of the business that we were acquiring and the cost of integrating that business into
our business, because the bank would have been acquiring the undertakings of the Verde business. Our ability to integrate that, together with the economics of the business that we were acquiring, were a concern at that time and we had those discussions with Lloyds about our lack of willingness to proceed.

Q497 Chair: I understand. One further question. Did you leave of your own accord or were you eased or pushed out? I do not want to question with respect to employment law. I am asking you a question with respect to exchanges that you will have had.

Barry Tootell: That is fine. If I could clarify the terms on which I came into the role in the first place. I was acting chief executive from mid-2011 at the point when Mr Richardson left the business. I was brought into that role to consider whether the transaction of Verde was viable for the group, and then the group would have to decide who the chief executive would be going forward. So in a way I came into the role to assess the Verde transaction. In January 2013, I had a discussion with my chairman, and with my chairman of remco. I said I did not see myself staying on in the role even if we did not do the Verde transaction.

Q498 Chair: You had already decided to go.

Barry Tootell: I had had the conversation in January 2013. I would say the timing of my departure was as much in the hands of the new group chief executive—

Q499 Chair: Just remind us who that conversation was with.

Barry Tootell: I had three conversations. I had a conversation with my chairman in January 2013 about my medium-term future with the business. I had the same conservation at the same time with my chairman of the remuneration committee. Then in early May, after the arrival of the new group chief executive, Euan Sutherland, I had a similar conversation with Euan about his plans and my plans for the future.

Q500 Chair: By the beginning of 2013, you had made up your mind that you were looking to go?

Barry Tootell: At some stage. Yes.

Q501 Chair: I am not pressing this point. I am trying to clarify whether you were pushed out or whether you left on your own accord. You are giving us a very clear steer that you had already made up your mind and you were thinking about this for many months, perhaps up to a year, before you did go.

Barry Tootell: Yes, indeed, and I made that point clear with my chairman.

Q502 Chair: One last point before I hand over to colleagues. In the overview to the Co-op’s 2012 financial statement you said, “Our balance sheet remains strong”. Were Moody’s already in the Co-op by that time, looking at your papers?

Barry Tootell: Neither Moody’s nor Fitch were ever engaged in those privileged briefings.

Q503 Chair: They never asked you for papers? They never asked you for any information in order to do their assessment?

Barry Tootell: Yes. They were not in the business. It is common practice for banks to brief the rating agencies on the—

Chair: I am using that metaphorically.

Barry Tootell: Okay, sorry.

Chair: They obtained briefings.

Barry Tootell: Yes, we had briefed the rating agencies.

Chair: On privileged terms.

Barry Tootell: Indeed.

Q504 Chair: I am asking you whether they were already engaged in those privileged briefings.

Barry Tootell: We had briefed them at the time of the March 2013 announcement of the 2012 results. We had briefed both rating agencies at that time and, when I say the balance sheet was strong, we had—

Q505 Chair: I just want to clarify this role of Moody’s. They were already engaged with you at the time that you have said, “Our balance sheet remains strong”, or not? That was on 20 March 2013.

Barry Tootell: Indeed. Chair: They were?

Barry Tootell: They were engaged and they had been engaged for years gone by. This was not an immediate engagement.

Q506 Chair: This is not a continuous engagement by rating agencies, is it? At specific periods when they look at specific questions, they have a heightened level of involvement.

Barry Tootell: They do and they take the—

Chair: We will agree that they do. To say that they were continuously involved could have been misleading, but we have cleared that up.

Barry Tootell: Sorry, if I may clarify?

Chair: They were at a heightened level of engagement at the time?

Barry Tootell: At the time.

Chair: At that time, right.

Barry Tootell: Typically they would meet me and the chief financial officer every six months, and they did so in March 2013.

Q507 Chair: Six weeks later they downgraded you.

Barry Tootell: Indeed.

Q508 Chair: A £1.5 billion capital shortfall was exposed. Is that correct?

Barry Tootell: The £1.5 billion shortfall was announced by the PRA to the markets in June 2013.

Q509 Chair: Yes, so only a few weeks after that. Within a few weeks, not only had you been downgraded but the regulator had also said you needed a lot more capital—a huge amount more capital—bearing in mind your size in relation to your balance sheet, core tier 1. Is that correct?

Barry Tootell: Correct.

Q510 Chair: In retrospect, would you think that saying, “Our balance sheet remains strong” was misleading?
Barry Tootell: We continued to have a 9.2% core tier 1 ratio in March 2013. We had had 9.6% CT1 in year-end 2010 and 2011 from memory, but certainly 2011 was 9.6%. Despite the difficulties the business was facing, in terms of impairment emerging through the P and L and hitting the balance sheet clearly, CT1 remained at 9.2%. We were very careful not to mislead the markets by using words such as “strong” too glibly. Nevertheless, CT1 at 9.2% was regarded as being broadly consistent with the CT1 we had previously had, despite taking the hit.

Q511 Chair: I will quote another line, “The bank’s underlying financial strength remains intact”. It is a bit difficult to square with a £1.5 billion capital call, isn’t it?

Barry Tootell: That was referring to the analysis of the business between core and non-core. If you look into the year-end financial statements, you will see the core profitability of the business remaining at a viable level and the losses essentially emerging out of the non-core business, which is the asset deterioration in the non-core portfolio, together with the one-off hit for 2010 write off of the intangible assets and the provisions for PPI. The underlying business still remained profitable, and that was what that statement referred to.

Q512 Chair: While you say that that remark and the remark that, “The balance sheet remains strong”, were carefully thought through—which is what you are telling me now—when you were doing that thinking through, you already had in mind the risk that there might be a downgrade and a need to handle the £1.5 billion capital shortfall. Is that correct?

Barry Tootell: It was, but it was not a £1.5 billion capital shortfall in the way in which the PRA announced it in June. What we had was a future capital requirement, which we had been discussing with the PRA during quarter one of 2013 as a medium-term requirement for us to achieve a certain level of capital for regulatory purposes. That is not a hole in the balance sheet in the year-end 2012. That is a requirement on us to increase our capital on a go-forward basis. At that time, certainly by March 2013, we had announced our intention to sell our general insurance business and we were already in the process of completing the transaction to sell our life and savings business. The capital from both those transactions was to be redeployed into the bank, and that was intended to offset the deteriorating capital base because of the non-core business.

Q513 Chair: You were already well aware of the things that Moody’s might find and that the PRA were finding, but you felt that that was consistent with being able to say that your balance sheet remained strong?

Barry Tootell: Yes, but there was nothing for Moody’s to find. We had been very open with the regulator and with rating agencies, in terms of the asset quality of the balance sheet. Moody’s assessment of our credit rating was based upon their look-forward basis of assessing that asset credit quality and the means by which they thought we would accommodate that, and their judgment was a multi-notch downgrade of the business way beyond that which we anticipated.

Q514 Chair: I know I have asked this question before, but it will strike some as something of a surprise that saying that your balance sheet remained strong was not in any way misleading the market, bearing in mind that you have said you were already fully aware of the concerns that led to the £1.5 billion capital shortfall at the time that you made it.

Barry Tootell: We were comfortable with that statement, yes.

Q515 Mr Newmark: That flows into the questions I want to ask you. You are a qualified person with respect to a financial services business. On the one hand you are saying you went out to the market and you said, “Yes, our balance sheet is okay”, when clearly you were holed below the waterline in some way. I am curious, did you rely a lot on your accountants to make that judgment call, or where did that judgment call come from in terms of saying, “Our balance sheet is okay”, when subsequently it was not?

Barry Tootell: The point refers to the balance sheet 9.2 status, which is the ratio of our core equity to our risk-weighted assets.

Q516 Mr Newmark: No, I understand that. But clearly there was a problem though, right?

Barry Tootell: There was a problem that we were addressing. This is the requirement for us to increase our capital structure further, which we were doing, by divesting other aspects of our business within the broader Co-operative Banking Group and redeploying it into the bank to face off against what we saw as the deteriorating capital base in the underlying non-core business.

Q517 Mr Newmark: Who were your accountants at the time?

Barry Tootell: Our auditors were KPMG.

Q518 Mr Newmark: What feedback were you getting from them to give you the confidence to come out and say what you said with respect to your balance sheet? I don’t want to tread on Mr Love’s territory, but I am just curious.

Barry Tootell: Extensive discussion in terms of the wording of the statutory accounts for the year-end 2012. That review takes place within my finance community, in dialogue with the auditors, ultimately into the audit committee and to the board itself. It is a board statutory account approval process.

Q519 Mr Newmark: With the benefit of hindsight, do you think their advice in the end was a little dodgy or not at all?

Barry Tootell: No, there was discussion around the appropriateness of wording, as there always is in any statutory accounts process. We were comfortable that that statement, together with the plans that we had in place, was appropriate to address the go-forward capital requirements of the business. As I say, it reflects the fact that we had a 9.2% core tier 1 ratio for the year ended—
Mr Newmark: You keep repeating that.

Barry Tootell: It is very appropriate for the accounts that we were commenting upon.

Q520 Mr Newmark: But from the market’s perspective, it did not subsequently address the fact that you had a huge problem with your balance sheet. No?

Barry Tootell: There is a difference between the year-end statutory accounts and the regulatory requirements that we had for the future that we were doing something about.

Q521 Mr Newmark: Neville Richardson’s written evidence suggests that, in May 2008, Britannia was approached by David Anderson, chief executive officer of Co-op Financial Services, to broach the subject of a merger between the two organisations. Is this your recollection, namely that the Co-op was the activist partner in seeking a merger?

Barry Tootell: I know Mr Richardson has said that. My first recollection or awareness of the opportunity to acquire the Britannia business was David Anderson announcing to our executive committee that he had had a discussion with Neville. I honestly do not know who approached who.

Q522 Mr Newmark: Do you think that he was the driving force behind the merger or who was?

Barry Tootell: I think both parties were keen to explore the opportunity that the merger or the acquisition presented. I honestly don’t know whether Neville approached David or vice versa.

Q523 Mr Newmark: In board minutes there was nothing in there giving any sense of which direction the pressure was coming from?

Barry Tootell: We could check, but I am not aware of such.

Q524 Mr Newmark: What was the rationale from the Co-op’s perspective of seeking to merge with Britannia?

Barry Tootell: We were a £15 billion banking business with only 90 branches and, therefore, subscale in distribution reach, and subscale in balance sheet size in order to serve our customers and our members better. It was always the intention of the business to seek to expand its reach to our customers. Therefore, the 250-branch network of Britannia was of significant interest to us because it would broaden and deepen our reach within the UK. In addition to that, we were a clearing bank, but we had a relatively small savings and mortgage business, yet Britannia complementarily had a very significant mortgage and savings presence.

Q525 Mr Newmark: You reckoned between the two management teams you had the management depth to make sure that was all integrated and everything fine?

Barry Tootell: Indeed.

Q526 Mr Newmark: Who else within the Co-op was pushing for a merger between the two organisations, and was the group or the bank pushing more strongly for a merger?

Barry Tootell: It was an interesting opportunity that was presented to us. We were not trawling the market looking for targets. I believe it was through David Anderson’s previous relationships with chief executives of building societies, given that he used to be the chief executive of the Yorkshire Building Society—so he knew many of his counterparts in the industry on the mutual side—that that meeting came about. It was not because we were searching for a target and who within our business was supportive—

Q527 Mr Newmark: It sounds like Mr Anderson was the one pushing a little bit more, in that it is sort of implicit from what you say.

Barry Tootell: I could not say. I am suggesting that they knew each other through that relationship.

Q528 Mr Newmark: No, I know that element of a relationship. We all know loads of people. But somebody is taking a more activist approach. I am trying to get to understand who was taking the more activist approach in this.

Barry Tootell: I am sorry, I could not comment. I don’t know who was driving more so than the other. My understanding at the time was that both parties were keen to explore the opportunity.

Q529 Mr Newmark: Right. But they did not suddenly wake up one morning, each independently, and say, “Gee, it would be a great idea if we got together”. Somebody must have approached one or the other.

Barry Tootell: Indeed, one of them must have made the first contact.

Mr Newmark: So who was it?

Barry Tootell: I don’t know the answer to your question, I am afraid.

Mr Newmark: Come on. Okay, fine.

Chair: Are you sure about that?

Barry Tootell: Yes. I would have told you, Chairman, if I had known the answer.

Chair: Okay.

Mr Newmark: It would be interesting to see if there were any board minutes or anything.

Barry Tootell: Indeed.

Q530 Mr Newmark: I will let Mr Chairman figure out if we can get hold of those. Peter Marks told us that, while he voted for the Britannia deal as a non-executive director, he was not driving the Britannia deal. Is that the case and, if so, what does it say about group oversight of the activities of the bank?

Barry Tootell: At the time, the governance structure of the business was a little different. David Anderson did not have a direct reporting line to Peter Marks and Peter Marks was not as involved in the banking group business as he has been for probably the past two or three years. Yes, David Anderson was the driver of the transaction from within the banking group or from within the Co-operative group. You are right with your summary of the situation, which was that Peter Marks was supportive of the transaction as a non-executive of the bank. Indeed, he spoke in favour of the
transaction, in his capacity as the group chief executive, in the group board meeting that finally made the decision to progress the transaction.

Q531 Mr Newmark: But based on information that he received during the board meetings as opposed to any other ambitions for the group or anything like that?
Barry Tootell: Indeed.

Q532 Mr Newmark: Or did it tie in with his ambitions for the group?
Barry Tootell: Strategically, it was the right thing for the banking group, and he supported it for that reason. He was not involved in detailed day-to-day conversations with David Anderson that I am aware of, in the way that he has been more recently with me in the context of the Verde transaction.

Q533 Mr Newmark: You would not say that, once he was sold on the idea, he was championing the deal in any particular way internally?
Barry Tootell: No.

Q534 Mr Newmark: How did Britannia react to the approach from the Co-op?
Barry Tootell: Again, I do not know whether Co-op approached Britannia. How did Britannia react to the opportunity? They were optimistic about completing the transaction and, again, from their point of view they thought that it was a very complementary transaction. If I look now at the Britannia business, what didn’t they have that they would benefit from by a transaction with the Co-operative? They did not have bank clearing capability. They did not have internet capability. They did not have the general insurance and life assurance manufacturing capability that we had. So the complementary nature of the transaction was appealing to both parties.

Q535 Mr Newmark: It might have been complementary, but do you think it was more of a rescue operation of Britannia or was it a merger of some sort of equals in your view?
Barry Tootell: An incredibly interesting question in the context of what we have seen happen over the past years with hindsight, but, no, at the time—

Q536 Mr Newmark: You thought it was a merger of equals, not a rescue operation?
Barry Tootell: We were very clear to make that sort of comment to the marketplace, and we genuinely believed that from within the bank and in all the discussions that we had with Britannia, There was no sense from Britannia or from our business that this was a rescue of Britannia. It was never discussed in our boardroom, and to my knowledge was never discussed in the Britannia boardroom and never discussed between parties and never discussed with the regulators. This was a bringing together of two businesses that were complementary.

Q537 Mr Newmark: In putting the two businesses together, there was nobody internally saying, “This is not a merger of equals; these guys could be in a bit of trouble here and we have leverage in this merger”? It was truly a sense of the merger of equals?

Barry Tootell: No.

Mr Newmark: No? Yes?
Barry Tootell: No as in, no, we did not think that.
Mr Newmark: No, you didn’t see it.
Barry Tootell: The only comment to that end is a comment made in the final group board meeting, when one of the directors noted, “Perhaps Britannia need this a little bit more than we do”. Apart from that passing comment, there was never any discussion.

Q538 Mr Newmark: I am curious, what led that person to make that comment?
Barry Tootell: Just the assessment of the relative capital strength of each business. Capital was slightly more constrained at Britannia, because at the time the FSA was encouraging them to improve their capital planning capability and was asking them to hold back capital because of that. So they were slightly more constrained. That was an issue that was removed on acquisition or merger because, under our capital planning oversight and stewardship, that capital planning issue was waived by the FSA. In standalone terms, perhaps Britannia needed the transaction slightly more because they were slightly more constrained, but this was never ever discussed as a rescue in any way, shape or form within the business.

Q539 Mr Newmark: So there was no pressure from the regulatory authorities or even the Government to encourage this—I view it as a rescue operation of Britannia—merger with Britannia? There was no pressure from either the regulator or the Government to do this?
Barry Tootell: Not at all to my knowledge. I did not have any such conversations with regulators or Government.

Q540 Mr Love: I draw the Committee’s attention to my designation as a Labour and Co-operative Member of Parliament. Mr Tootell, what role did you play in the due diligence that the Co-op conducted on Britannia?
Barry Tootell: The due diligence was undertaken under my area of responsibility as a CFO. It was undertaken by KPMG working with my risk officer who reported directly to me, so it was my responsibility.

Q541 Mr Love: When he appeared before the Committee, Peter Marks told us that the Co-operative Bank had relied very heavily on the fair value and due diligence work that was done on its behalf by KPMG. Would you agree with that statement and do you think you were overly reliant on the advice and work undertaken by KPMG?
Barry Tootell: That is a very interesting question, again, with the benefit of hindsight. If I refer to even more recent publications from the Parliamentary Commission on Banking Standards, which has a real focus on responsibility of officers and directors. I take responsibility for the due diligence that we had undertaken. I do not blame KPMG for any retrospective view of the shortfall in that due diligence
work. Yes, we took comfort from it, but I do not believe that management abdicates responsibility by engaging consultants or advisers to assist them in their work. So, yes, we did take comfort from the KPMG work—just as I took comfort from the work that my risk team and my finance team had done—but ultimately it was the board’s decision to do the transaction based on that input.

If I could just comment for a moment, Chairman, on the content of that work or the timeframe within which that work was done. This was done in late 2008, when the level of arrears in the Britannia business was relatively low. We identified the areas of risk within the Britannia business and, notably, they were the non-conforming, self-certified mortgage books in the platform intermediary portfolio, together with the distressed books that they had acquired from General Motors or GMAC, together with the level of exposure that may sit within the corporate book. We made sure that we focused on those areas when we did the due diligence work and we assessed them based on our understanding of those areas. We stressed them based on our future economic outlook for the UK economy.

That future economic outlook accorded with Bank of England publications at the time in terms of where we as a UK economy thought the economy was going. The board assessed that and took comfort from that and, even in the board meeting where we finally made the decision to proceed with the transaction in January 2009, there was commendation for KPMG and the due diligence work by JP Morgan, for the thoroughness of the due diligence, the rigour within which we assessed the stress areas of the book and the capital planning of the business.

I look back with the benefit of hindsight and think that we have had a lot more credit risk exposure from the Britannia business than we ever thought possible. At the time we genuinely thought we had put appropriate fair value in place to protect ourselves. We put almost £700 million of fair value in place beyond that which the auditors of Britannia—which is PwC—and the Britannia management and board felt appropriate, based on their provisioning work that they would have done in the natural course of business. We put an additional £700 million away. With the benefit of hindsight, that has proved not to be enough. Do I think that KPMG let me down at that time? My personal view is, no, they did not. Based upon the economic circumstances at the time, I think they did a very, very thorough high-quality job that I took comfort from, as the chief financial officer, as did my board.

**Q542 Mr Love:** We will come to the emergence of impairments in a moment, but let me ask you this. You mentioned all the risky aspects of the Britannia balance sheet. I understand KPMG did all the work in projecting various scenarios, but did they throw up any concern that the level of risky assets on their balance sheet might cause problems in difficult economic circumstances?

**Barry Tootell:** Yes, because otherwise we would not have put £700 million of fair value protection aside to protect ourselves. They did not raise issues beyond that which we could afford within the capital plan for the combined business and, therefore, the business was a viable and attractive proposition for the Co-operative business. They raised several areas that were insightful and helpful to management in considering the transaction.

Interestingly, with all that we have seen more recently in terms of the emergence of significant losses from the non-core business of the Co-operative, which almost exclusively contains the Britannia assets—there is some Co-operative asset in there, but it is mainly Britannia assets—much of that exposure that has come out in 2012 and 2013 has related to the corporate business and not the intermediary business. At the time, we were much more concerned about the intermediary business and we did extensive work on that. That is not to say that we did not look at the corporate business, but it was not our major area of concern at the time. It was the intermediary business that was the major focus for us.

**Q543 Mr Love:** Who do you hold responsible for not looking at what turned out to be a very risky area? Do you accept responsibility yourself on behalf of the Co-op Bank or should KPMG, carrying out their functions as regards the due diligence, have thrown this up as a possible problem area? What I am trying to get to is that you accept that KPMG did the best it could. I am trying to figure out how reliant the Co-op was on the judgments made by KPMG in the negotiations over the merger with Britannia. That is what Peter Marks said, but you seem to be suggesting that the responsibility lay with the Co-op, rather than the advice given by KPMG.

**Barry Tootell:** To be clear, we did not blindly make a decision based upon the evidence of KPMG. We took comfort from KPMG’s input to us. If I look back, do I take responsibility? I take responsibility as the CFO, with oversight of the due diligence process, for the support I gave to my chief executive and my board in an important decision. I took comfort, as my board took comfort, from the support of advisers. Do I look back and think of the economic circumstance at the time, and do I think that they missed something? They were working on the basis of economic projections that were consistent with Bank of England and market consensus; they were doing that assessment of the business only three or four months after the FSA conducted a supervisory review of Britannia and reaffirmed, give or take, a £30 million or £40 million—I think it was from memory—increase in their capital requirement. Broadly speaking, the FSA reaffirmed the capital requirements of Britannia, having done a thorough supervisory review process.

As I say, we and KPMG did a review of the risk areas of Britannia, based upon current and stressed economic projections. I can think of no individual or committee or board or firm—in the sense of KPMG—that did not exercise the utmost professional care in pursuing what was an important transaction for the group. Were we right in hindsight? Self-evidently, no. As we have seen over the past three years, the level of losses from that business far exceeds that which we reasonably thought could come to pass.

**Chair:** We are going to move on, Andy. One very last quick question and a quick reply, please.
Q544 Mr Love: One last question. It is in relation to KPMG as auditor, which has very specific responsibilities. How important a role do KPMG have in relation to the statements that have been made through this recent period, where you have gone from having limited impairments to having significant impairments and a deterioration in the capital position? Did KPMG authorise all the statements that were made or did they advise that these statements might be inappropriate at any particular time?

Barry Tootell: No, we had no disagreement with KPMG in terms of our published financial statements.

Q545 Mr Love: As the auditor, they approved all the statements that were made?

Barry Tootell: Yes, they did. It is not really for them to approve, it is for the board of the business to approve. It is not for the auditors to approve, but they gave appropriate confirmation to the shareholders and the directors as a combination of their audit work on the accounts.

Q546 Mr Love: There were no discussions that the statements might be misleading the market from your auditors, KPMG?

Barry Tootell: No.

Q547 Jesse Norman: Mr Tootell, I am grateful for the clarity of your responses so far, thank you. So KPMG were the auditors to the Co-op at the time of the merger?

Barry Tootell: The financial advisers for the transaction on the Co-op side were PwC and KPMG were the auditors to the Co-op at the time of the Britannia transaction, PwC were the auditors to Britannia. Can you remind us who your financial advisers were?

Barry Tootell: The financial advisers for the transaction on the Co-op side were JP Morgan.

Q548 Jesse Norman: Yes, and who on the Britannia side?

Barry Tootell: I believe it was Citigroup.

Q549 Jesse Norman: Very quickly, what were the terms of the merger?

Barry Tootell: The terms of the merger were a zero consideration transaction. There was no payment made.

Q550 Jesse Norman: From the point of view of if you were a Britannia mutual member and you became a mutual member of the enlarged whole; if you were a Co-op member, you became a Co-op member of the enlarged whole, there was no other form of recognition of value as between the two groups?

Barry Tootell: Interesting perspective then, because members of the Co-operative are not members of the banking business. They are members of the group, so—

Q551 Jesse Norman: Yes, but you had that exposure to the banking business through the Co-op.

Barry Tootell: Indeed, but the Co-operative members do not become a member of the enlarged business. They remain members of the Co-operative Group. We enabled and accelerated a process by which all members of Britannia—and bear in mind that not all customers of Britannia were members of Britannia—were to become members of the Co-operative movement on an accelerated basis. The terms of paying a dividend to members was different from a Co-operative versus a Britannia. It was not a dividend in the Britannia world, but as a mutual they paid something called a Britannia Membership Reward, BMR. What we did was accommodate the members of Britannia with a transitional arrangement whereby we would enable them to earn a dividend within the Co-operative movement, which was no less than they would have otherwise earned as a member of Britannia. That was the only concession made.

Q552 Jesse Norman: From your point of view then, this has been a disaster from the Co-op members’ side, because they have had an exposure to a Britannia book that has turned out to be vastly worse than anyone could have anticipated. Britannia members have done remarkably well, because they have come into the Co-op Group as accelerated mutual members of the whole. Is that right?

Barry Tootell: Yes, in broad terms.

Q553 Jesse Norman: Because otherwise the Britannia members would have been forced to have the share of their own mutual. They would have had to bear the full value of the £1.5 billion shortfall that we found in the Britannia balance sheet.

Barry Tootell: Yes. In hindsight, I find it hard to envisage what the future of the Britannia business would have looked like on the emergence of the losses from its commercial book, as we have now seen it. Then again, in isolation, neither can I predict what the management of Britannia would have done to accommodate that emerging issue.

Q554 Jesse Norman: But it is a reasonable assumption that Britannia would have been wiped out if it discovered the size of this without the capital strength of the Co-op to keep it afloat?

Barry Tootell: Or they would have sought other means of addressing their issues. If I may just diverge for one second, Chairman—

Jesse Norman: Very quickly, if you do not mind, because I have a very short period of time to ask questions.

Barry Tootell: If I look at what has caused the demise of the Co-operative business in the here and now, it has essentially come out of two major things, one of which is the cost of redress on PPI, together with the asset decline of the business, and a significant part of that is the non-core assets that I have discussed. In terms of our means of accommodating those issues, there are two means available to a business. It is either to generate profits to increase retained earnings and, therefore, capital, or to raise new capital. As a co-operative, we cannot generate new capital because we do not have market access in the way others do. Interestingly, taking you back to the Britannia analysis, a building society does have market access because it can—as Nationwide has announced this year—issue CCDS as a means of raising capital. That is not available to the Co-operative.
Q555 Jesse Norman: Therefore, if anything, the Co-op board—both the board of Co-op Financial Services and the board of Co-op Group—was under a special obligation to ensure that there was nothing bad about the Britannia assets because they had limited other recourse to raising other forms of capital?

Barry Tootell: Yes. We have seen that the model of the Co-operative is very conservative, notwithstanding what you see as being the difficulties the business has just faced here and now, partly because of that, because it cannot raise capital.

Chair: Not conservative enough, though.

Jesse Norman: Is it conservative enough to have been wiped out by this incautious acquisition.

Chair: Yes, exactly.

Q556 Jesse Norman: Mr Tootell, Neville Richardson stated to us that he opposed proceeding with the Verde transaction in July 2011. He said mounting pressures were facing CFS, putting it at unacceptable risk because the merger had not achieved full integration. Is that your recollection of events?

Barry Tootell: It was one of the transitional programmes that we would have to face as a business. Neville’s main debate with the board—and I think he is on record in this Committee—was the Unity programme, but the Verde opportunity would have been yet another transitional or change programme that we would have had to face.

Q557 Jesse Norman: Did you share Mr Richardson’s position that this was the right deal at the wrong time?

Barry Tootell: We had undoubtedly been busy, to say the least, considering the Verde opportunity, in and among managing the BAU business.

Q558 Jesse Norman: So you were being massively stretched at that time?

Barry Tootell: We were stretched, but that did not stop us doing the right thing by the business and at the same time considering the opportunity, and at the same time embracing the Unity programme.

Q559 Jesse Norman: Did he express concerns to you at the time about the Verde transaction and the Unity transaction?

Barry Tootell: We had no extensive debate on the Verde opportunity at that time. It was an interesting opportunity, which, by the time that Neville left the business; we had done very limited work on Verde. The main debate—and indeed, Neville is correct with what he said to this Committee—that he had in the boardroom was with regard to the Unity programme rather than Verde.

Q560 Jesse Norman: But he is overstating the concerns he had when he spoke to us about the concerns he had and was presenting to the board. He has overstated it, is that what is happening?

Barry Tootell: No, he mentioned both matters in this Committee room and he mentioned both matters in the boardroom, but of the two, his major area of concern was the Unity programme, at the same time as completing the integration of the Britannia business and commencing or completing the IT transformation programme.

Q561 Jesse Norman: But the point is you supported the Verde bid yourself?

Barry Tootell: Yes.

Q562 Jesse Norman: So you were in disagreement with your chief executive?

Barry Tootell: Yes.

Q563 Jesse Norman: That is why, when he presented his concerns to Peter Marks, he had to go, because he was not supported by his own management team and Peter Marks was driving the transaction from within group?

Chair: Is that correct?

Barry Tootell: I cannot speak to why he left the business because I was not in the boardroom when that debate was had by the board, at either the banking group board level or the group board level. I would not suggest—to repeat your words, Mr Norman—that he had to go because he did not have the support of management. I think Neville’s own evidence to this Committee was that he left because he was in disagreement with the board in terms of strategic direction.

Q564 Jesse Norman: Right, but you then became chief executive, you disagreed, and you backed the bid. He did not have the support of his own chief financial officer. He was the man who had come with Britannia. You had been at the CIS before that. The Co-operative is deciding to reject this person who is not agreeing with their strategy.

Barry Tootell: It was not part of the debate as to Neville’s departure from the business.

Q565 Jesse Norman: Was it your understanding that he stepped down because the CEO and the board of the Co-op Group did not accept his warnings about this transaction or Project Unity?

Barry Tootell: I do not wish to be pedantic, but I would reverse that sentence and put much more emphasis on Unity. 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.

Q566 Jesse Norman: A final question. You complete the transaction, by which the Co-op merges with Britannia in April 2009. By that time, you have already seen not merely the collapse of Northern Rock, but the disastrous results of the Lloyds/HBOS merger, which came out in February 2009. It now turns out that the assets you acquired were grievously compromised, to the extent that, had it continued with them, Britannia would almost certainly have been wiped out and had to seek some kind of emergency financing or partnership. Do you not feel that the writing was absolutely on the wall at that time? The combination of decline in the economy and decline in the financial sector, and the specific examples of the
wreckage of HBOS and Northern Rock, should have
given you pause as to the quality of the assets that
you were acquiring.

Barry Tootell: You are absolutely correct to suggest
that it gave us pause. Interesting insight, we were the
clearing bank for Northern Rock, so we were unique
in the UK marketplace in seeing just what happens
with a run on a bank, so we understood exactly what
that felt like.

Q567 Jesse Norman: Sorry, I am being delicate
about it. It should have given you screaming cause for
concern. You are responsible for this transaction and
you are acquiring a bunch of assets while the asset
quality all around you is being degraded visibly in
front of you. Why don’t you act on it? Why don’t you
call off the transaction and preserve that £1.5 billion
of your mutual members’ capital?

Barry Tootell: That would suggest then that no bank
should do a transaction, as opposed to, if you are
going to do a transaction, you make jolly sure that
you do appropriate levels of due diligence to protect
yourselves. We genuinely thought we had done the
latter. We were absolutely aware of the consequences
of hurried due diligence, and that was what the market
perceived to be the issue with the Lloyds/HBOS
transaction—there was not enough due diligence done
on the HBOS assets. We genuinely thought we had
done extensive due diligence.

As I say, it was commended in our boardroom in
January 2009 just how much quality due diligence we
had done. In Northern Rock’s case, that was the
consequences on liquidity management of a run on a
bank and we were clearing that bank. We understood
explicitly what that felt like and, again, modelled
that extensively.

Q568 Mark Garnier: Can I take you to December
2012, when António Horta-Osório of Lloyds Bank
told us that he first identified this capital shortfall with
the Co-op, and he approached the Co-op to discuss
their concerns about this. Peter Marks says he
remembers the approach but does not remember any
details of the conversation, and he also tells us that it
did not discover that we were having greater difficulty
in 2012, in which we projected forward the level of
impairment from our non-core book, predominantly corporate, together
with continuing provision for PPI, we were looking at
a capital position for the bank that was tighter than it
had been previously. We factored that into the plan.
We rolled it forward appropriately, and we shared that
with Lloyds on an open basis after the board had
approved that in November 2012. So Mr Horta-Osório
did not discover that we were having greater difficulty
on capital; we shared it with António and his team.

As he has suggested to the Committee, he came back
via one of his senior managers to one of my senior
managers, who were the nominated people to have
active, ongoing day-to-day dialogue on the deal. They
raised their concerns. Why was that not an earlier
answer? Which was it raised, the flag and pulled the plug on the
deal? It wasn’t the appropriate time because we had a
plan that suggested capital was tighter, and this brings
me back to the point on the strong capital position in
the year-end accounts. We had a capital plan that
looked like capital was tighter and below the risk
appetite of our own board, and clearly therefore not
where we wished to be for the future, but we had
plans to address it.

We were then determining the possibility of selling
our general insurance business. We were already in
the process of selling our life business, and we had
committed in that planning process to deleverage
more aggressively the corporate portfolio. Those three
things gave us a capital position that would still make
the deal viable; otherwise we would have pulled the
plug on the deal. That was the emerging position
that we shared with Lloyds in December 2012 that they
raised their concerns about.
Q574 Mark Garnier: So Operation Pennine now became key. If I remember, this was a way to look at raising more capital. Operation Pennine was now key to this deal, going forward. I am trying to get a flavour of the dynamics that were going on, because certainly the impression that we have been getting in this Committee from the evidence so far is that it was Lloyds approaching you to say they were uncertain that you could go ahead with this deal and that absolutely the dynamics were that they were initiating this conversation. Now it sounds as if you are suggesting that that was not quite the case. It was a two-way dialogue and you were saying, subject to Pennine going ahead, that things were going to be fine, you as an organisation were less strong than they perhaps originally thought but, nonetheless, you were still able to go ahead with it.

Barry Tootell: Indeed. Believe me, we were doing a lot of work to ensure that we were strong enough to operate on a day-to-day basis as well as undertake a transaction with the significance of Verde. We did not leap into action because Lloyds prodded us to do so. We were already working extensively on the capital plans to bring our capital to a position that the board had set as its risk appetite for the future.

Q575 Mark Garnier: You were telling the regulator about your findings as well?

Barry Tootell: Gosh, yes, the regulator was completely engaged.

Q576 Mark Garnier: What were they saying to you about this? Were they comfortable with what you were doing? Did they agree you had a problem? Did they say, “Don’t worry, chaps. They are doing fine”?

Barry Tootell: They agreed we had a capital position to be worked upon. Andrew Bailey—apologies, I forget whether it was his evidence to the Committee or whether it was to me in a letter more recently—said that he had never approved the transaction. Indeed, they did not. They were never asked to approve the transaction, but they were consulted on our progress towards pursuing the transaction on a very, very regular basis, both in terms of the underlying plan and then the mitigating actions with Lloyds. We shared the information from us to evidence why we thought the capital of the combined business, and standalone, was appropriate.

Q577 Mark Garnier: Did Lloyds interpret your financial modelling differently from the way you did?

Barry Tootell: I do not believe so. Barry Tootell: We had not shared with them the detailed options that we were considering, such as the general insurance disposal and so on, because that would have been market-sensitive information. We had shared more of an underlying plan without some of the remediation actions that we were considering.

Q578 Mark Garnier: It is quite an important point. You thought things were okay to go ahead and they did not at that time?

Barry Tootell: We had not shared with them the detailed options that we were considering, such as the general insurance disposal and so on, because that would have been market-sensitive information. We had shared more of an underlying plan without some of the remediation actions that we were considering.

Q579 Mark Garnier: Let us be clear about this. Lloyds were not aware that you were looking to sell the insurance services in this December 2012 conversation?

Barry Tootell: I do not believe so.

Q580 Mark Garnier: So at that point they were highlighting the fact that they did not think this deal could go ahead and they were seriously worried about it?

Barry Tootell: The choice of words is slightly different to the reality at the time. They wanted more information from us to evidence why we thought the capital of the combined business, and standalone, was appropriate.

Q581 Mark Garnier: This is not including the fundraising from Operation Pennine?

Barry Tootell: Project Pennine was not in progress at that time. There were certain events in 2013 that precipitated me establishing Project Pennine, which I can come on to if the Committee wishes me to.

Q582 Mark Garnier: I am still slightly confused by this. At the time of these conversations with Lloyds, you were not proposing to raise any money from the sale of the insurance services and the other stuff?

Barry Tootell: Yes, we were. That was in our plan.

Q583 Mark Garnier: That was in your plan, but you did not tell Lloyds about that?

Barry Tootell: I would have to check. I do not believe we did. The plan was presented in two parts. One was the underlying plan and then the mitigating actions and I don’t think we shared the full detail of the mitigating actions with Lloyds. We shared the underlying planning assumption, the roll-forward of our business into the future, and on that basis the capital would have looked weaker without remediation.

Q584 Mark Garnier: The remediation was selling the insurance services, that which then became known as Project Pennine?
Barry Tootell: 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.

Q585 Mark Garnier: When you had the conversation with Lloyds, was there an assumption that you were going to inject? Were Lloyds aware that there was going to be an injection of capital one way or the other into the bank?
Barry Tootell: As I say, I do not recollect whether we told them about those remediating actions in December.

Q586 Mark Garnier: This is very, very important. There is an awful lot of sort of corporate amnesia about this. Having spoken to Peter Marks last week, he was amazingly—
Chair: Amnesiac.
Mark Garnier: Amnesiac, thank you, Chairman. I am slightly worried that this is catching among the board of Co-op, so I am going to press you on this. It is really important: did Lloyds know full well that there was going to be a capital injection or not? You must be clear about this.
Barry Tootell: I am sorry, I do not recollect, and I think your challenge is a little unfair.
Mark Garnier: I think it is very fair.
Barry Tootell: I have been extremely open with the Committee but—

Q587 Mark Garnier: This is the difference between a deal going ahead and not going ahead. This is the difference between a bank being solvent and effectively not being solvent. This is very, very important stuff. I genuinely cannot believe that you would forget the importance of that conversation at the time.
Barry Tootell: This was not a major milestone in the negotiation or the engagement of Lloyds.
Mark Garnier: Really? It was not a major milestone?
Barry Tootell: This was an ongoing sharing of information with Lloyds, an iteration. In the iteration that we shared with them in December, “There will be a level of capital, which is not an insolvent bank but is a bank that requires additional capital”. The comment to Lloyds was, “and we are working on that” and we were continuing to do just that.

Q588 Mark Garnier: Can I summarise how this is coming over? So you run a full projection model and you realise that you have a problem with your bank. Part of your process of resolving that is to sell off a couple of assets and then inject capital into that bank. You have a general conversation with Lloyds, Lloyds say they initiated it but you say it was a general conversation—I do not want to be pedantic about those points, just leave it at that—and within that, Lloyds come out and say, “We are not sure that this is going to go ahead. We do not think you are capable of doing this deal”.

The one thing that is going to save that is this capital injection from the sale of other assets outside the bank itself and you forget whether you mentioned that or not. The one deal that is going to be able to bring Co-op forward and you, kind of, forget that you have two big transactions going on that are going to save this deal, which is incredibly important to the future of the bank. How do you forget that?
Barry Tootell: It was made clear that that would have included capital injection. I am not clear on whether we had told them which assets Co-operative Banking Group, or indeed our parent, may choose to sell.

Q589 Mark Garnier: You were being a bit woolly about this a bit earlier, so thank you for clearing that up. You are now saying that you definitely said there would be a capital injection from the parent company?
Barry Tootell: I was not in the meeting. I would expect so.

Q590 Mark Garnier: It is so important. I cannot believe that you guys who are running this bank cannot remember these really important details.
Barry Tootell: This is day-to-day liaison between managers—
Mark Garnier: No, it is not, this is a major strategic transaction.

Q591 Chair: Are you describing this huge deal as part of day-to-day liaison?
Barry Tootell: The particular meeting—
Chair: This was make or break for Co-op.
Barry Tootell: If we were not able to address the capital shortfall through the remediating actions, it would have been a showstopper for the transaction. Yes, I accept that.

Q592 Chair: But you cannot remember what was told to Lloyds?
Barry Tootell: The information that was provided, the detailed discussion of that at that point, bear in mind our teams were meeting several times a month, several times a week, sharing information, sharing plans. They were sharing plans with us; we were sharing plans with them. In one of those meetings, yes, we did agree we were going to share with them our underlying three-year planning assumption for the standalone business that was going to be part of the Verde transaction, but it would have shown—and it did show—a lower level of capital than the deal would require and there would have had to have been a capital injection. I am not clear on whether we said, “That will come from the sale of the GI business” because at that time we had not made the board decision to divest. That was not until quarter one 2013, but we were progressing our thoughts along those lines.

Q593 Chair: This is not long ago, we are not digging up something from a decade ago and there will be notes of comments that were or were not made, won’t there?
Barry Tootell: Yes.
Q594 Chair: Have you made an effort to look at those before coming today?
Barry Tootell: I have not done, no.

Q595 Mark Garnier: There is a very important point to this, which is Lloyds’ due diligence on how they go about this. If you are suggesting there is going to be a significant importation of capital from a mutual parent, quite justifiably, Lloyds would ask where that capital would be coming from. They would want to know where it is because, as a mutual, you do not have the easy ability to raise capital in the same way that a listed company would do.
Barry Tootell: No. It was clear that the only means we would have had to inject capital would be the divestment of assets of the group and more likely the assets of the banking group. So, yes, general insurance and life and savings were known businesses that we could divest if we chose to do so.

Q596 Mark Garnier: But you are saying you would not have told them what it was. As an organisation, Lloyds would have to take a massive amount of trust on what you are saying. Do you think they would do that? This is a huge deal. This is a very public deal with a publicly-owned bank, with the biggest mutual in the country, with huge amounts of importance on the whole of the transaction. You cannot remember what was going on. You are now telling us you were not prepared to reveal to Lloyds what the assets were that were being sold because they were market sensitive. Lloyds would have had to accept, on a massive amount of trust, the fact that as a mutual—well, obviously has difficulty raising capital—you could raise this capital. Are you suggesting that in all these conversations in December, which seem to be the key conversations that were going on, you cannot remember what was happening then?
Barry Tootell: I cannot remember the specific of whether we said, “We are selling our GI business”.

Q597 Mark Garnier: You did say earlier that you said you weren’t.
Barry Tootell: Yes, but I did not say we did not tell them. I cannot recall whether we told them specifically which asset we were considering selling.

Q598 Mark Garnier: You said you could not, because it was market sensitive.
Barry Tootell: Yes.

Q599 Mark Garnier: So what is it? You cannot remember whether you said it or you did not say it?
Barry Tootell: I apologise. I said before, I do not recollect whether we told them that we were selling our GI business and injecting it. I suspect we would not have done because it was market sensitive, but I do not know whether we shared that mitigating plan with Lloyds. I agree with your comment that Lloyds were taking the work that we were doing on trust, because we were asking them to wait while we developed our mitigating plans and then we would share the detail of that with them. During the process of engagement—we were meeting them regularly, day in, day out, week in, week out—we were sharing the emerging view of things with them.

Q600 Mark Garnier: Mr Norman asked you a bit earlier about who were the advisers on the Britannia deal, which for the Co-op was JP Morgan and for Britannia it was Citigroup. I believe JP Morgan and Citigroup were the advisers to the Project Verde deal.
Barry Tootell: Indeed.

Q601 Mark Garnier: Do you think they knew more about your business as a result of that link with the corporate advisers of that deal than you did at the time?
Barry Tootell: Did they know more about?
Mark Garnier: Because they had two advisers that had been party to the Britannia deal, do you think Lloyds had a better insight into what was going on in your business than you did, because they understood how to run your business better than you did?
Barry Tootell: I would suspect not. One could argue that because I had Credit Suisse and BarCap working for me, we would know more about them than they would have told us. To suggest any of those factors was true is to suggest that the strict confidentiality over any engagement of an adviser was breached, so I would suggest not.

Mark Garnier: Okay, fair enough.
Barry Tootell: As a corporate, JP Morgan clearly understood us in some detail.

Q602 Mr Ruffley: Mr Tootell, you have been very strategically forgetful in your last few answers, so I am going to help you along. In our hearing with Andrew Bailey in July this year—you have read his evidence, I take it?
Barry Tootell: Indeed.

Q603 Mr Ruffley: You have. Good. He says that towards the tail-end of 2011, he told the board of Co-op Bank that it was not clear to the regulator that the Co-op 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. He then went on to say, “Then we set out five things, the five areas that they would have to deal with: capital, liquidity-risk management, integration, governance and management”. That is obviously a pretty full set. He starts with that list of five things that the board would have to address as capital. What did he say about the level of capital, if anything, and what was your reaction to his flagging a capital shortfall, which is implicit in what I have just read out?
Barry Tootell: There was no implication or indication of a capital shortfall I think.

Q604 Mr Ruffley: What did he mean by “capital”?
What was your understanding when he said “capital” in that list of five things I have recited?
Barry Tootell: That we had to evidence sufficiency of capital to do the transaction in order to proceed. He said that in July 2011. He reiterated that by one of his team writing to me, as I said before, I think it was November or December 2011, to reiterate those
points. Those points were presented as the key criteria, the key heads that we would need to address in seeking any approval from the regulator to proceed with the deal.

Q605 Mr Ruffley: Let me just nail this down. I am not going to read it out again, but he said there were five things and capital was one of them. What was the response by Co-op Bank to that representation by the regulator when he says, “Areas to be addressed”? Describe to us, as best you can, what your response was. Was it in writing? What did you say to the regulator when the regulator pointed out capital as being one of the five areas of concern?

Barry Tootell: It was not raised with us as an area of concern. It was raised with us as an area that we would—

Q606 Mr Ruffley: Hang on, hang on. This is serious stuff, okay. The regulator is saying, “We set out five things, the five areas that they would have to deal with”. What I am asking you, Mr Tootell, is how did you deal with it? I am quoting the regulator here. There is no point in smiling quietly to yourself.

Chair: No, steady on. Let us just—

Mr Ruffley: Let us have an answer.

Barry Tootell: It was not a concern about the business in 2011. It was Andrew Bailey being very clear with us as to which areas we would have to specifically address in order to proceed with the transaction.

Q607 Mr Ruffley: We understand. What was your response? Why can’t you answer that? He asks you to deal with capital. What did you do or what did your colleagues do, to the best of your knowledge and belief, Mr Tootell? How did you respond to that capital issue? He asks you to deal with it. What did you do?

Barry Tootell: Capital is fundamentally important to the transaction. I could also argue that the capital, and perhaps all of this—

Q608 Mr Ruffley: You are waffling now. What did you do in response to the regulator, and I quote, “To deal with it”? What did you do? Did you write to him? What did you show him? What did you say to the regulator?

Barry Tootell: We had detailed dialogue on an ongoing basis with the regulator at all levels.

Mr Ruffley: On the capital, but what—

Barry Tootell: In addressing all five of those things and we updated them on our progress.

Mr Ruffley: No, let us stick with capital.

Chair: Hang on, Mr Ruffley; let us just hear what Mr Tootell has to say on that point.

Barry Tootell: We updated them on a regular basis with our progress towards addressing the five areas that they were expecting us to evidence sufficiency or progress around in order to do the transaction. 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”. We completely agreed with those five things and we were working tirelessly—

Q609 Mr Ruffley: I have been asking about capital, not the other four, but I think the record will show that you are trying to slide away from that. Never mind. Was a potential capital shortfall ever expressed to you or any of your colleagues by Mr Bailey or any of his colleagues at the regulator, yes or no?

Barry Tootell: No.

Q610 Mr Ruffley: In relation to the tail-end of 2011 discussion?

Barry Tootell: No.

Q611 Mr Ruffley: Andrew Bailey told the Treasury Committee that he asked you to make clear his concerns to Lloyds Banking Group. Peter Marks claims that you did this.

Barry Tootell: We did.

Mr Ruffley: You did it, did you?

Barry Tootell: We did.

Mr Ruffley: Sorry, you personally?

Barry Tootell: I do not know whether it was a letter signed by me, but we briefed Lloyds on the conversation we were having with the regulator and the key areas.

Q612 Mr Ruffley: When did you do this?

Barry Tootell: I do not know the date of the letter.

Mr Ruffley: You cannot remember?

Barry Tootell: But we absolutely briefed the Lloyds team.

Q613 Mr Ruffley: What date approximately? Give us a month.

Barry Tootell: It was December 2011, because the letter formally came to us—

Mr Ruffley: December 2011. No, we have that.

Chair: Just let Mr Tootell reply.

Mr Ruffley: He has replied.

Barry Tootell: The letter came to us in November or December 2011 and it would have been very quickly thereafter. It may have been as early as November 2011. It was no later than December 2011.

Q614 Mr Ruffley: Was a capital shortfall one of the concerns you relayed to Lloyds in late 2011?

Barry Tootell: Again, it was not a capital shortfall, but it was the list of things that the regulator needed us to evidence in order to do the transaction. It was never voiced as a capital shortfall.

Q615 Mr Ruffley: Fine, okay. You are rejecting the words “capital shortfall”. Let me try this one on you. What did you say about capital to Lloyds towards the end of 2011? I am not using the word “shortfall”, by the way. What did you or any of your colleagues say in writing or verbally about the capital issue? I am not using the word “shortfall”; what did you say to them, Mr Tootell?

Barry Tootell: But again, it was not a capital issue. It was being—
Q616 Mr Ruffley: What did you say about capital then?
Barry Tootell: We said that there are five key areas of focus for the regulator that we will be evidencing and spending—
Mr Ruffley: No, capital. Not the other four issues, capital, Mr Tootell. Please do not slide away to the other four issues. I am focusing on capital. What did you say about the capital position and your expected capital position to Lloyds in late 2011, Mr Tootell? What is the answer to that question?
Barry Tootell: We told them specifically that, among four other things—
Mr Ruffley: Oh dear.
Barry Tootell:—but on capital as one of those things, but capital was a key area of focus for—

Q617 Mr Ruffley: What do you mean “key area of focus”?  
Barry Tootell: The regulator demanded, as we would demand of ourselves, that we evidence that we have sufficient capital to do the transaction and that was a natural thing for our board to accept. 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.

Q618 Mr Ruffley: How was it proposed to evidence that?
Barry Tootell: Probably since 2011 we have been running with a board risk appetite, which was to have a minimum level of core tier 1 of 10% in order to satisfy ourselves on our capital position for the future. We accepted it was a timeline to get there and it wasn’t going to be an overnight fix, but 10% was our board appetite for capital adequacy. That was the plan that we were working towards on a standalone basis. That was also one of the underpinnings in considering the Lloyds transaction. That was our board’s view. Therefore it accorded with the regulator’s view that capital is key, and we agreed and we told Lloyds that.

Q619 Mr Ruffley: Finally, let’s move on to the second half of 2012, the regulator again. Let us see if you can do any better with this. Andrew Bailey told this Committee that the FSA’s stress-testing in the second half of 2012 confirmed the suspected capital shortfall in Co-op Bank. Did the regulator express fresh concerns to you about Co-op’s Verde bid in response to this?
Barry Tootell: No, it did not.  
Mr Ruffley: It did not.  
Chair: Okay.  
Mr Ruffley: I am not quite finished.  
Chair: We will take one more question and then we must move on.

Q620 Mr Ruffley: The chief executive of Lloyds told this Committee that Lloyds was “not approached by the Co-op bank or the Co-op Group board” regarding the confirmed capital shortfall in December 2012. Why not, Mr Tootell?
Barry Tootell: There was no capital shortfall in 2012. There was an increasing level of capital that was being—

Mr Ruffley: No capital shortfall. Nonetheless—
Barry Tootell: In 2012. The capital shortfall emerged in 2013, which was the addition of future capital requirements on top of the underlying capital guidance requirements of the FSA. What we built into our planning process was the direction of travel for the capital guidance, which the regulator sets for all banks individually. I am afraid I cannot share it with you because of market sensitivity.

The issue that became the capital shortfall, which ended up getting announced in June 2013 by the PRA, was the requirement of the FPC and the PRA that all banks build into their future capital projections the ability to achieve a level of capital requirement under Basle III arrangements but adjusted for known areas of future emerging exposure. That was announced in June 2013. We had the first indication of the scale of that in early 2013, and that created the heightened concern beyond what we were aware of in December 2012. December 2012 was about our capital guidance figure, not around future capital requirement, which was crystallised in the June 2013 announcement.

Q621 Chair: Just to be clear there. As I understand it, what you are saying is that the goalposts were changed slightly by the regulator. They were tightening your capital requirements.
Barry Tootell: Yes, not just for us but for the whole marketplace because the regulator and the FPC were looking for banks to—

Q622 Chair: I understand. Therefore, because you had little margin for error—you did not have much of a cushion—this hit you particularly hard. Is that what you are saying?
Barry Tootell: Indeed. As I alluded to before, that was the trigger for Pennine in early 2013. We had done a plan based on what we thought the capital requirements were going to be, as crystallised within the individual capital guidance for the bank, and we were doing mitigating action to that end. Then in January 2013, we had the first indication of the heightened level of capital, which, broadly speaking, was consistent with the FPC and PRA announcement in June 2013. But it was that heightened level of capital requirement that caused Project Pennine to be initiated.

Q623 Chair: You would agree, though, that that does sit slightly oddly with your comment in March that “our balance sheet remained strong”?  
Barry Tootell: Indeed. That is why we were doing Project Pennine to remediate the action.

Q624 Chair: I am being pretty gentle about it in saying it sits oddly. Going back to the conversation with which we began this hearing, you would agree with that, would you?
Barry Tootell: The accounts as a whole have an extensive area in them of risk assessment, considering not only our view of risks to the business—that was very clear on the scale of risks—but effectively to support the going concern opinion of the business. There was an extensive section there on the potential risks and mitigants to emerging risk. It was the
Q625 Chair: The key point is that you were right up against these limits already. You were sailing close to the wind, and when some further demands were made of you, that was too much.

Barry Tootell: Indeed.

Q626 Chair: Therefore, it does sit oddly to say that your balance sheet remained strong because it wasn’t very strong. A puff of wind could blow you over.

Barry Tootell: It was adequate at 2012 year-end. We were looking not so far as our own balance sheet standalone was concerned in December 2012, but looking generally to what the markets and the regulator were going to look to banks to address off into the medium-term future. It was that that gave us the significant challenge rather than the position of the year-end December balance sheet. But I think the combined package of the going concern review, together with the risk assessment, was an adequate packaging of the statutory accounts.

We were working extensively on remediating the difficulties this was going to cause for the bank and, from January onwards, we were doing the plan that was referred to by the FPC and PRA in June. All banks were doing their capital plans to address the future requirements—not a black hole, but the future requirements for the banking industry, and we were doing our own. The tipping point then for the transaction was that beyond February/March, when we were concluding our accounts process, but into April, it was me reaching the conclusion that—off the back of the capital planning work that we were doing to address the FPC/PRA papers for June—we were not going to put sufficient remediating actions in place to address the future capital requirements. It was on that basis that I concluded that we should not pursue the Verde transaction.

Q627 Chair: But given that you were already sailing so close to the wind, would it not be right to characterise the attempted deal with Lloyds as a rescue operation?

Barry Tootell: I think very clearly, no. Even though we had emerging or growing concerns around our future capital requirements and the demands placed upon us, we were very clear that—and I was very clear with Andrew Bailey, as early as January 2013—notwithstanding the fact that the deal could make us a little bit stronger, this was not a deal to go into if we were not strong enough to do it. Therefore, we could not countenance it as a rescue because we needed to be convinced as a board that we had enough capital strength to go into it.

If I take you to the 2011 comments and the letter from the FSA, the one of the five key things that they set for us was capital. It was very clear to us and to the regulator that going into the deal as a rescue was not going to work. We would not have done it anyway, but it was not going to work because we needed to demonstrate capital sufficiency to do the transaction in the first place.

Q628 Mr McFadden: Thank you, and thank you for clarifying about tomorrow, Chair. Mr Tootell, I want to turn to a slightly different area on these critical decisions we are taking in this structure of Co-op Bank or Co-op Financial Services with a parent Co-op Group sitting on top of it, which wholly owns Co-op Financial Services. In his evidence last week, Peter Marks explained to us that he did not sit on the board of the Co-operative Group, which was an elected board, but that he chaired the executive committee of the group. Sitting from where you were, what did you regard as the key decision-making body in the Co-op Group? Was it the executive committee or the group board, given the structure?

Barry Tootell: It was very clearly the group board in overall terms. Peter Marks attended each board meeting as the chief executive and, therefore, primary officer of the group. He was not a member of the chief board itself but he attended these board meetings. So, yes, he was a chairman of the risk management committee, but I would regard the primary decision-making forum as being the group board.

Q629 Mr McFadden: When it came to recommend going for the Verde transaction in the first place, who is taking that decision? Who is the key decision-maker when the bank decides to do that?

Barry Tootell: The group board needed to make the decision to support the continuation of exploring the opportunity. As with any board, if the chief executive is not able to support a decision or a transaction, that will be a significant issue for the board. The board will be very minded of the opinion of the chief executive. Peter Marks would clearly have been a significant influential character in that process, but the board is the decision-making body that would have allowed us to proceed or not with the transaction.

Q630 Mr McFadden: My colleague, John Thurso, when he was questioning Peter Marks on this kind of area last week, used the analogy of a Government and a Parliament. With the executive committee being the Government and the board being the Parliament. Do you think that is a fair way to sum this up?

Barry Tootell: If we are talking about the executive committee and the board of the group, yes, that would be a fair way to sum up the way in which the broader group or the trading aspects of the group operated, but not its oversight over the banking business.

Q631 Mr McFadden: Again, going back to Verde, would this have been a recommendation made by the executive committee of the group, which then goes to the board for approval, or would it have been something that originated within the board as being a good thing for the group to do?
Barry Tootell: No, we did recommend to the board that they allow us to continue with this opportunity, and they approved that course of action. In terms of the decision-making bodies below the board and the support that that gave to the process, Peter and I were pretty clear that if it did not have the unanimous or broad support of the executive committee of my banking group, and, similarly, if he did not have the broad support and unanimity of the group executive, it would not be something that he and I would be willing to take to the group board for decision. Unless the business underneath the board is supportive of the transaction, it would not be helpful for the board to be asked to approve something knowing that the management do not agree with that transaction.

Q632 Mr McFadden: Apart from Neville Richardson, is there any senior figure, in either the Co-op Bank or the executive committee of the group or the board of the group, who disagreed with going for the Verde transaction?

Barry Tootell: I would have to look back at the group board minutes. As I say, I am not a member of the group board either but we could look at the board minutes to check on the voting. Oftentimes it is consensus and oftentimes it is a vote. We did have a vote for the group board decision to proceed with the transaction or otherwise. On some of those votes, we have not had complete unanimous support. There have been abstentions but we have the vast majority of the board in favour of the transaction. I do not recollect whether that complete unanimous approval, versus the split vote, was in relation to the heads of terms that we signed in mid-2012 or the initial decision to proceed with the transaction.

Q633 Mr McFadden: I am trying to get to the bottom of that. You are saying there were other voices on the group board that were uncomfortable with the Verde transaction? It was not a unanimous decision?

Barry Tootell: There was not a unanimous approval at all times. Quite validly and quite rightly, there were questions and concerns about the capacity of the group to do the transaction. Essentially, that was not a concern about the transaction itself. There was a concern about the financial capacity of the group to fund the transaction because the transaction consideration was £350 million up front, which would have been financed by the group injecting capital into the bank and the bank utilising that to buy the business we were acquiring. The group would have to encumber itself to the tune of £350 million, and that was a major area of focus for group board directors.

Q634 Mr McFadden: They were asking, “Can we afford this?”

Barry Tootell: They were, absolutely. You would expect them to do so and, yes, they did. It took a lot of input from the group finance and group audit committee in that deliberation, and you would expect them to do just that.

Q635 Mr McFadden: You had a long-term involvement both as CFO and then CEO of the bank. In that time, how much involvement did the Co-op Group board have in the running of the bank?

Barry Tootell: Relatively limited. They were the shareholder and therefore responsible for their investment in the group. They did not oversee and interfere, let’s say, with decision-making within the banking business. The banking business was set up with some representatives of the group board on the banking group board. Then importantly, we recruited from the market place independent, professional non-executives with industry skills and experience in order to run the bank as a bank needs to be run. They relied and took comfort from their professionalism and did not oversee or dabble in the decision-making of the banking group. There were occasions when the banking group needed to go to the group board for approval for certain matters because there would have been matters reserved for the group board itself—as I said before, major acquisitions and disposals. For example, the decision to sell the life business needed to be approved at the group board level.

Q636 Mr McFadden: When we have this—I guess you could call it—eclectic group board of these 20 elected members from various backgrounds, what you are saying to us is when it came to the running of the bank, most of the time they were pretty hands off? I am not trying to put words in your mouth, you use your own.

Barry Tootell: They were reasonably hands off. I attended the group board each month to account to my group shareholder representatives, effectively, as to how the bank was performing, talking about the major risks, talking about the major opportunities and talking about the day-to-day performance of the banking business. So there was accountability and there were appropriate and challenging questions on key issues from time to time, but there was no detailed involvement in decision-making. May I say that is consistent with other businesses within the group? There are three subsidiary boards within the group. There is one for food, one for specialist businesses and one for the bank. There is a similar approach for non-executives to be recruited from the marketplace to support each of those boards in turn.

Q637 Mr McFadden: Yes. This is important because I want to get to how the overall Co-op Group and these subsidiaries work. Sticking with the bank, when it comes to setting strategy for the bank are you saying that is done by the bank itself or by the group?

Barry Tootell: It is done by the bank. We have a strategy session that starts in July, which is more high-level strategic, culminating in November of each year with a lower level of granularity and rigour, financials, capital and so on. That in turn is used to inform the group board as part of group-wide strategy settings. The group strategy would have been the sort of discussions that Peter Marks alluded to in this room, in terms of the diversity of interests of the group. For example, which businesses are we in? That is the sort of level of decision-making the group would get into in group strategy setting. Not the detailed strategy plans of each individual entity.
Q638 Mr McFadden: I will slightly change tack here and ask you one further thing following on from Mr Ruffley’s questions about Andrew Bailey’s list of five concerns. In his evidence last week, Peter Marks said several times that he saw proceeding with Verdes as the answer to three of those five, including the capital question that Mr Ruffley asked. You seem to be giving us a different emphasis, which is, “These are five things that we have to show we have answers to before we can proceed with Verdes”. Which is right? This is an important difference. Was Verdes the answer to Andrew Bailey’s list or was this a list of things that had to be satisfied before Verdes could be contemplated?

Barry Tootell: No. To be clear, these are things that we would have to address for ourselves in order to do the transaction and not looking for Lloyds or Verdes to do it for us. Very clearly so.

Q639 Mr McFadden: Therefore, Verdes is not the answer to Andrew Bailey’s list. The answer has to come before Verdes can proceed.

Barry Tootell: Indeed. If I take capital as an example. We had to demonstrate capital sufficiency before we considered the transaction. By the same token, the transaction itself will have to be complementary to that, it cannot erode. Therefore, the Verdes opportunity will have to help rather than hinder. There is a primary position, which is that the bank needs to evidence sufficiency of capital first. We cannot look to the Lloyds opportunity to fix the five challenges that came from Andrew as part of the transaction.

Q640 Mr McFadden: That is important for us. Finally I will end with this. When it came to the decision to pull the plug on Verdes, who took the decision?

Barry Tootell: Ultimately it is a board decision. It was my recommendation. It was my judgment as the chief executive. I cannot remember the sequence, whether I told my chairman first or Peter Marks first. But I told both parties that in my opinion this deal could not proceed. I told the chairman and Peter Marks, and that decision was supported by both parties. It was my judgment.

Q641 Mr McFadden: You told them and then the group executive goes to the board and says, “We don’t think we can proceed with this”, is that how it worked?

Barry Tootell: Peter and I informed the group board that it was no longer the recommendation of management that we could continue with the transaction. By the same token, I did the same thing with my board.

Q642 Chair: You have had much the same problems as an institution that most other banks have had. You also had a risk management committee structure in place. Were you sitting on those committees and were they flagging up concerns?

Barry Tootell: I was not sitting on the committees because, in line with the pursuit of greater governance—

Chair: You would be in attendance. Sorry, I should have used the words “in attendance”, you are quite right.

Barry Tootell: I attended, yes. For example, my risk officer had a direct reporting line to the chairman of the risk committee. They were challenging meetings. We absolutely did not have an easy ride—and nor should we—with our risk committee and our audit committee in the management of the business on a day-to-day basis.

Q643 Chair: Were they flagging up the risks on the commercial lending you were doing?

Barry Tootell: No more so than we were briefing them upon. We got challenging and searching questions.

Q644 Chair: That does not sound very challenging if you brief them to ask certain questions and then you reply to them.

Barry Tootell: No, they were asking us challenging questions on the detail that we were presenting. I am suggesting that they did not unearth something we had not spotted. But the insightful and searching questions that we received from those committees were very challenging, and very appropriately so.

Q645 Chair: But much like other banks it did not stop this exposure developing, did it?

Barry Tootell: It did not stop the exposure emerging. If I take us back then to 2008–09 when the now fateful decision was taken to acquire the Britannia business. Everything that has ensued thereafter has been the consequence of having done so. From mid-2009, in a way the die was then cast because we had the PPI exposure in the underlying co-operative business. We then had the exposure in the non-core business, predominately Britannia assets. Therefore, the challenge thereafter was one of management and mitigation and monitoring the emergence, but importantly, seeking to do something about it rather than simply watching the issue emerge. These were not new issues but these were a growing—

Q646 Chair: I want to ask one other question with respect to what was going on in early 2013. Did you have to give assurances to your auditors in 2013 to achieve the going concern signoff?

Barry Tootell: Yes, we did, but then—

Q647 Chair: What were they? What were the assurances that year?

Barry Tootell: We shared capital plans with the auditor to enable them to pass their opinion on the accounts.

Q648 Chair: What opinion did they give? What were they most concerned about at that time?

Barry Tootell: They were concerned about the eroding capital position because of capital risk weights.

Q649 Chair: The same eroding capital position that was taking place as you said that your balance sheet remains strong?
**Barry Tootell:** Yes. But it is a future ongoing emergence that needed parallel mitigation in order to accommodate. That is, what the plans said we were doing. Those are the plans that we shared with the regulator in April 2013.

**Q650 John Thurso:** Can I go back to 2008, and first just clarify your own background. You are a banker by profession with fairly extensive experience in a number of commercial banks at a divisional CFO level?

**Barry Tootell:** Indeed.

**Q651 John Thurso:** When exactly in 2008 were you recruited?

**Barry Tootell:** I joined on 17 December 2007.

**Q652 John Thurso:** In other words, before anybody mentioned Britannia?

**Barry Tootell:** Yes, indeed, I joined on an interim basis, and I joined on a permanent basis on 1 April 2008.

**Q653 John Thurso:** Coming from a background in normal—yes, the wrong word—but non-mutual banking, if I can put it like that, what were you recruited to do and what were your thoughts about the business you were going into?

**Barry Tootell:** I was recruited specifically to strengthen the finance team and our finance capability in a challenging external world, where the challenge to banks to perform with greater rigour and the desire for finance communities to play a more significant role in the stewardship of the business was something that the Co-op had absolutely embraced and had specifically looked for me to join the business and help them achieve.

**Q654 John Thurso:** The reason I ask that is, of course, because my memory of that year is very clear, having sat on this Committee with the report into Northern Rock. I remember very well going to events in the City, in June and July of 2008, where the then HBOS were complaining bitterly about being shorted and they were a very strong institution. Of course, it was not until the meltdown in September/October 2008 that the real crisis started, and it did not manifest itself in corporate lending until 2009. What I was trying to get at is the interesting view that you would have had at the very beginning, because it is pre-crisis, of "What is this business I’m coming into and what is it I’m being hired to do?"

**Barry Tootell:** It was a business that had historically operated with a high degree of competency. I was quite impressed in joining the Co-operative that not only did they have a culture within the business that was hugely collaborative and very, very open and non-political and a great place to work, but also with very high calibre people recruited into some of the key roles. I was quite pleased when I joined the business that they were not—it is a slightly disrespectful view—sleepy and backward looking as I might have thought they were; because I was brought in to help them get better. I was pleased that I was trying to help them get better from quite a high starting point.

**Q655 John Thurso:** Because in his note on the background to the Britannia merger Neville Richardson says, “CFS had a current account, corporate bank and insurance business. It lacked distribution and was badly in need of replacement IT systems, the cost of which would be difficult to recover over CFS’s small distribution base”. The point being that that is quite a significant identification of weakness in CFS at that time. Was that something you would agree with?

**Barry Tootell:** I would agree with it. It was not the reason for the transaction with Britannia but it is a fair assessment of where the Co-operative was at the time. We did have a small balance sheet size and a small distribution network, and we did have—consistent with other banks in the UK marketplace—quite old systems that needed more work to make them more resilient. You have seen that play out in the past year or so. We were no different from many other institutions and we were keen to replace or enhance our IT systems. Neville’s comment would be correct, that our capacity to do that major infrastructure project with the scale of bank that we were would have been stretching or penal for us. Doing it once for a much bigger business would have been economically more doable. I would then suggest Britannia were in a similar position—that they also had IT systems that required work.

**Q656 John Thurso:** Not the new IT systems that Mr Richardson described in the note?

**Barry Tootell:** They had a more modern mortgage platform than the Co-operative. It was the same mortgage platform as the Co-operative, but it was a slightly newer version of it.

**Q657 John Thurso:** David Anderson, who was then the CEO of CFS—and tell me if this is wrong, just because it is in evidence from somebody does not mean it is right—the evidence given is that David Anderson asked to meet Neville Richardson, who was running the Britannia at that time, and pointed out the synergies and the strengths that would accrue within a merger. Was that an accurate picture?

**Barry Tootell:** I completely agree with the evidence that has been presented in terms of the complementary nature of the transaction. As I said before, I do not know whether David approached Neville or the other way round.

**Q658 John Thurso:** There is another way of looking at this, which is that the Co-op was in a degree of trouble going forward, with difficulty in growing. In looking to Britannia as a merger that gave strengths and solved quite a lot of problems, it would be fair to say that it was not a question of Britannia being taken over or rescued in any way by Co-op, it was CFS seeing in Britannia a solution to its problems and a counterweight to some of the weakness that had been identified.

**Barry Tootell:** I completely disagree. Aside from the fact that the IT replacement would have been economically more viable if we had done it from a much larger business perspective, the future of the Co-operative, if we had not expanded, would have been...
Q659 John Thurso: So Co-op would have been able to deal with PPI on its own?

Barry Tootell: Yes.

Q660 John Thurso: This is now close to April 2008, so you were the full-time chief financial officer. The relationship between a CEO and CFO is the tightest in any organisation, usually. So you would have been heavily involved in this. At what point did the internal CFS discussion about “This is a good thing to do” move to being first of all that the CFS board started to talk about and then the board of Co-op were brought into?

Barry Tootell: I believe it was as early as July 2008.

John Thurso: For the CFS board or the Co-op board?

Barry Tootell: Both the CFS board and the Co-op Group board.

By August 2008 we had engaged advisers to proceed with the exercise. Then in January 2009 we had announced to the market that we were progressing towards the deal.

Q661 John Thurso: At the time, given the expanding size and your professional knowledge of the regulatory requirements, were you content with the corporate governance structures that were in place?

Barry Tootell: Yes. The quality of the non-executives that I had on my bank board at the time was impressive and they remain so today. So, yes, I had a very strong board back in 2008.

Q662 John Thurso: Sorry, because I just do not know this, how many of those non-executives were from a banking background?

Barry Tootell: I think we had five external non-executives.}

Q663 John Thurso: That is not the Co-op non-executives, but the externals?

Barry Tootell: The external non-executives, the IPNEDs; the independent professional non-executive directors. I think two of them were. Bearing in mind we were also a multi-disciplinary business—we were a general insurance, life assurance and banking business—we had directors that covered each of those areas of our business.

Q664 John Thurso: Do you consider that to have been an adequate structure now that you know what has happened?

Barry Tootell: Yes. That is not to say we were complacent at the time. I think we have shown our desire and willingness to strengthen still further over the time that has ensued thereafter. Today we see greater banking expertise than we had at the time.

Q665 John Thurso: You intimated earlier that you had had an opportunity to read the Banking Commission’s reports. Did you read the one on HBOS entitled: An accident waiting to happen?

Barry Tootell: I did.

Q666 John Thurso: Did you notice any similarity between the composition of the boards, your own and that of HBOS?

Barry Tootell: No. The composition of the board, at both executive and non-executive levels in the bank, and the broader financial services business benefited from the detailed skills and experience from the broader marketplace. I thought you were going to ask was there a similarity between the issues that emerged. The answer to that would have been “yes”, because clearly what was identified through the due diligence process proved not to have been sufficient to identify the problems that then ensued, with the benefit of hindsight. At the time, we genuinely thought we did an incredibly professional job.

Q667 John Thurso: The point behind this is that you had variously 16 to 17 people on the bank board, not the main Co-op board, of who roughly one-third are from the Co-op board, who broadly do not have any financial services experience?

Barry Tootell: Indeed.

John Thurso: You obviously have your executive members who clearly do and you had two out of five of the non-execs who had some experience. That falls very considerably short of all the recommendations made by the Banking Commission on the balance of
Q668 John Thurso: Ultimately the board you had in 2008 was as weak as the boards of a number of other banks. So at what point does the advantage of the culture of the mutual that owns the bank—but the bank is a share-structured and regulated equity-based company—become outweighed by the weaknesses of the structure that was put in place?

Barry Tootell: I think we have genuinely benefited from the diverse opinions that we see in our boardroom. We have the represented views of the broader membership of the group sitting in our boardroom and playing a part in the debate that we have as directors. Whether that be bringing the ethical card to bear or whether that be representing the broader view of the membership, it is a helpful check and balance to some of the decision-making that we have undertaken. I do not think we have fallen short by having that broader democratic representation in our boardroom.

John Thurso: I am having difficulty with this. You are no longer there, but the Co-op Bank—something a lot of us would like to support, both in concept and reality—is now likely to end up as a listed company, with 30% of its equity owned by the Co-op board. It is going to have to be run in the way of companies listed on the market with all the good and bad that come with that, and it has probably set back the concept of mutuality in finance for some considerable time. I am looking to see what could or could not have been avoided in the corporate governance structures, and you are telling me—notwithstanding the sort of cluster what-not that this has become—that it was all fine. Why should I take that as a credible piece of evidence?

Barry Tootell: It wasn’t all fine. We made the decision to acquire assets from Britannia in 2009—decision-making at the end of 2008 into early 2009—based upon the economic data that we had at our disposal and shared extensively with the triumvirate of the regulators, which were HMT, Bank of England and FSA at the time. We put it through a rigorous challenge in the boardroom and we acquired assets. Previously, in the late 1990s, early 2000s, we had sold PPI products. Those two things are essentially what have brought the business essentially to the position it is in today. So the governance of the business in the here and now or even back in 2008—bearing in mind we made that acquisition based on the available information about the future projections for the economy—I can point to no decision that was made at that time that was not made with the utmost care and professionalism. Could there have been more banking directors on the board? Yes, there could. Would it have changed the decision? I am not sure that it would, based on the information we had at our disposal in 2008/2009.

Q669 Chair: Your evidence there is suggesting that you were happy with the non-executive structure and with the scrutiny on risk provided from that structure of corporate governance. Having heard what John Thurso and others throughout the hearing this morning—and it is now this afternoon—have been saying, is there anything in retrospect, with respect to the corporate governance structure, that you would want to have changed?

Barry Tootell: Both for its own benefit and to respond to challenge across the marketplace, the business has to continue to evolve and strengthen its governance still further. It is continuing to bring greater banking expertise to the fore and is actually reducing the level of group democrats.

Q670 Chair: That is a question about the institution now. I am asking you a question with the advantage of hindsight, and I will have one more go. In retrospect, at the time that all these things started to go wrong, or a little prior to that, are there things with respect to corporate governance, ways in which this institution was being run, anything at all that you feel you would like to have altered?

Barry Tootell: I do not believe so.
Wednesday 6 November 2013

Members present:

Mr Andrew Tyrie (Chair)
Mr Brooks Newmark
Mr Andrew Love Jesse Norman
John Mann Teresa Pearce
Mr Pat McFadden Mr David Ruffley
Mr George Mudie John Thurso

Examination of Witness

Witness: Reverend Paul Flowers, former Chair, the Co-operative Bank, and former Deputy Chair, The Co-operative Group, gave evidence.

Q672 Chair: Thank you very much for coming to give evidence this afternoon. I apologise for the fact that it is being held this week, rather than last week. Could everybody turn off any electronic devices they have so that we can have an uninterrupted session? I do not think we are going to have any divisions, so that will make life easier this afternoon. I would like to begin, Mr Flowers. Just remind us, you were chairman between which dates?

Reverend Flowers: Between April 2010 and the very beginning of June of this year.

Q673 Chair: What happened to profits during that period?

Reverend Flowers: Profits for the basic core bank during most of that period were fairly flat, but they were profits. They were of the order of £100 million to £120 million a year.

Q674 Chair: I have figures in front of me for the half-year to June 2010—the full-year figure was rather more—showing profits of about £100 million, between £50 million and £100 million.

Reverend Flowers: They did go up and down. They fluctuated a little around the £100 million mark.

Q675 Chair: What were they when you left?

Reverend Flowers: There was a loss, as you are fully aware, sir.

Q676 Chair: What was the loss?

Reverend Flowers: When you have to add in altogether the impairments, the IT matter and the PPI, I believe we are looking at a loss of around about £750 million to £800 million.

Q677 Chair: Let us just have a look at the capital situation. What was your core tier 1 capital ratio, which you inherited when you came in in June 2010, roughly?

Reverend Flowers: Which I inherited?

Chair: Which you, as chairman, inherited from your predecessor.

Reverend Flowers: It might be helpful to say that I was also a director of the bank for a year before I became the chair.

Q678 Chair: You acquired a much higher level of responsibility.

Reverend Flowers: The core tier 1 capital must have been around about 8% at that time. It went up to and fluctuated between about 9.4% and 9.6% towards the end of my tenure.

Q679 Chair: What is it now?

Reverend Flowers: Fortunately, I am no longer a director of the bank—

Q680 Chair: What was it when you left?

Reverend Flowers: It was around about 9.6%.

Chair: When you left?

Reverend Flowers: I believe so.

Q681 Chair: I have a figure of 4.9% in front of me.

Reverend Flowers: No, that is not right, sir.

Q682 Chair: That is incorrect, is it?

Reverend Flowers: It is entirely incorrect.

Q683 Chair: In June 2013 your core tier 1 capital ratio was about 9%?

Reverend Flowers: As I understand it, yes.

Q684 Chair: We will take a look at that. I think that is worth a look. Give me, and everybody listening to this, an idea of the size of the Co-operative Bank. Roughly, what is your total asset value?

Reverend Flowers: Valued at just over £3 billion.

Q685 Chair: I am talking about the assets, so we are looking at the balance sheet here.

Reverend Flowers: I am talking about the assets too.

I am talking about the assets and the balance sheet, just over £3 billion. Those were the figures I just looked at recently.

Q686 Chair: How many loans did you have out—

Reverend Flowers: I would have to ask someone to tell me that because—

Chair:—as a proportion?

Reverend Flowers: I could not tell you the actual figure. I am sorry.

Q687 Chair: Do you know roughly how many loans and advances you had made to customers at the time you left?

Reverend Flowers: No, because it was not my function as the chair of the board to have all those
Chair: You do not know what that figure is, even roughly? Reverend Flowers: I cannot give you that figure at the moment but I will come back to you with a note, if that will be helpful.

Chair: But the loan book is the core asset of exposure committees, and in particular to audit, risk and exposure committees.

Reverend Flowers:

Q689 Chair: Your total assets in June 2013 are listed at about £47 billion, just to give you an idea. You were offering me £3 billion, and I am telling you that your annual accounts show it at £47 billion. Reverend Flowers: Indeed they did, forgive me.

Q690 Chair: Your loan book is about £32 billion. These are very basic numbers for a chairman of a bank. What expertise did you have in banking before you became chairman?

Reverend Flowers: Perhaps it would be important for me to say that I was appointed as chair because the Co-op had a practice of appointing a democrat from within its own numbers as the chair of that board. I went through a process that was rigorous and considerable. In terms of the appointment process itself, I was one of four on a shortlist and I am told I was the unanimous choice of the sub-committee that appointed.

I then had to go through a rigorous process with the Financial Services Authority, as it then was. I had already gone through a process to be appointed as a director of the bank in 2009, which were the significant influence function interviews, and passed those. Before I was confirmed as chair of the bank, in the spring of 2010 I also had to go through similar but somewhat more robust interviews with the FSA to see whether or not they felt that I was an appropriate person to be the chair of the board. That was undertaken by a panel of people at the FSA and was very rigorous and very searching. At a time when they were also turning down other prospective directors and chairs of financial services organisation, it was their judgment that I was an appropriate person and they confirmed that view.

To answer the implication in your first question, sir, I worked for a bank for four years after I left school, and I undertook the examinations of the Institute of Bankers. I completed part one and the best part of part two of those examinations, before I went to become a Methodist minister. I have some experience, but I would judge that that experience was largely out of date in relation to the needs of contemporary banking. Nonetheless, I still had that grounding.

Q691 Chair: You just used a phrase, “the needs of contemporary banking”. Was there anything in your background that prepared you or would have prepared you to chair a sizeable bank with assets on the balance sheet of £47 billion?

Reverend Flowers: I think you have seen my truncated CV. You will know that what I believe my skills to be, and what others have judged my skills to be, is in terms of governance and not necessarily in terms of the specifics, which are faced—

Chair: We will come on to that in a moment. Reverend Flowers: I would argue that is a discrete and important aspect.

Q692 Chair: But I am asking a very specific question, which is, do you accept—let us put it in a different and even more direct way—that you did not have any of the experience required to run a commercial bank, any banking experience required?

Reverend Flowers: With respect, I accept that the FSA believed that I was an appropriate person.

Q693 Chair: That is just passing the buck. By all means make that point, and we might have a discussion with the FSA or the successor bodies about it at a subsequent date, but at the moment we are asking you questions and I am asking you whether you think you had that experience?

Reverend Flowers: I did not have the sort of experience to which you specifically refer, but I had other skills and experience. I was there specifically because it was a co-operative, as an elected member of the Co-operative, to represent the members of the organisation that owned the bank. That was why I was there.

Q694 Chair: Yes, I know. You have explained that to us, and that explains how you got the job. I am not asking that question. I will have one more go. Did you or did you not have the experience—with the advantage of hindsight, now looking back—required to run this bank? Was it a mistake for you to have taken this job in 2010?

Reverend Flowers: With respect, I thought I had answered your question. I said that I clearly did not have the degree of banking experience that you are referring to but I did have other experience, and I do not believe it was a mistake either, sir.

Q695 Chair: Do you agree with one of the central recommendations of the Parliamentary Commission on Banking Standards that chairmen of banks should have a great deal of financial and banking experience?

Reverend Flowers: Are you referring to the Vickers Report?

Chair: No. I am referring to the Parliamentary Commission on Banking Standards.

Reverend Flowers: I understand the distinction, forgive me. I understand that. However, I would again rest on the judgment made about me by my peers and by the regulator.

Q696 Chair: Do you know any of the recommendations of the Parliamentary Commission on Banking Standards?

Reverend Flowers: I read it some time ago.

Q697 Chair: Can you name one other recommendation of the Parliamentary Commission on Banking Standards?

Reverend Flowers: Not at this particular point in history, no.
Chair: So you have read it but you cannot remember one. This is a bank that was in—or appeared to be—a reasonable nick in 2010, and is now holed below the waterline, needed a lot more capital, is in desperate straits and the obvious question, the inevitable question that has to be asked at a hearing like this, is what responsibility do you feel you bear for this catastrophe?

Reverend Flowers: Can I answer that in two parts? The first is, if I reiterate very briefly—

Chair: Do not say what you have already said.

Reverend Flowers: May I adumbrate some of it by talking about the role of governance and the way in which I sought to increase the amount of specialist expertise on the board, which is specifically what I did? I inherited a board that had been just over 22 members at one stage. It was at about 20 when I took over. By agreement with the regulator, we agreed that it had to be reduced but particularly beefed up in relation to banking experience.

When I took over the board, which was first of all exclusively male—and I changed that too—the board had six executive directors from the bank itself, as well as too many people representing the Co-operative Group. We had also inherited four directors from the merger with Britannia. It was very important that we substantially increased the amount of banking experience on that board, and that is precisely what I did by bringing in a considerable number of people whose wealth of experience was important to the development of the bank. I hope that that is an important thing for this Committee to understand in relation to changes of governance.

Chair: We will come on to governance in a moment, but the question that I am asking you is, what responsibility do you personally feel you bear for the near-collapse of this bank?

Reverend Flowers: First of all, the bank has not collapsed. Secondly, it has not required any Government support, either in the crisis of 2007/2008 or now. The bank has not collapsed. The bank—

Chair: I am going to have a third go.

Reverend Flowers: I am trying to answer your question.

Chair: I am asking a very straight and simple question. The answer is, "I bear no responsibility", "I bear some responsibility", or "I bear a lot of responsibility", and then by all means elaborate. What responsibility do you bear for the near-collapse of this bank?

Reverend Flowers: If you will allow me to elaborate once I have answered the question, then. I take very seriously the issue of responsibility for something that appears to go wrong during your watch and, therefore, I resigned in the beginning of June this year. I believed it was important to do so because I believe that when you are the head of an organisation, whether or not you totally were aware of all of the circumstances of what had gone wrong, when you are that person in the chair, you must take responsibility and I did.

Chair: Do you feel let down by them?

Reverend Flowers: Of course. Merlyn Lowther, Peter Harvey—

Chair: Can you name them, or any of them?

Reverend Flowers: She was the first female Chief Secretary to the Bank of England.

Chair: That is not commercial experience.

Reverend Flowers: She had had commercial experience in the retail arm of the Bank of England, and she appointed a considerable number of people, including most of the people now running the FSA.

Chair: So we have Merlyn Lowther, who had some experience via working in the commercial arm of a central bank. Who else do we have on this list?

Reverend Flowers: Peter Harvey.

Chair: Peter Harvey had his commercial experience from what job?

Reverend Flowers: Barclays.

Chair: That is two. How many others do we have here? You said six.

Reverend Flowers: I think I said six. Rodney Baker-Bates, who was one of my two deputy chairs.

Chair: What banking experience did he have?

Reverend Flowers: As general manager of Midland Bank in one of its incarnations before it became immersed in a larger entity.

Chair: When your bank was getting into difficulties, were you calling on these people a lot and saying, "What the hell is going on?"

Reverend Flowers: Part of the agreement with the FSA about my appointment was that we would appoint two deputy chairs specifically to advise and assist me. They were fully aware that my skills were not those of a banker, and, therefore, we came to an agreement that there would be two deputy chairs specifically to assist. Rodney Baker-Bates was one of them and David Davies was another.

Chair: Do you feel let down by them?

Reverend Flowers: Not at all.

Chair: So, where does the responsibility lie?

Reverend Flowers: I told you, sir, that I took responsibility as the chair, but I assumed that
responsibility for things that have happened lay with all of us.
Chair: We will leave it there for the time being.

Q713 Mr Mudie: Good afternoon.
Reverend Flowers: Hello.
Mr Mudie: When you were interviewed by the FSA, at what level were you interviewed?
Reverend Flowers: On the second occasion when I became chair, and there was a panel of about five people. My recollection is that there was a very senior representative of the FSA present, together with two or three other people in different roles in the FSA. The FSA also had a panel of people, which it regarded as very senior, outside skilled people whom it would bring in. They had a particular name for them, but I cannot remember. I think it was called silver something-or-other. I was going to say “foxes”, but I do not think that is right.
One of the people from that panel was Graeme Hardie. He was present during the interview process. He had had a considerable amount of experience in Scottish banking, and was a person of considerable honour and integrity when it came to some of the crises affecting Scottish banking.

Q714 Mr Mudie: You are aware of and have referred to a very senior person. Do you know who it was?
Reverend Flowers: I believe it was Andrew Bailey, but I cannot remember at this time.

Q715 Mr Mudie: Do you think you could possibly find a piece of paper that would tell us who interviewed you and found you acceptable?
Reverend Flowers: I am sure that we could.

Q716 Mr Mudie: That would be very useful. Good. I thought you seemed a bit defensive about your banking experience. As I view the Co-op, lovely as it is, it is not Barclays, and everybody would say, “Thank God it’s not”. It is not a big investment bank, into sub-prime and CDS and the like. Why are you so defensive? You said you were a bit old-fashioned or things had moved on. What sort of things happened in the Co-op in 2010? I always thought it was a very sleepy, well-run, conservative bank.
Reverend Flowers: I would judge that it was very conservative, with a very small “c” of course. I believe that the experience that I had as someone working in a bank, which was from 1968 to 1972, was such that banking was in a very different place. I started working for the old Westminster Bank before it merged with the National Provincial and the District to become the National Westminster Bank. I went through a considerable amount of in-house training, which was exceptionally good quality training, as well as the training at night school, in my case, for the Institute of Bankers’ examinations.
I would guess that the basics of how you look at running a bank, especially in terms of trust and probity, were there and still are. I still happen to have a fairly high view—very unfashionable—of bankers. I think that a considerable number of people in banking are profoundly decent and good people, and I learnt that when I was doing my own work a long time ago.

Q717 Mr Mudie: I accept that, but I am almost seeking to see why you think you are old-fashioned in terms of the technical aspects of banking. Has it moved on that much? The Co-op was into current accounts, mortgages and a bit of personal lending, and perhaps a bit of commercial lending.
Reverend Flowers: Indeed it was.
Mr Mudie: But not overwhelming. It was pedestrian—
Reverend Flowers: It was.
Mr Mudie: —in a nice way.
Reverend Flowers: I would hope so.

Q718 Mr Mudie: Then how had it changed in 2010, apart from the Britannia merger?
Reverend Flowers: It changed partly because of the Britannia merger, and if you wish I can—

Q719 Mr Mudie: No, but Britannia brought mortgages plus some doubtful commercial lending.
Reverend Flowers: It also brought some savings.

Q720 Mr Mudie: But that would not have changed. That would change the quality, but lending is lending. What was different in terms of the 2010 Co-op from the 1990 Co-op?
Reverend Flowers: Not very much, if look just at the Co-op Bank itself, because the Co-op Bank had been exceptionally prudent in its lending, but it carried on lending during the crisis.

Q721 Mr Mudie: I wondered why you were so defensive. You joined the Co-op in 2009, when the Britannia merger was being finalised.
Reverend Flowers: Yes.

Q722 Mr Mudie: Did you play any part in that merger? Did you have any views on the merger?
Reverend Flowers: I did indeed. I was a member of the group board from 2008, so a year before, when the initial discussions were being held. We had a considerable number of due diligence reports, not just one but three in all. The first was commissioned from Deloitte, which was the initial due diligence process about whether or not a merger would be sustainable and would be able to occur. The second was done by KPMG, with a third specific report, which was done by KPMG, on the issues of fair value adjustments, and in particular how that related to potential bad debts from the commercial and platform arms of the former Britannia.
I was not on the bank board at the point when that was being discussed, but I was on the group board, which looked at the substantial issue. It was my view that we took a considerable amount of evidence from those preparing due diligence reports. We relied as well upon other work done by specialists whom we employed to assist us. If anything, I think we were told at the time that the due diligence reports were of the best that had been done by anybody in this sort of sphere.
Q723 Mr Mudie: I presume these are still available. Reverend Flowers: Indeed. I have copies elsewhere but I am sure they are, yes.

Q724 Mr Mudie: If you have copies, it might be easier if you gave us copies, if you would not mind, in due course.

Reverend Flowers: I am sure that can be done. I will probably have my wrist slapped by somebody.

Q725 Mr Mudie: We had KPMG on the premises this week, and I can perhaps understand your problems, but it would be interesting to see what they wrote.

Reverend Flowers: If might add to what I said to you first, I think the only question that I did raise on the group board at the time was a question about who should be the chief executive of the bank, going forward. In the group board discussions, I recall specifically questioning the advisability of appointing Mr Richardson, as opposed to appointing Mr Anderson who I felt would have had more trust within the bank itself.

Q726 Mr Mudie: Going on to that, when the merger was going through and you arrived, what was the prevailing view among the group officials and the bank officials?

Reverend Flowers: The view with—

Mr Mudie: Was it a good move?

Reverend Flowers: It was overwhelmingly that this was a good move.

Q727 Mr Mudie: Yes. When did you personally start to have doubts about whether the due diligence was as good as it was supposed to be?

Reverend Flowers: Those came to a head through 2012 and certainly towards the beginning of this year, but certainly through 2012. I think it is important to say that we had significant committees that looked at areas of risk, audit and exposures, and each of those was chaired by one of the experienced bankers that we had on the board. In particular, from early 2012, the exposures committee had pointed up to us that there were a range of quite difficult loans, which had been made under the Britannia book, which were likely to cause us future problems as, indeed, they have done.

Q728 Mr Mudie: Does that mean that your view personally is that the present problems—the Britannia merger and the problems that came with it, I mean the financial problems in terms of the assets—were a major part in the present problems you find yourself in?

Reverend Flowers: With respect, hindsight is a very—

Q729 Mr Mudie: No. I am not asking you for hindsight. I am saying that, as we are sitting here and more and more is coming out, you are starting to say the due diligence was lacking.

Reverend Flowers: I am not quite saying that, sir. I am saying—

Mr Mudie: No, I am saying it.

Reverend Flowers: Fine, but I am wishing to demur a little bit from that by saying that I believe that the due diligence reports that were undertaken were done faithfully and well, and that they were undertaken by good professionals who knew what they were doing. I would add the rider that, after the merger, the whole country faced a deteriorating economy, and that, in company with everybody else, we were working through an economic situation that was not particularly good for banks or for anybody else, exacerbated of course by the flattening of base rate at 0.5%. Banks need to make some money somewhere in order to exist, and a base rate of 0.5% does not give you the opportunity to earn the margins that you would hope to earn in a reasonable market.

Q730 Mr Mudie: No, but you went through the crisis and suddenly it starts falling apart.

Reverend Flowers: Yes.

Q731 Mr Mudie: If it was not for Britannia’s loan book—

Reverend Flowers: It was.

Mr Mudie: It was?

Reverend Flowers: It was, and I—

Q732 Mr Mudie: I think you are being too gentle and perhaps not seeking to be controversial. Do you not think that those loan books, professionals looking at that financial situation in Britannia, even in 2009, would have started worrying or would have been worried and perhaps not seeking to be controversial. Do you not think that those loan books, professionals looking at that financial situation in Britannia would have started worrying or would have been worried?

Reverend Flowers: Or course most of those reports were done in 2008.

Q733 Mr Mudie: Yes, well, the world was in a bad place in 2008.

Reverend Flowers: It was, and the Co-op Bank was surviving that fairly well because it had a liquidity ratio that was exceptionally high. As a bank we did not lend what we did not have in, which was a good, old-fashioned way of doing banking. It was the Britannia book and the deterioration of that book that brought the bank to a difficult place.

Q734 Mr Mudie: What I am asking you is—and this is my final question—are you being too charitable to say that these were professionals doing a fine job? They were doing a fine job in 2008, allowing you to wander into a merger with a seriously troubled loan book, which has erupted and caused severe damage to the Co-op.

Reverend Flowers: I have a professional obligation to be charitable, and I try to be. I hope I can also take a rigorous view of the reports that we had at the time. What I am trying to do is to acknowledge that things deteriorated badly, but that in good faith I believed people did their best to analyse the situation appropriately in 2008 when they looked at fair value adjustments.

Q735 John Mann: When Jesus kicked the moneylenders out of the temples, was he just having a bad day?
**Reverend Flowers:** Yes. No, he was not. I am happy to have a theological discussion with you. He was having a perfectly good day.

**Q736 John Mann:** That is where I wanted to take the questioning because that is the third biblical question I have asked on this Committee. We happened to start at the same time. I came on to this Committee at the same time you went on to the Co-op Bank, so I can remember timelines very, very distinctly of what was happening. You are the first banker who could have had a theological discussion, but the others might have had more of a banking discussion. I am not interested in whether you are at fault or, to be frank, who is at fault. I do not really care. Although I am surprised that you say that the Co-op Bank has not collapsed. For the Co-operative Bank to have to put in £430 million to be run by two American hedge funds is not what most members would describe as a success. Why did you not ask about the loan book of the Britannia when you came on the board?

**Reverend Flowers:** We did, and it was under constant review. It was under constant review by the appropriate committees, who reported to the board on the loan book.

**Q737 John Mann:** What was your view of the fact that the Britannia had moved from being a traditional building society into commercial high street lending?

**Reverend Flowers:** At the time, the lending that they were engaged in appeared to be sound. Appropriate questions were raised in the board, and—

**Q738 John Mann:** No, I am asking what your view was of the fact that the Britannia, which for decades had lent mortgages, had branched out into an entirely new area of business recently before the merger, i.e. commercial high street lending. What was your view on that?

**Reverend Flowers:** My personal view was and will remain that that was ill-advised for a building society to undertake that.

**Q739 John Mann:** Was that your view at the time?

**Reverend Flowers:** Yes.

**Q740 John Mann:** So you are there, and I am not arguing or discussing whether or not it should be a lay chair of professional. It is an issue, but it is not an issue for me. What I am interested in is here we have the Co-op Bank—and you have come through the membership ranks—that for 100 years has acted in a very specific way in how it has lent. Suddenly it decides to do something it has not really done before, it is going to buy out somebody else and bring them in. But they have just changed from being a traditional building society into an organisation that is becoming more powerful; it is doing commercial lending.

**Reverend Flowers:** I think it might be important to say that, as part of the due diligence reports, there was considerable analysis of the distinction between ordinary mortgage lending on the Britannia book and the more risky elements of the lending that they had engaged in. We also had in the board—

**Q741 John Mann:** I am not interested in the due diligence, although others may be. I am looking at your position, not the position of specialist bankers looking at due diligence. I am looking and thinking. First question I ask, coming on this Committee, is what sub-prime is around? Who has it? What problems is that going to cause? The Chancellor at the time, Alistair Darling, asked the same question in more brutal ways. It cannot have been missed by you or anybody else involved.

**Reverend Flowers:** He did it well.

**Q742 John Mann:** Why are you not asking these very basic questions, whether they can be described as ethical or of ethos and purpose of the organisation?

**Reverend Flowers:** They were asked, and they were set alongside a range of other issues about why the merger might be beneficial. The unanimous view of both boards was that the merger would be beneficial. Some of the reasons for that were that the Co-op did not pay a penny piece for the Britannia merger. We did not put any money on the table whatsoever. We acquired the assets for nothing. You could in fact say that it was not a merger so much as an acquisition of the Britannia Building Society, but that might not be quite such a palatable word for some here.

**Q743 John Mann:** You put that as a virtue. When I bought a house, I had a clause added in that gave me a barn free. The reason it was put in free was that it was falling down, and I have had to build it back up. The fact you are given something for free might tell the lay person that there is something that is rather a problem there.

**Reverend Flowers:** First of all, I am sorry about your barn; but, secondly, there were considerable good other reasons why we should have that acquisition. The extent of the branch network that we were taking over, making certain that the Co-op moved from branches of about 90 to about 340, was a considerable reason for doing the deal, and when we analysed the thing in totality we still believed—as I believe you heard last week from my former colleague, Barry Toottell—that there was complementarity between the different abilities of the bank and of the building society and that we each brought considerable benefits to the whole. That was while also acknowledging that there were problems with the corporate lending book.

**Q744 John Mann:** I have been a member of the Co-op for over 40 years, and I sit in this Committee. No one asked me my view as a customer or as a member. Did you ask the view of any politicians?

**Reverend Flowers:** Politicians?

**John Mann:** Yes.

**Reverend Flowers:** I was not in a place where I would know whether that happened at the time, but I do not believe so.

**Q745 John Mann:** What I am trying to get my head around is that it is fairly obvious to everyone on this Committee that the Co-op was out of its depth, or a long way out of its depth, and that it expanded at the wrong time. There is no argument about that: it expanded at the wrong time, with the wrong decisions.
There are two questions, the specifics and the Co-op, but there is a deeper underlying question of how organisations are structured and managed. What I am not hearing is where precisely the lay non-banker voice is saying, “Hang on a minute, why are we doing this?”

Reverend Flowers: With respect, that was being heard all the time. It was being heard from the group board that were on the bank board, and I was one of four on the bank board from the group. When the substantive issue of whether or not the acquisition should be acquired at all went to group board, first of all, it was analysed in considerable detail by my colleagues on the risk committee of the group board and then by the group board itself. It then further filtered down to regional boards and area committees, who were all consulted about that acquisition. All those questions were raised at the time.

Q746 John Mann: But none of them were experts. Reverend Flowers: No.

Q747 John Mann: In the answers to the Chairman’s questions, you again made a virtue of the fact that you had brought in lots of people with additional banking experience. What that says is that the Co-op that is—others used the word “trundling”—doing perfectly satisfactorily for its membership and its customers, which had not uniquely but remarkably survived the financial crisis in 2008, suddenly decides to massively expand, not once but twice. That says to me that it all went to your head a bit. You had survived the crisis, and you thought, “Ah, the co-operative model. We are a membership-based organisation. Mutuals and so on. That is the way forward. We are going to expand, because everyone else is collapsing” and that was actually the driving motivation. I put it to you that you and your ethos was a critical part of the drive in motivation, because you would be there saying, “Mutuals, co-operatives, look at the rest of them. We can fill the gap in the market”. That is why you jumped into bed with the Britannia, and then went even further and tried to do so with Lloyds.

Reverend Flowers: I think there are two distinct issues in terms of the one merger that did occur and the merger that has not occurred. On the first, there was considerable parliamentary support for the merger between the Co-operative and Britannia.

Q748 John Mann: From whom?

Reverend Flowers: 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.

Q749 John Mann: Who precisely in the Treasury?

Reverend Flowers: Mr Balls, in particular, was very supportive of the whole process.

Q750 John Mann: In what way?

Reverend Flowers: Talking with us and encouraging us, in the same way that Conservatives did as well.

Q751 John Mann: Which Conservatives?

Reverend Flowers: I cannot recall all the names at this stage. This was before the Conservatives came into office.

Q752 John Mann: Presumably Mr Osborne was—he is a well known figure. You would know if it was Mr Osborne.

Reverend Flowers: If I just say that, if you want some sense of parity of this matter, although we clearly took the Britannia into our ownership, we were also approached by the Coalition Government shortly after it came into office in 2010 to see whether or not we would be prepared to take over another building society.

Q753 John Mann: We have not heard anything about this. Could you elaborate?

Reverend Flowers: I would be happy to do so. The building society was the Presbyterian, in Northern Ireland, which went into considerable difficulties. First of all, we had an approach from the most senior civil servant from the Office of the First Minister and Deputy First Minister in Northern Ireland, who came to see me in my room in Manchester with my colleagues. He came in and said that he felt like he was coming as a snake oil salesman, representing the Government, to offer us the opportunity to take over the Presbyterian Building Society. That was pursued with meetings, where I was invited to meetings with the then Secretary of State, Mr Paterson, his junior Minister and his most senior civil servant. That meeting occurred in his bedroom at the Hyatt Hotel at the Conservative Party conference in 2010, when I was the one—not the banker, I have to say, just the humble democrat—who had to tell them that the figures they were looking at were £100 million adrift and that there was a black hole in their own figures, and that was why we would not take over the Presbyterian as they had asked us to do.

Q754 John Mann: Now we are getting somewhere. I am trying to put myself in your shoes, as someone with no banking background—I have been a member of the Co-op for many years—thinking, “I am there, appointed”. You were part-time chairman, were you?

Reverend Flowers: The agreement was that I would do three to four days a week and I did.

Q755 John Mann: So you were part-time chairman, working out, “Right, I have this position. What do I do? Who do I seek advice from?” You are saying you were getting politicos of both leading parties pushing the Co-op in a certain direction.

Reverend Flowers: Exactly the same thing happened with the Verde process as well.

Q756 John Mann: I will come to that in a minute. We have asked others from the Co-op this question. You know who has been here before. They have flatly denied that there was any—I do not think the word
was—“pressure”. That may have been used, but I have asked more gently as well whether any politicians have been involved, and they have denied it flatly. They have said, “Never, not once, no pressure, no discussion, no meetings”. It would probably be helpful to have a note from you because you are saying, first of all, Mr Balls when he was in the Treasury.

**Reverend Flowers:** Yes.

**Q757 John Mann:** That must be around—

**Reverend Flowers:** 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.

**Q758 Chair:** Roughly what date? Sorry to interrupt.

**Reverend Flowers:** This would have been just before the merger occurred, so in the spring of 2009, I think.

**Chair:** Sorry, John, go ahead.

**Q759 John Mann:** Then we have Mr Paterson and officials from the Northern Ireland Office in 2010 with a separate but the same; I am hearing what you are saying—

**Reverend Flowers:** They were asking us to take the Presbyterian, which was a basket case.

**Q760 John Mann:** Yes, and you used the words, “Politicians cheerleading” when you first raised this. Any more? Anyone else from the Treasury at any stage?

**Reverend Flowers:** I think I said that there were further 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.

**Q761 John Mann:** What is a nod of support? How do you define that?

**Reverend Flowers:** Clear messages of encouragement.

**Q762 John Mann:** How?

**Reverend Flowers:** Telephone, and other messages of goodwill, that this is a desirable outcome, and that if the—

**Q763 John Mann:** Direct contacts to the bank?

**Reverend Flowers:** Yes, and if the process that was enunciated in the Vickers Report about the need for a bank of scale, which could act as a challenger to the other banks, could come about, then there was a political steer that that was desirable. There is one further thing to be said about that. I had many conversations with Andrew Bailey of the FSA. He was the regular point of contact that I had during all of this process.

**Q764 John Mann:** Sorry, by “all of this process”, what time? There are two processes. There is Britannia and then there is—

**Reverend Flowers:** Forgive me. During the whole of the time that I was chair, I did have regular meetings with Andrew Bailey and with other officials. During the time of the Verde process, which began in 2011 and ended in the spring of this year, I also had regular conversations with him about the process and the issues that were under debate. It would be fair to say that on one occasion I specifically remember—he was an absolute gentleman and he would always take you to the door after any meeting with him—in the process of the walk back to the door, he once said to me that they would do their best to ensure that the process was assisted, although, as you would expect them to do, they would still apply due rigour and due process. He also indicated to me that he was under no doubt at all that there was considerable political support for this deal from members of the Government, and he wanted me to be aware that he was aware that that was the case.

**Q765 John Mann:** We are talking of around 2011?

**Reverend Flowers:** This would be 2012.

**Q766 John Mann:** I have two more questions, When you say “regular contact”, there are different definitions of “regular”. Is “regular” every six months, every three months, every month? What do you mean when you say “regular”?

**Reverend Flowers:** My meetings with Mr Bailey?

**John Mann:** Your discussions and meetings.

**Reverend Flowers:** At least every two months, and sometimes more frequently than that. In terms of Project Verde, we set up a specific team who met with officials of the FSA every single week to keep them abreast of all of the issues. They met with them every single Friday, from the beginning of the process until the end.

**John Mann:** My final question—

**Chair:** It really is your final question?

**John Mann:** It is my final question. It is just to draw it together with the—

**Chair:** No more questions from you for six months.

**Q767 John Mann:** Just on the three political parties because you have named all three main parties or four,
I think. We will include the fourth, being the Northern Ireland parties as well, so—

Reverend Flowers: Forgive me. The Northern Ireland representation was a civil servant and not the politician.

John Mann: But, I understood, with political backing from Northern Ireland.

Reverend Flowers: One must presume so.

Q768 John Mann: You are giving a clear impression that, as a lay chair, who is not a banker, not perceived as a banker by the outside world in particular, which is perhaps more important, you and your organisation—the Co-op, the Co-op Bank, the Co-op Group—are getting very clear encouragement to expand in the ways that you attempted to expand from successive Governments and from key people in the Treasury in successive Governments, and others in Government.

Reverend Flowers: I have absolutely no doubt that that was the case.

John Mann: Thank you.

Q769 Chair: Just go back a moment through these episodes. Are you saying that these two episodes are similar in kind, that is the episode of the enthusiasm of Ed Balls for Britannia and the enthusiasm of Mark Hoban for Verde?

Reverend Flowers: I think that there was a distinction between the two, in that Mr Balls had a specific role at the Treasury. Was he Chief Secretary at the time? I think so. He 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.

I do not want to misrepresent Mr Hoban, but my understanding is that in the many telephone conversations that there were—and there were many—he was trying to keep a watching brief on what was happening and was clearly indicating the Treasury’s desire that if a deal could be done, and if all the hurdles that we had identified with Lloyds and that the regulator had also identified could be addressed, then the Treasury was indicating its pleasure and support for such a deal because of the way in which a challenger bank would be created.

Q770 Chair: I will be slightly more precise with the question I want to ask. Did either of these discussions go to the point where you felt that either of those parties was sharing in some way a responsibility for the decisions that were taken?

Reverend Flowers: No, not at all.

Chair: So, the responsibility for both of these, for each of them in turn, both the one in which Ed Balls and the one that Mr Hoban was involved in, you are very clear that the discussions you had did not amount to political pressure?

Reverend Flowers: No, I do not believe they did. They were—

Q771 Chair: Neither of those were discussions, therefore, that would be considered inappropriate?

Reverend Flowers: No. There was no interference in process and there was no undue pressure, but in each instance we were left with a very clear view that this was something that, if it could occur in each case with two different scenarios, each would support.

Q772 Chair: But your attitude to it would have been, “Well, that is all very interesting, but responsibility still lies with us, and we have to do it, so we will take the decision on its merits”. Is that what you did in response to this?

Reverend Flowers: Of course we did, sir. However, it was more than just interesting. When you get senior Government Ministers in different circumstances indicating their likely encouragement for what you are doing, you get some sort of a feel that it has a secular imprimatur.

Q773 Chair: In what way? I do not necessarily want to move forward with secular imprimatur, but what I want to know is whether you felt that in any way the decision had been altered.

Reverend Flowers: No. Not at all.

Q774 Chair: Therefore, it was of interest and it was perhaps nice that the Government might want to support each of these respective deals.

Reverend Flowers: Forgive me, sir, I think it was more than that.

Q775 Chair: But it is less than something that led you to feel that you might have taken a decision other than the one you were going to take anyway.

Reverend Flowers: No. We took the decisions on their merits, but it could so easily have been the other way round.

Q776 Mr Love: Can I refer the Committee to my designation in the House as a Labour and Co-operative Member of Parliament? Can I briefly pursue the questioning that we have had prior to my questions? It is really to get the view of the Co-op Bank, because one the one hand we have been told as a Committee by Mr Bailey that the regulator was sceptical of the possibilities of the Verde measure. You are telling us that Mr Hoban was enthusiastic.

Reverend Flowers: Yes.

Q777 Mr Love: He did not directly intervene, but he was enthusiastically in favour. Did that lead to any confusion at the Co-op Bank about what was being said to them in relation to Verde?

Reverend Flowers: No, because old co-operators are quite used to dealing with politicians and are used to dealing with the ways in which politicians sometimes speak, and, therefore, it was something that you listen to, hear and receive. I think we took the view of Mr Bailey much more seriously, because he actually had the ability to say “yea” or “nay” to the proposals before us.

Q778 Chair: I am sorry, Andy, but can we deconstruct what you have just said there? Are you saying that you did not take what the politicians said seriously but you did take what the regulator said
seriously? Can you put this in plain man’s language, please, Mr Flowers?

Reverend Flowers: Forgive me; I will try not to be so obtuse. Of course we took what everybody said seriously, and it was lovely to have affirmation from senior politicians of all parties. But, with respect, they had no locus in the matter when it came to the final decision.

Q779 Chair: For which purposes you ignored what they had said, set it aside?

Reverend Flowers: No, you do not ignore, because of course you are—

Q780 Chair: I asked you earlier whether it had any influence on your decision, and you said no.

Reverend Flowers: It does not have any influence on the final decision.

Q781 Chair: How can it not be ignored and simultaneously not have influence?

Reverend Flowers: With respect, we did not ignore it. You never ignore what somebody says to you, particularly if they are a very senior politician. It is how you take that offering and whether or not you use it in any way in what you are deciding. We did not.

Chair: I do not think we have made much progress there.

Q782 Mr Love: Let me ask a further question. You mentioned Mr Bailey, and he has told this Committee that he raised five concerns in relation to Verde. Did you or others at the Co-op Bank discuss these with Mr Hoban on any occasion, and were you given any impression that they would assist in any way to overcome these hurdles?

Reverend Flowers: I certainly did not, but I do not know whether anybody else did. I cannot answer the question, because I am not certain.

Q783 Mr Love: Can I come on to a conundrum that this Committee has been grappling with and we hope you can shed some light on it? It is about the provisions for loan impairments. Your accounts show that you recognised £100 million or so loan impairments in the year 2009. Then for 2010, and the first part of 2011 into 2012, did no one point out that the Co-op Bank seemed to be an outrider in terms of provisions?

Reverend Flowers: I certainly did not, but I do not know whether anybody else did. I cannot answer the question, because I am not certain.

Q784 Mr Love: I understand that, but that letter was also sent to all the other banks.

Reverend Flowers: It was.

Q785 Mr Love: They provided for loan impairments at a much earlier stage. If I can put it crudely, they seem to have been much more prudent than the Co-op Bank was. Why did that happen?

Reverend Flowers: I cannot answer for other banks. All I can try to do is answer for the one that I chaired for a time, and I believe that we had endeavoured to act prudently. I think we would have had some conversation with the regulator about the fact that some of the figures that were included within the end-of-year 2012 figures for impairments may not in the end actually be bad debts, and that they may turn around over the next few years. Nonetheless, we did what we believed was right and we recorded the figure that we believed was just.

Q786 Mr Love: Did anyone at the bank look at the figures from other banks and say, “These seem to be providing for loan impairments at a much higher rate than we are”?

Reverend Flowers: Yes.

Q787 Mr Love: This was from 2009. I understand you were not chairman for part of that period, but right through 2011 into 2012, did no one point out that the Co-op Bank seemed to be an outrider in terms of providing for loans in this way?

Reverend Flowers: I cannot recall so, sir, no.

Q788 Mr Love: You do not remember any conversations of that nature?

Reverend Flowers: No.

Q789 Mr Love: Did internal audit or anyone from the auditing side draw this to the attention of either the board or some of the other committees?

Reverend Flowers: In relation to what other banks might be providing for?

Mr Love: That you may not be as prudent as other banks in terms of provisions.

Reverend Flowers: I would believe that if they had, then that would have been discussed in the appropriate committee and would certainly have been discussed in the board, and I do not recall any discussion of those comparisons.

Q790 Mr Love: You mentioned earlier on, when you were asked about KPMG, that you thought they had done what the bank and its board had asked of them. But as your auditors, they are tasked to provide a true and fair view of the accounts. Do you remember any occasion on which the auditors drew to the attention of either the board or members of internal audit those tasks with risk by the board, drawing to your attention that you may not be as prudent as necessary in terms of loan provisions?

Reverend Flowers: No. I think it is important to state that, because I chaired the bank board, I was of course
not a member of audit. That would have been improper in terms of governance processes. Nonetheless, the audit committee had regular meetings with the auditors without officers of the bank being present. They had separate meetings with them. I also had my own meetings with the senior partner of KPMG in Manchester, a man called Jonathan Hurst, who has a long experience of working for KPMG. It was my practice to have meetings with him at least every six months, just to see whether there were any issues that he as the senior auditor wished to bring to my attention. Those issues that you have just talked about were not part of that discussion.

Q791 Mr Love: Let me refer you to the written evidence that Neville Richardson gave to us, and this is in relation to his explanation of why the Britannia merger was sensible in the circumstances. This is talking about mid-2011. He said, ‘There was no indication of the need for significant additional impairment provisions. This was supported by the many ‘clean’ external audit reviews’. He goes on to talk about the due diligence that was carried out by the Co-operative Bank. What the merger first took place in 2008/2009. He seems to have put a lot of weight on what the auditors and the due diligence showed. Do you think you put too much weight?

Reverend Flowers: With hindsight, probably yes. I believe, though, that when you are in the roles that we were in, you must take cognisance of the advice that you are given by those who do due diligence reports, which you must submit to rigorous discussion. You must also put due cognisance by the advice of your duly appointed auditors, and when they are prepared to give clean reports on your accounts and they tell you that there are no reasons why they would not do that, then you listen to that advice, and most people in those circumstances would do.

Q792 Mr Love: Let me just ask, finally, KPMG have a long relationship with the co-operative movement. They have been auditors, I think, of all the majors. There is a lot of discussion about whether or not you should have to revolve your auditors, in order that you do not develop too close a relationship, because they have a different viewpoint and provide an independent and provide a true and fair view. Do you think that that was a factor, in the fact that you got those clean reports, the fact that the due diligence turned up no problems with Britannia, yet in 2009 to 2011 the problems started to emerge, and they really came to fruition in 2012 and the first part of 2013?

Reverend Flowers: I think there would be two points to my response. The first is that, yes, the Co-operative Group has had a particularly long relationship with KPMG, but that has not been for want of going through the normal process of review and placing the tender up for a bid. I believe the last time that occurred was about two years ago, when KPMG were faced with considerable opposition from three other firms, and still, through due process, retained the contract as the auditor.

The second point of what I would say to you is that, although in principle I agree that it would be wiser to have rotation of auditors between organisations, there is the additional problem that in this country at the moment there are probably no more than three or four firms that have the expertise to be able to handle the sort of accounts with which we are dealing. It is a little bit like a cartel, in that people move from one of the large firms to another. You would like to see more churn, but in reality it is quite difficult because of the substantial numbers of mergers of accountancy firms that there have been over the last 20 or so years.

Q793 Teresa Pearce: I would like to take you through some of the evidence that Neville Richardson gave us, but just before that: KPMG are your auditors, but do you buy in accountancy or tax planning advice from any other firm?

Reverend Flowers: A considerable number of other firms.

Q794 Teresa Pearce: Would they have been involved in that advice at all on the merger or on the acquisition, or would it just have been your auditors?

Reverend Flowers: No, first of all, there was a report from Deloitte. That was a substantial piece of work, which was the first piece of due diligence done for the group board about the potential acquisition of Britannia. It was a very lengthy and detailed report looking at the likely position should there be a merger. There was then subsequent official due diligence work done by KPMG. In addition, to my certain knowledge, we have employed PricewaterhouseCoopers in recent years as well.

Q795 Teresa Pearce: Thank you. As you are aware, Neville Richardson gave evidence to this Committee, and I would like to run past you a few of the things he said. One of the things he said was that it was you who was very keen on the Verde bid. Is that your recollection?

Reverend Flowers: Mm?

Teresa Pearce: Yes, you, and that you wanted to pursue the transaction strongly.

Reverend Flowers: No, I think that is unfair. I believe that the role of the chair is to encourage other people to speak, and that was what I sought to do from the chair in the meeting. As it happens, at the end of the process, I was certainly supportive of the bid but no more so than any other member of the board was supportive. Indeed, there was a unanimous vote of the group board to support the process of going through Verde as well. So, yes, I supported it, but I was not the person who was pushing it.

Q796 Teresa Pearce: Thank you. He also told us that the decision to bid was driven by the group, rather than the bank, and that the bank executives were sceptical. Is that your recollection?

Reverend Flowers: No, it is not.

Q797 Teresa Pearce: What Mr Richardson said to us is that it is his view that it was the case of the group’s view trumping the bank’s view.

Reverend Flowers: No, I think that is grossly unfair. The board, which had to run and deal with all the detail, and certainly went through all the iterations of a different potential deal, into the spring of this year,
Q798 Teresa Pearce: Yes, it does answer the question. Mr Richardson said that he was concerned that his views were not heard or accepted and that he needed to bring the matter to a head, and he did that on 10 July 2011 in a telephone conversation with you. Do you remember that conversation?
Reverend Flowers: I do indeed. I do.

Q799 Teresa Pearce: Did you accept any of the concerns he raised, or were you completely at odds?
Reverend Flowers: It was my duty to listen and to accept his concern, and it is important to state that I shared that concern with my two deputy chairs—that Neville, although offered considerable support and opportunity for advancement within the organisation as a whole, did not really want to work in any way at all to somebody else. He always wanted to be his own boss. It is my judgment that that was what was behind the comments that he made. I think it is fair to say that the regulator was consulted at every point about Project Verde, and supported the fact that the bank and the other businesses clearly needed to reduce costs, and that shared back office functions was not at all a problem as far as the regulator was concerned.

Q800 Teresa Pearce: Yes, please do.
Reverend Flowers: Cotermiously with the initial discussions about Verde, the whole organisation was going through a process known as Project Unity. This was specifically to try to make certain that the different businesses within the Co-operative Group spoke to each other and worked together corporately. One of the very real problems that we had for decades was businesses operating in what I would call silos, where there was very little real communication between the different businesses that were part of the Co-operative Group as a whole. Part of the problem with that is that there was also considerable duplication of functions, and very little of anyone saying, “This is just plain crazy, and you should get rid of this duplication and have common back office functions especially across the whole organisation, which can then be seen to be much more rational”. It was partly about saving costs, but I would remind you and the Committee that one of the problems that Co-operative Bank has had for a considerable period of time is that the cost-income ratio of the bank is extremely high and we needed to bring down costs. My successors are now grappling with that issue as we speak. Therefore, Project Unity was specifically about trying to make certain that costs were reduced and that businesses related more effectively to each other.

Q801 Teresa Pearce: Mr Richardson stated that he stepped down as chief executive of the Co-op Bank because, “The board and the CEO of the Co-operative Group and the CEO of the Co-op Bank at that time did not accept my warnings and were determined to press ahead”. Are you saying that his disquiet was not particularly about Project Verde, it was about Project Unity?
Reverend Flowers: Forgive me, I know that it was. The month before, he and I had been on an official visit to China, where we had a number of commercial interests at the time. I recall spending a particularly sunny afternoon in my hotel room in Shanghai with Mr Richardson, and the only sustenance that we had between us was half a bottle of white wine, and having a very long discussion about all of these issues. I know, from that very long discussion with him, that the actual import of the matter was about whether or not he would be top dog.

Q802 Teresa Pearce: Did you try to persuade him to stay and not resign?
Reverend Flowers: No.

Q803 Mr McFadden: I would like to take you back to the issue that John Mann and the chairman asked you about a few minutes ago. You said to us that there was political encouragement for Co-op expansion from both Governments and several political parties. You also said that in relation to Mr Balls and Mr Hoban, these were not quite the same thing. Can you tell us what you meant by that?
Reverend Flowers: Of course I can. Specifically in relation to Ed Balls, he had the responsibility within his office as Chief Secretary to the Treasury—
Q804 Mr McFadden: He was not Chief Secretary. Reverend Flowers: Forgive me. However, my recollection is that he had to present some legislation to Parliament, which came out of the Private Member’s Bill. In other words, a Minister has to lay a paper.

Q805 Mr McFadden: He was responsible for the legislation that allowed you to do this. Reverend Flowers: Precisely. Well, no, the legislation was a Private Member’s Bill, which had been given a clear steer by Government. It had been given time. Subsequently, when it became an Act, he then had legal responsibility for making certain that certain legislation was tabled in Parliament to enable the process to occur. Therefore, you could judge that his role was neutral, in that, although he clearly supported it, he was doing his job as a Minister. I hope that makes sense. I believe Mr Hoban was encouraging the process on behalf of the Government, on behalf of the Treasury. I could make no other interpretation of the cause than that.

Q806 Mr McFadden: When you say “encouraging the process”, you mean Project Verde? Reverend Flowers: Yes, indeed.

Q807 Mr McFadden: Let me put it this way. The competition to the Co-op, in relation to Project Verde, NBNK, has alleged that there was Treasury favouritism or political favouritism towards the Co-op as being a preferred bidder in this deal. Is that what you felt? Reverend Flowers: Not at all, sir. I am sure that the esteemed former chair of this Committee, who was a director of NBNK, and his colleagues believe that. Nonetheless, if you look at the rigour that is within the Vickers Report in terms of the scale of a challenger bank that would be able to take on the others, and which would be encouraged in the Vickers Report, we were looking at a challenger bank that would have somewhere between 6% and 7% of market share. We were also looking at a bank that already had a banking licence and already had a range of branches across the country; in our case, over 340. The problem for NBNK is that, although it was able to attract capital from a range of City institutions, it had none of the other things. It had no scale, because it did not have any bank at all, and it certainly did not have a banking licence, and it did not satisfy the criteria that were part of the Vickers Report recommendations on what ought to be the case for a challenger bank. Those are the main issues that NBNK has to answer.

Q808 Mr McFadden: But you have told us today that Mr Hoban encouraged the process, encouraged the deal. Reverend Flowers: I did, and I believe he did. He did not interfere with the deal—I have tried to make that clear—but he wanted to be informed of progress and was regularly in contact with us about that.

Q809 Mr McFadden: Did he want the Verde deal to happen with someone, or did he want it to happen with the Co-op? Reverend Flowers: With respect, I think you would have to ask him that question. He gave us the impression that he would like it to happen with the Co-op.

Q810 Mr McFadden: You also mentioned Mr Cable. Can you tell us what Mr Cable’s involvement in this was? Reverend Flowers: I cannot tell you that there was any obvious conversation with anybody that I know of, but we were informed that the Secretary of State for Business wanted the whole thing to succeed.


Q812 Mr McFadden: Can you tell us who they were? Reverend Flowers: Not at this time, no.

Q813 Chair: Why not? Reverend Flowers: Because I think it would breach some confidentiality. However—

Q814 Chair: This is a parliamentary inquiry— Reverend Flowers: I accept that. Chair:—into, among other things, that question, so we would like an answer, please, Mr Flowers. Reverend Flowers: I am now trying to recall precisely who those Members of Parliament were.

Q815 Chair: So it is not the confidentiality point; it is that you cannot remember? Reverend Flowers: It is precisely that, sir.

Chair: Okay, well then we will go back to Pat McFadden.

Q816 Mr McFadden: Reverend Flowers, other witnesses from various parts of the Co-op Bank and Co-operative Group have been asked by this Committee in recent weeks, “Was there any political interference in the Verde deal?” They all said no. You are giving a very different account to us. Could you explain that?

Reverend Flowers: No, sir, forgive me, I am not giving you a different account. I have made it clear that I do not believe there was political interference, nor do I believe there was political pressure. I believe there was political goodwill for a deal to succeed, and I think there is a very distinct difference between a steer and a goodwill that something should happen and any improper interference. There was none of the latter.

Q817 Mr McFadden: Thank you. So, you would characterise this as encouragement, best wishes, but not pressure or interference? Reverend Flowers: Yes.

Q818 Mr McFadden: Can I turn slightly to another subject, which is the process by which the deal
unravelled and the Co-op reached the conclusion this was not going to fly? Lloyds told us that in December 2012 they realised there was a problem with capital at the Co-op. Can you tell us the time scale of when the Co-op decided this deal could not fly?

Reverend Flowers: I think it is important to say that the deal went through about six different major changes between the beginning of the process and the end of the process, and the deal that was on offer at the end was substantially different from the one that was on offer at the very beginning. We had been discussing the issue of capital adequacy for the standalone bank, regardless of whether it was to merge with the Verde operation, from 2011 in particular. We set up a board sub-committee, looking specifically at issues of capital, which was to report to the board every single month.

Q819 Mr McFadden: A bank board sub-committee reporting to the bank board?

Reverend Flowers: A bank board sub-committee reporting to the bank board, specifically about capital, and that used to meet very regularly and report to the bank board for the whole of 2012, especially after we had received a letter from the FSA in December 2011 addressed to me. The issue was about capital adequacy and the ways in which we would seek to address that need to have further capital. You will know that one of the things we had already decided was to sell the life insurance and asset management business, which has at last been transferred to Royal London. If at all possible, we wanted to have a solution that would enable the thing to go to another mutual and that is what we secured. We had on the books and were discussing in detail the sale of the general insurance business. I think that there were other internal political reasons why that was more fraught, because the group board would have been more chary of the sale of such a business, having just sold the life insurance business. Nonetheless, that was on the list as were a range of other options. It is also important to say that at the same time we were also engaged in a huge amount of lobbying to try to get the law changed, specifically to enable mutuals like ourselves to be able to raise capital in a way that is similar to our mutual comparators, particularly in the European Union.

Q820 Mr McFadden: Who were you lobbying?

Reverend Flowers: We were lobbying, first of all, internally, in this House and that was predominantly with our colleagues, with the Building Societies Association. Also we were lobbying through the aegis of the European Association of Co-operative Banks because the European Parliament and Council were also discussing appropriate legislation, which is still in process.

Q821 Mr McFadden: I want to bring you back to this Verde decision. What I am interested in is that Neville Richardson leaves in the summer of 2011 as the bid is being formed. He has told us that the reason he left is because, “It was the right deal at the wrong time”. He did not want to go ahead with it. After he leaves, is the bank board completely signed up to the Verde deal until April 2013, or are there other people on that board who are doubtful about it?

Reverend Flowers: There are some who had become doubtful about it, as I believe I indicated earlier, as part of process. There is one other thing to add, and that is that it is important to recall that a substantial part of the discussion about Verde with Lloyds was also about the injection of a substantial amount of capital from Lloyds into the newly created bank, should that have occurred.

Q822 Mr McFadden: Did the bank board take a vote on the Verde deal, or were there votes between Neville Richardson’s departure and the decision to cool the deal?

Reverend Flowers: The bank board took a vote on whether to go into the Verde deal in the first place.

Q823 Mr McFadden: Was that vote unanimous?

Reverend Flowers: No.

Q824 Mr McFadden: So the board were divided?

Reverend Flowers: There were two votes against.

Q825 Mr McFadden: Two votes against, out of how many?

Reverend Flowers: Out of 15.

Q826 Mr McFadden: Fifteen. Were there subsequent votes after that initial 13:2 split?

Reverend Flowers: No. It is a very difficult area, but it was my judgment as chair that to have taken votes at particular points in the process might have been premature, and that we should allow the process to continue to a natural conclusion, and then for the board to take a decision one way or the other, and that is what we did. The final vote was unanimously against.

Q827 Mr McFadden: So, between that 13:2 initial vote in favour and the final vote unanimously against, were there any other votes along the way?

Reverend Flowers: Not about the process, no.

Q828 Chair: You have said that there was no political pressure placed upon you with respect to the Verde deal. That question was also asked of Peter Marks and he replied similarly. He said, “None that I am aware of”. When these telephone conversations and meetings were taking place between you and Mark Hoban—

Reverend Flowers: Not between me and Mr Hoban.

Q829 Chair: Between who?

Reverend Flowers: Mr Hoban and Mr Marks.

Q830 Chair: I see. So when he said, “None that I am aware of” he was being a little bit economical with the truth, was he not?

Reverend Flowers: I do not know what Mr Marks said to you about a conversation with Mr Hoban.

Q831 Chair: You have not looked at the transcript?

Reverend Flowers: Not only have I looked at the transcript, I looked at the television—
Chair: So you do know, I mean you must know. I will read you what it says:

The question is, “tell us whether, in your experience, any political pressure was brought to bear to encourage the Co-op to bid for the Lloyds branches”. The reply from Peter Marks was, “None that I am aware of”.

Reverend Flowers: That is his interpretation of it and it is correct in that there was no pressure.

Q832 Chair: All right. So, I am now asking you, was he economical with the truth? Bearing in mind you are now telling us that there were heaps of telephone conversations, things that you described elsewhere as “lovely” conversations, “nice” conversations, “interesting” conversations and that when politicians ring you, you take notice.

Reverend Flowers: I think your question was about whether Mr Marks was economical with the truth, and my belief is that he was not being economical with the truth. He told you what he believed was the truth. That he had had no interference from any politician.

Q833 Chair: Then why then have you felt the need to tell us so much about these telephone conversations that are of so little consequence? Clearly, if somebody asks you, “Was any political pressure brought to bear?” the logical thing to do, if you think this is relevant, is to say, “Well, perhaps not pressure but there were a good number of telephone conversations”.

Reverend Flowers: With respect, that is what I thought I had said.

Q834 Chair: Yes, it is what you said. But it is not what Mr Marks said and I am asking you whether you think he was economical with the truth.

Reverend Flowers: I am not answerable for Mr Marks, sir.

Q835 Chair: I am asking you whether you think he was economical with the truth since he had all these contacts.

Reverend Flowers: With respect, I have already replied to that and I have said that I do not believe that he was.

Q836 Mr Newmark: I want to go back to the beginning of this meeting, with respect to the competency of the board and how much you ended up having to rely on outside advice as opposed to using your own judgment and the balance of that. You said yourself to the Chairman at the beginning of this meeting that you lacked the expertise and qualifications to make a real judgment call on the finance of the business. You were there to provide other sorts of judgments. It has been said that the Co-op Group board lacked banking expertise and experience at the time that the Co-op submitted its initial Verde bid. Would you agree that the same would apply to the rest of the Co-op board, or not?

Reverend Flowers: Are you talking about the group board or the bank board?

Mr Newmark: The group.

Reverend Flowers: In my experience of it, the group board has to rely considerably upon the advice of its own senior executives in coming to a judgment about matters before it. After sitting on that board for several years, however, I would argue that the level of debate is often extremely robust and that lay people are not necessarily conned or cowed into taking a view that some experienced person believes they ought to take. Very often they will raise questions that some of those people would least expect to hear.

Q837 Mr Newmark: At the end of the day, where this bank in particular would succeed or fail was based on having a good grip on the numbers, the balance sheet, the income statements and so on—

Reverend Flowers: Forgive me; there is a danger of confusing the roles of the group board and the bank board. The group board was not responsible for the day-to-day management of the bank. If it had been, then the group board directors would have been declared shadow directors by the FSA and would have been seen to be interfering in the running of the bank. The bank board had the ring-fenced function of running the bank and making certain that questions were raised.

Q838 Mr Newmark: Right. But the group board has to make certain judgment calls with respect to the businesses it is responsible for. You had a bank as part of that group. So, do you think it is appropriate for the board of a non-financial company, lacking in banking expertise, to involve itself in the affairs of a banking subsidiary, notwithstanding obviously, not falling into the trap of being shadow directors?

Reverend Flowers: For over 150 years it worked.

Q839 Mr Newmark: Why do you think it worked and why do you think it did not work this time?

Reverend Flowers: I think we are rehearsing some of the issues that we faced in recent years. It has not worked because the Britannia merger gave us a corporate lending book that seriously deteriorated as the economy deteriorated and that there were particular problems with much of that book. Nonetheless, we have seen a process that included considerable debate on the bank board about whether or not there should be what is called resolution, which would effectively have meant handing the keys over to the Government and the Bank of England and saying, “There it is. You get on with it”. We did not do that either. What actually happened is that, although there has been a crisis, the bank is still operating—in a very different form, but it is still operating—and it has not needed fiscal support from the Government or the taxpayer in order to do that.

Q840 Mr Newmark: If I differentiate between acquiring a far more complex business and buying a business that ultimately proved to be holed below the waterline, your argument seems to be, “We were not necessarily buying into a complex business, it was that it was holed below the waterline and we just did not see that”.

Reverend Flowers: You are correct.
Q841 Mr Newmark: In its report into the failure of HBOS, the Parliamentary Commission on Banking Standards stated that the board of HBOS lacked the expertise or experience to identify many of the core risks that the bank was running. Given that you guys perhaps did not have the expertise or competency to ask the right questions, do you think there are lessons to be learned for the Co-operative Group in this statement?

Reverend Flowers: I would challenge the question, first of all, because we did have at least six or seven experienced bankers on the bank board. Those people were appointed after a process where we consulted the regulator about their appointment, and the regulator was always comfortable with the nature of the people that we were bringing on to the board. So I would challenge that we did not have some experienced people who were bankers around the table.

Q842 Mr Newmark: So when did you do this acquisition?

Reverend Flowers: Which acquisition, forgive me?

Mr Newmark: When you looked into the Verde situation, or Britannia, did you think some good questions were being asked that would have helped identify the risk, or from your memory were the questions that should have been asked not asked?

Reverend Flowers: The former. I know that we completely rejigged the board meetings to make certain that substantive items of business and of principle should always come first and, therefore, should take the dominant part of each meeting. I am also aware that my role was to make certain that those who had considerable experience of those matters should be encouraged to speak about them and to raise questions in the meetings. The minutes will record that that is precisely what happened.

Q843 Mr Newmark: If I switch my target slightly from the board, who you seem fairly satisfied with, how about your advisers: do you think you were well advised by KPMG and your bankers at that time, given what ultimately happened?

Reverend Flowers: Are you talking specifically now about Verde?

Mr Newmark: Yes.

Reverend Flowers: We had other advisers as well as KPMG. You have to take people at face value, hear what they say to you, do your best to question the evidence they are bringing to you and question their judgment about what they are saying.

Q844 Mr Newmark: It is not judgment. KPMG’s job is to drill down into the numbers and you pay them lots and lots of money to do this.

Reverend Flowers: We do.

Q845 Mr Newmark: Given what subsequently happened, do you feel that in many ways the board was let down by its advisers?

Reverend Flowers: No, the board is ultimately responsible for its own decisions and that is why I take responsibility for what we decided.

Q846 Mr Newmark: I appreciate you falling on your sword but I am trying to understand because it raises a wider question, particularly with KPMG with other institutions that it was advising. With the benefit of hindsight, do you think that they really did a proper job in drilling down and understanding what it was they were advising you, as an institution, to get involved in, given how it holed you guys below the water?

Reverend Flowers: I think it is important that I tell you that, at a significant point in the discussions about Verde—about three months before we finally decided not to proceed—I asked for a private meeting with three of the senior representatives of KPMG. It is invidious to try to place your auditors in a position where they would express a judgment that would contrast with their role as auditor, but I what I was trying to do was to drill down myself and see whether or not they believed that we should proceed with the deal.

I came away from a very long meeting with those three representatives of KPMG persuaded that they were clearly of the mind that it would be deleterious—very bad—for us to proceed with the deal, and I believe that that was helpful. So my judgment is that, both publicly and privately, KPMG were doing their best to be helpful.

Chair: I have three more colleagues who want to come in and we have already been going on for an hour and three quarters. I will encourage colleagues to keep going rather than take a break. That is the option before us.

Q847 Mark Garnier: If I can I take you back to the Project Verde deal, back in particular to the conversations that were had between Lloyds Bank and the Co-op Bank in December 2012. Were you familiar with those conversations?

Reverend Flowers: Yes. But not all the time.

Q848 Mark Garnier: So he was part of that team.

Reverend Flowers: We had a specific team that worked on those.

Q849 Mark Garnier: Do you remember who was on that team?

Reverend Flowers: Yes. It was led by Rod Bulmer, who was senior executive within the bank. The other person who entered into those discussions from time-to-time was Peter Marks.

Q850 Mark Garnier: So he was part of that team.

Reverend Flowers: Yes. But not all the time.

Q851 Mark Garnier: No, but if he was not there, he would have been aware of what was going on.

Reverend Flowers: Absolutely, and he often had particular meetings with António Horta-Osório.

Mark Garnier: The chief executive of Lloyds Bank.

Reverend Flowers: Yes.

Q852 Mark Garnier: At that time, did either Rob Bulmer or Peter Marks raise with you this
conversation that António Horta-Osório has mentioned that took place in December 2012?

Reverend Flowers: No.

Q853 Mark Garnier: Why do you think they did not?

Reverend Flowers: Forgive me; it is one of those questions that if you start with a negative it is very difficult to know why someone has not asked you something.

Q854 Mark Garnier: Fair enough. I will rephrase the question. When António Horta-Osório came to see us, he made a big play of this conversation that was had between Lloyds and Co-op in December 2012. We are told that at that point he raised very serious doubts as to whether this deal was going to go ahead. This is something that clearly Co-op was very keen to do. We have seen a little bit—well, quite a lot—of corporate amnesia going on between Barry Tootell, Peter Marks, about this particular conversation. While it seems that Lloyds Bank could not have been clearer about the fact that they very specifically raised this point, that they felt that Co-op was not in a position to be able to go ahead with Project Verde, nobody at Co-op seems to have had the slightest idea that this was going on. As chairman, what would you say to that extraordinary revelation and the apparent corporate amnesia?

Reverend Flowers: I hope I can try to address it. The conversations—whether that specific conversation or generic conversations at any point—were always reported to each subsequent board meeting.

Q855 Mark Garnier: How frequent were the board meetings?

Reverend Flowers: Every month.

Q856 Mark Garnier: What period of the month, the end or the beginning?

Reverend Flowers: It varied but it was normally the middle of the month, so we would be talking about the middle of January in this particular case. There were always reports back about the conversations.

Q857 Mark Garnier: Let me just be clear, it would have been perfectly acceptable that a conversation between the vendor of Project Verde, and the purchaser—being you guys—that this deal may be off, could wait up to four weeks before anybody brings it up?

Reverend Flowers: No, that would not be acceptable and I would have viewed it as utterly unacceptable.

Q858 Mark Garnier: So did you hear at that board meeting in the middle of January that there had been a conversation between António Horta-Osório and your project management team?

Reverend Flowers: Yes, and because the teams continued to meet there was further discussion about the possibility of whether or not a different sort of deal could be struck.

Q859 Mark Garnier: The starting point was Lloyds had come to Co-op to say, “The deal looks pretty dodgy”. That was the starting point of the report back to the board. Were you happy that that took up to four weeks to get to you?

Reverend Flowers: No.

Q860 Chair: What did you say at that meeting? Give me a sense of your tone. Give me a sense of your pleasure or displeasure when you heard this news that, before Christmas, the chief executive of one of the largest banking groups in the UK had come along to say that they thought your bank that you were in charge of was not solvent, or had a question mark over its solvency to the point where they felt they could not go ahead with the sale of 650 branches to you guys, and it had taken—well, you had presumably gone off and celebrated Christmas and New Year, got over the hangover and got back to work and everybody had got their feet back under the desk, and it was two weeks—

Reverend Flowers: Actually I was working through Christmas.

Mark Garnier: Many of us do. But two weeks into the new year—assuming you have your meetings around the 15th of the month—you were told that this major revelation had been presented before Christmas to the bank that you ran. So give us a bit of a sense, just a general sort of idea, of your frame of mind when you were told that Lloyds Banking Group were accusing you of running an organisation that was about to go bust.

Reverend Flowers: Forgive me; I fear that in a similar way to Mr Tootell last week, I cannot recall precisely the conversations I had in January. All I do know is that the issues were discussed, and that we particularly discussed the likelihood of whether or not we should continue in discussion with them and whether another sort of deal was achievable.

Q861 Mark Garnier: Can you elaborate on those discussions?

Reverend Flowers: In the course of the year we went through something like six different processes.

Q862 Mark Garnier: What about in January, which I am particularly interested in? The whole point about this conversation that António Horta-Osório raised to us is that this is the number one flag. This was the point at which the, “We think this is going to fail” flag was run up the proverbial flagpole and we are getting absolutely no sense at all—

Reverend Flowers: Forgive me, but my recollection is that one of the issues that were discussed was whether or not Lloyds would be able to enhance the amount of capital it put into the deal. That was part of the discussion in the early part of 2012.

Q863 Mark Garnier: So, three or four weeks after the initial problem had been raised and the first point at which you were told about it?

Reverend Flowers: Yes.

Q864 Mark Garnier: At no point had the chairman of the bank been told that a counterparty to a pretty substantial transaction felt that you guys were in financial trouble?
Reverend Flowers: I believe that what Lloyds were saying was a reiteration of a letter sent from the regulator that had been sent in December, which was specifically about a range of issues that the regulator had, where we had been specifically asked to inform Lloyds about those issues, one of which, as you heard in detail last week, was about capital—

Q865 Mark Garnier: Can you start on that again? There was a letter that was sent by the regulator to you? I want to make sure I have got this right.

Reverend Flowers: In December.

Q866 Mark Garnier: In December 2012?

Reverend Flowers: 2011.

Mark Garnier: Yes, but we are talking about 2012 so this is a year earlier.

Reverend Flowers: I thought you were talking about the beginning of 2012.

Q867 Mark Garnier: I was talking about the conversation António Horta-Osório had in December 2012 in which they raised the problem. Sorry, you are quite right, there was a letter at the end of 2011 when Andrew Bailey airs his concerns. But I am talking about this whole business of the António Horta-Osório conversation with your project management board— as you have described it—at the end of 2012, which you then did not hear anything about until the beginning of 2013.

Reverend Flowers: I believe that is the case.

Q868 Mark Garnier: That is right. I am still trying to get a flavour of what was going on in the management of this organisation that you run.

Reverend Flowers: I tend not to do synthetic anger, sir. I think it is important that when you are chairing a meeting—

Q869 Mark Garnier: You do not have to be synthetically angry to be worried about the management process of a bank that fails to keep you in touch.

Reverend Flowers: I accept that, but that is about trying to then deal in the board with the actual issues before you and trying to make certain that you address those issues.

Q870 Mark Garnier: Part of those issues are management communication issues, are they not?

Reverend Flowers: Yes, indeed.

Q871 Mark Garnier: How did you tackle this management communication issue? Nearly a full month went by before the chairman of a bank was told that a counterparty to a major transaction—

Reverend Flowers: I do not think it was a full month.

Q872 Mark Garnier: All right, three weeks. If it was more than a few minutes or a few hours, it would be worrying and I am sure you would agree.

Reverend Flowers: I do.

Q873 Mark Garnier: So what discussions happened about the management processes within your organisation that withheld critical information about the stability of your institution for more than a few days?

Reverend Flowers: Forgive me, I do not recall any such discussion and that was probably because I was at fault.

Q874 Mark Garnier: Why not?

Reverend Flowers: I should have done so but I did not.

Q875 Mark Garnier: Is it minuted?

Reverend Flowers: What is minuted is the discussion in the board about the issues themselves and the way in which we then addressed them in the board.

Q876 Mark Garnier: There is a bit more to go; we have a few other issues. There is a bit of a timeline of amnesia and it is a rather interesting management style. So in July 2011, Andrew Bailey visits Co-op Bank board dinner—

Reverend Flowers: At my invitation.

Mark Garnier:—at your invitation, and questions the Co-op’s ability to take on Verde. Do you remember that?

Reverend Flowers: I do.

Q877 Mark Garnier: How did that go?

Reverend Flowers: What Mr Bailey was doing was putting down a marker about the particular hurdles that we would have to overcome should we get the FSA’s support for a potential deal. He was doing his job.

Q878 Mark Garnier: This would have been general sort of chitchat. There is nothing menacing about this type of conversation at all.

Reverend Flowers: No, it was not menacing but it was certainly rigorous.

Q879 Mark Garnier: I appreciate that. But there was nothing threatening coming out of it. No bad news or anything like that.

Reverend Flowers: Not at all.

Q880 Mark Garnier: This was mentioned to us by Neville Richardson, not remembered at all by Peter Marks. You also mentioned that, “At the tail end of 2011, Andrew Bailey airs concerns to Co-op Bank that it will not be able to transform itself sustainably into an organisation on the scale that would result from Verde”.

Reverend Flowers: Yes.

Q881 Mark Garnier: This is the letter, “Andrew Bailey asks Co-op Bank to make his concerns known to Lloyds” and you did that, yes?

Reverend Flowers: I believe so.

Q882 Mark Garnier: Again, can you remember what happened within the management at the time? There was a lot of effort put in to that. Can you give—

Reverend Flowers: Forgive me; this is all part of a regular process where all these issues are debated.
every single month in the board meeting. This is an
overriding concern from the regulator about a range
of issues that we had to treat with great seriousness.
Therefore, the team seeking to do the deal had to be
supported in looking at those discrete issues and
advise the board on whether or not we were likely to
achieve a potential deal and whether, therefore, we
could make certain that the issues raised by the FSA
could be addressed.

Q883 Mark Garnier: At the beginning of this
session, the Chairman asked you if you could
remember anything about the Parliamentary
Commission on Banking Standards and the report.
You said you could not remember anything about it.
Has anything come back into your mind at all since
we have been talking over the last hour and 45
minutes?
Reverend Flowers: I fear that my mind has been
preoccupied by a number of other things in the last
hour and a half, so, no, I cannot.
Mark Garnier: You cannot. No, that is fair enough.
Reverend Flowers: Forgive me. I do remember
reading the report a long time ago.

Q884 Mark Garnier: When you say “a long time
ago”, how long ago do you think? I just wonder if you
are not confusing it with something else. When do
you think it came out?
Reverend Flowers: I believe it came out in 2010.

Q885 Mark Garnier: No, we are at cross-purposes.
If you remember, this is a report that was
commissioned by the Chancellor of the Exchequer last
year, as a result of the LIBOR scandals, and comes—
Reverend Flowers: Then we are talking at cross-
purposes about different things.

Q886 Mark Garnier: We are talking at cross-
purposes. It is quite an important report. I was on it
myself, along with the Chairman and one or two other
members of this Committee. It was a very well-
crafted report—
Reverend Flowers: Of course.
Mark Garnier:—and had a number of very high
profile and very important issues. It was published in
July this year. What is very interesting about this is
it had a great deal of comment to make about the
responsibility of people who run banks. It would have
been very, very relevant to you, particularly in the
light of what has happened. I suggest you go and have
a look at it.
Reverend Flowers: With great respect to you, if it was
published in July this year, that was after I had
resigned as chair of the bank.

Q887 Mark Garnier: So, after you resigned as chair of
the bank, you took no further interest whatsoever
in anything to do with the industry that you had been
running just a few weeks beforehand.
Reverend Flowers: Not entirely. However, when you
have been run through the mill and when you have
gone through a fairly fraught time—as many people
in this room will understand—it is reasonable to take
a rest from the normal arduous issues that you were
dealing with. I am not likely to have any future
engagement in financial services and, although I have
an interest in the matter, I am not going to take the
close interest that I once had to.

Q888 Mark Garnier: Interestingly enough, one of the
things we were very interested in in the
Commission was the contribution that former chief
executives and chairmen of banks could make to the
regulation of future banks. It was something we
discussed and did not necessarily report on.
However, the most high profile publication of this, or
the one that received the most amount of interest by
the media, was the concept of senior bankers taking
responsibility for their actions; a senior persons
regime. This is something that will hopefully be
embedded within the regulation. The key element of
this is that, in the event of failed institution, rather
than the burden of proof being on the regulator to
prove that senior people—such as yourself—who are
in control of these organisations, were responsible for
the collapse, it assumes a reversal of that burden of
proof where people, such as yourself, effectively
would have to prove that they were not responsible
for the collapse of that institution. What would you
say to that?
Reverend Flowers: I would say what I said earlier,
that the institution has not collapsed. It has gone
through considerable—

Q889 Mark Garnier: It has had to be bailed out. I
think most people would define that as a collapse.
Reverend Flowers: Forgive me, sir, it has not had to
be bailed out. It has found capital from other sources
to enable it to survive. It has not required a bailout
from public funds.

Q890 Mark Garnier: It has required a bailout from
private funds.
Reverend Flowers: And indeed it has got them, which
is how the market operates.

Q891 Mark Garnier: There are quite a lot of very
worried people who have been bondholders. Less so
now, but they have been very worried as I think
probably everybody round this table has been—with
the exception perhaps of the clerk—who would have
received communications from these bondholders
who were extremely worried that they were being
asked to bail out this institution that you ran.
Reverend Flowers: I want to draw a line if I may
between what happened when I was the chair and
what happened after. I ceased being the chair at the
very beginning of June. The issue of the bailout from
hedge funds and others, and the issue of what
happened with bondholders were not on my watch. I
had resigned before then. I might have a view about
the matter but it was not a view that I had to have
as chair.

Q892 Mark Garnier: But you were running the
institution as it steamed on to some sort of rock.
Reverend Flowers: Forgive me, I was the chair of the
bank board and we all had responsibility. I have told
you that I take responsibility for what happened on my watch.

Q933 Mark Garnier: So, had the recommendations of the Banking Commission been in place, you would not have contested that you were culpable.
Reverend Flowers: Forgive me; I cannot answer a hypothetical question.

Q934 Mark Garnier: But you take responsibility for what happened at the bank.
Reverend Flowers: I did take responsibility. I resigned. That seemed to me to be the right thing to do.

Q935 Chair: You have said you do not intend to take any further engagements in financial services businesses. Do you consider yourself a fit and proper person to run a bank?
Reverend Flowers: I do, and so did the regulator and so did my peers within the Co-operative Group.

Q936 Chair: That is then. I am talking about now, now we know what happened.
Reverend Flowers: I still do. However, we all come to an age when we want to retire from things and I am at that age.

Q937 Chair: All right. This is a business that has lost—do you know what it has lost in IT?
Reverend Flowers: In the last year’s figures about £250 million.

Q938 Chair: About £300 million. Do you know what it has lost in PPI mis-selling?
Reverend Flowers: The figure keeps on going up. It is now round about £300 million.

Q939 Chair: Do you know what the loan loss impairments are?
Reverend Flowers: I think we went through that earlier on. They were round about £800 million.

Q940 Chair: Two-thirds of these losses are not related to Britannia, are they? They are related to what was going on in the Co-op that you were running independently of that deal.
Reverend Flowers: Forgive me; are you talking about PPI in particular?

Q941 Chair: All three.
Reverend Flowers: PPI was something that used to occur but never occurred while I was chair of the bank, nor was I ever a director of the bank that sold PPI.

Q942 Chair: No PPI was mis-sold under your chairmanship?
Reverend Flowers: No, not at all.

Q943 Chair: None at all?
Reverend Flowers: None at all.

Q944 Chair: It was all sold prior to or after you left. Since you left in July that means prior to.
Reverend Flowers: Forgive me; it certainly will not have happened after I had left because no bank in its right mind would ever sell PPI these days.

Q939 Chair: We have no PPI on your books for which you feel in any way responsible?
Reverend Flowers: I take corporate responsibility with my colleagues for something that the bank did. It happened before I became the chair. Nonetheless, it happened and all banks are culpable of that mis-selling.

Chair: We might come back to it in a moment.

Q945 Mr Ruffley: Reverend Flowers, looking at your CV before I heard your evidence I thought you probably knew too much about God and virtually nothing about mammon. But you are someone who is very political, are you not, Reverend Flowers? You say in your CV that you have been an active member of the Labour Party since you were 16, and it is on your evidence on politicians that I now wish to turn. The Britannia deal and your reference to Mr Balls; just on a point of clarification, do you agree with Neville Richardson and Andrew Bailey, who in evidence to this Committee suggested approximately £550 million of the non-core corporate loan impairment in the group arises from Britannia-originated assets? Does that sound about right?
Reverend Flowers: Yes.

Q946 Mr Ruffley: That is about right. That deal was not very good, with hindsight, was it?
Reverend Flowers: I think—

Mr Ruffley: A “yes” or “no”, was it good or bad?
Reverend Flowers: My view is that at the time it was the right deal.

Q947 Mr Ruffley: At the time it was the right deal. You talked about Ed Balls and I wrote down what you said. You said you had meetings in spring 2009. Let us remind ourselves. August 2009 is when the acquisition was completed. Then I think you are getting your dates muddled because you talk about the Private Member’s Bill. That was passed in 2008.
Reverend Flowers: No, I am not getting my dates confused, sir.

Q948 Mr Ruffley: Okay. I will ask you this question. How many times did you meet Ed Balls?
Reverend Flowers: I did not meet Mr Balls at all.

Q949 Mr Ruffley: You did not meet him at all. You thought he was supportive.
Reverend Flowers: I was not on the bank board at that time, sir.

Q950 Mr Ruffley: You were not a director?
Reverend Flowers: Of the bank board, no.

Q951 Mr Ruffley: When did you become a director in 2009?
Reverend Flowers: My recollection is that it was about May or June.
Q913 Mr Ruffley: May or June, and the deal was August 2009. 
Reverend Flowers: Yes. 
Mr Ruffley: So you were on the board at the time the deal went through, Reverend Flowers? 
Reverend Flowers: If my memory is correct in terms of timing, yes. But your question was about—

Q914 Mr Ruffley: No, hang on. August 2009, and you were the director in what month? It was before August 2009, we know that, Reverend Flowers. 
Reverend Flowers: Forgive me; I was a member of the group board at that stage. I now cannot precisely remember the month I went onto the bank board.

Q915 Mr Ruffley: You were. 
Reverend Flowers: Okay, then I was. 
Mr Ruffley: You were a director of the bank. 
Reverend Flowers: Okay.

Q916 Mr Ruffley: You mentioned Ed Balls in connection with the Britannia acquisition. 
Reverend Flowers: I tried to express what I believed his role was. That was specifically to facilitate the passage of some parliamentary process.

Q917 Mr Ruffley: Who told you about Mr Balls and his interest in the Britannia deal? 
Reverend Flowers: Forgive me; there was no interest in the Britannia deal save the official role he had to have.

Q918 Mr Ruffley: How did you find out about Mr Balls’ involvement? 
Reverend Flowers: It was a matter of common knowledge in conversation.

Q919 Mr Ruffley: It was a matter of common knowledge. But you did not take any phone calls from Mr Balls in relation to— 
Reverend Flowers: No, I was a very lowly director, sir.

Q920 Mr Ruffley: You were indeed a director. I am glad you could remember that at least. Did you speak to Mr Balls after the Britannia takeover on any aspect of Co-op banking? 
Reverend Flowers: No.

Q921 Mr Ruffley: None at all? You never met him? 
Reverend Flowers: I have met him. 

Q922 Mr Ruffley: Did you discuss on the phone or in person— 
Reverend Flowers: You asked me specifically if I had met him and discussed—

Q923 Mr Ruffley: Let me clarify. Did you meet him or did you speak on the phone to him regarding Co-op banking business? 
Reverend Flowers: I have never spoken on the phone to Mr Balls. I have met Mr Balls. 

Q924 Mr Ruffley: Did you discuss Co-op banking business?

Reverend Flowers: No. We— 
Mr Ruffley: No? Fine. 
Reverend Flowers: No. We mainly met at Labour Party conference functions.

Q925 Mr Ruffley: You did not speak about Co-op banking business. 
Reverend Flowers: No.

Q926 Mr Ruffley: That is fine. I want to clarify. You have given conflicting descriptions when you are talking about the absence of pressure or interference from politicians. I wrote down you have said variously in your evidence “There was no pressure” and then you have also said “no undue pressure”. Being an intelligent man, Reverend Flowers, which is it? Is it no pressure, meaning no pressure at all, or is it no undue pressure? Those are the words the record will show you used. No pressure at all. 
Reverend Flowers: I am trying, Mr Ruffley, to find the semantic distinction between the two.

Q927 Mr Ruffley: No pressure means none at all; no undue pressure means there was no serious undue pressure. 
Reverend Flowers: There was no pressure. 
Mr Ruffley: No pressure. 
Reverend Flowers: There was—

Q928 Chair: Due or undue. That is what you are saying? 
Mr Ruffley: Due or undue. There was zero pressure from politicians. Is that correct, Reverend Flowers? 
Reverend Flowers: Thank you for using my title so elegantly, sir. My understanding is that politicians were supportive of the deal and that—

Q929 Mr Ruffley: You used the words, “Plenty of politicians willing it on” earlier and I am prepared to accept that. Can we just go back? You are a man of the cloth in front of a parliamentary Select Committee, so I think you should answer the question I am going to ask very carefully indeed. When you were asked about the politicians who might have spoken on behalf of Vince Cable, you used the words, “Nods of support from Vince Cable”, and in response to Mr Mann you talked about other MPs. When you were challenged as to their identity you said you could not because of confidentiality. Then when you were challenged, looking very shifty—the average observer might say—you said, “Confidentiality”, you paused nervously, shiftily, and then said you could not recall. Which is it? 
Reverend Flowers: First of all, sir, it is never easy to be in a place where you sit before this august Committee and are questioned in detail about—

Q930 Mr Ruffley: You said it was a matter of confidentiality. 
Reverend Flowers: Forgive me; I am just about to try to answer your question. What I want to indicate is that we were given clear views that Mr Cable was supportive of the deal that we were trying to do. He made many public statements as well.
Q931 Mr Ruffley: We are talking about the identity of the individuals, not Vince Cable.
Reverend Flowers: Yes. I did not have those approaches myself.

Q932 Mr Ruffley: No, listen, you were asked for the names of those individuals, not Vince Cable.
Reverend Flowers: Yes, indeed.

Q933 Mr Ruffley: First of all, you said you could not say because of matters of confidentiality, and then you changed it to say you could not recall. They are two diametrically opposed views that you are expressing. Which is it, Reverend Flowers?
Reverend Flowers: Forgive me; I am trying my best to answer honestly.

Q934 Mr Ruffley: Who were they?
Reverend Flowers: I said to you about two seconds ago that the approaches were made by other people to others within the group. I did not have those approaches directly. It was clear from other statements that Dr Cable has made that he was very supportive of the Co-operative and the endeavour that we were trying to do of taking Verde. Those are matters on the record.
Mr Ruffley: I have that.

Q935 Chair: I would just like to clarify one thing. It is quite understandable that you cannot remember. You might have known once but you do not know now. There is no reason particularly that you should carry words in your head. Now, why did you initially give the reply, “It is confidential”?
Reverend Flowers: I think that was stupid, forgive me.
Chair: David, do you have any more?
Mr Ruffley: I have actually.
Reverend Flowers: My apologies, I had no intention of trying to—
Chair: Okay.

Q936 Mr Ruffley: In response to the Chairman’s questioning on Project Verde, you were giving the suggestion, and you have been very clear throughout your testimony that you think the fact that politicians were involved was quite significant. Otherwise, you would not have bothered to go on about it so much, would you, Reverend Flowers? In connection with the question put to you, “Did it have any influence?” or words to that effect, you said as a throwaway line—and I do not know if you were being stupid at this point—you said, “It could so easily have been the other way round”. What did you mean by that?
Reverend Flowers: I am trying to recall the context in which that question was asked.

Q937 Mr Ruffley: It was in the context of Mr Hogan’s involvement.
Reverend Flowers: It would have been equally possible for Government Ministers and other politicians to have expressed a view that the deal was not a good thing to happen.
Mr Ruffley: Absolutely mad.

Reverend Flowers: Precisely, and that they may have wanted another contender to have done the deal. That was always a possibility.

Q938 Mr Ruffley: Fine. I have one more question. The meeting that has been referenced when Mr Bailey came to see you and he referred to that as a meeting at “the tail-end of 2011”. He talked about several things but he especially talked about capital. Mr Flowers, what I wish to know from you is that when Mr Bailey talks about capital, on behalf of the FSA, what did you ensure happened: firstly, to transmit your action points in relation to capital back to the FSA; and, secondly, what in late 2011 did you transmit by way of information to Lloyds in relation to Bailey’s concerns about capital? The question is in two parts and then that is it.
Reverend Flowers: Indeed, if I can say so, the meeting with Mr Bailey about a range of issues occurred in July 2011.

Q939 Mr Ruffley: I am saying “the tail-end of 2011” are the words that Bailey uses. But, go on, we are talking about the same meeting.
Reverend Flowers: It was in July 2011 when he came to meet with the board and discussed a range of issues that would be game-stoppers if we did not deal with those issues appropriately. Those were reiterated in a letter to me in December 2011, and they were then the subject of a huge amount of debate. It was precisely at that point that specifically in relation to capital, which is the issue that you evince, we set up a special board sub-committee to look specifically at that issue as the prime issue among the others being talked about by the FSA. That was the issue that we continued to discuss with the FSA at monthly and much more regular intervals, in terms of the issues that we thought could be addressed to raise the capital. It was about capital adequacy for the bank going forward, as well as the lobbying that we were engaged in as well.

Q940 Jesse Norman: Thank you very much indeed. Should I call you “Reverend Flowers”?
Reverend Flowers: You may call me what you like, sir. Many people do.
Jesse Norman: Mr Flowers or Reverend?
Reverend Flowers: Whatever you wish, sir.

Q941 Jesse Norman: Reverend Flowers, I want to start from a slightly different point, which is the Rochdale Principles. How important were they to the Co-op when you were there and how important are they or were they to you?
Reverend Flowers: Because you, sir, have had more experience of the co-operative movement than probably many other persons on the Conservative benches, you will understand that the Co-operative Group has those embedded within its DNA. I think that there are occasions when they are honoured more in the breach than in reality. Nonetheless, they undergird everything we say we believe in. I genuinely believe that the group board in particular takes those principles extremely seriously. Whether or not we can remember all of them is another matter entirely.
Q942 Jesse Norman: Including principles of transparency and honesty and all that stuff? Do say yes.
Reverend Flowers: Yes.

Q943 Jesse Norman: I apologise, I was slightly late for this and therefore I might have missed it. Have you told the Committee about your earlier background or experience or qualifications in financial services or banking?
Reverend Flowers: Yes.

Q944 Jesse Norman: Could you just briefly recall? It seems from your CV that you did not come with any, and therefore what you have you picked up while you were there.
Reverend Flowers: No, not entirely. What the Committee heard a little earlier was that I was appointed as chair because my peers and others thought that I had governance skills to bring to the role. As it happens, I had four years working for a bank before I went to university to read theology.

Jesse Norman: You are correct in that.
Reverend Flowers: We had a discussion about the relevance and robustness of—

Q945 Jesse Norman: As I understood earlier, you were unclear about what the assets of the Co-op Bank were.
Reverend Flowers: Yes, indeed.

Q946 Jesse Norman: You also said—which I did hear, which I thought was odd—that the Britannia merger “cost us nothing”. That is not true, is it? The terms of the merger were essentially a pooling of interests but it did cost you something because Britannia came with a £500 million or £600 million hole in the balance sheet that the Co-op has had to pay for.
Reverend Flowers: You are correct in that.

Q947 Jesse Norman: I understand. Despite that lack of board-level experience and unawareness of the shape of the balance sheet, you still regard yourself as having been a fit and proper person to be chairman.
Reverend Flowers: I may have many failings, sir, but one of them, I hope, is how to run a board and to try to ensure that the board asks rigorous and appropriate questions. That was my role.

Q948 Jesse Norman: Right. A fit and proper person does not concern that, does it? It concerns whether or not, from a regulatory standpoint, you satisfy the regulator that you have the skills, the expertise and the experience to be specifically in a banking role. We do not ask for fit and proper person tests of people who run other kinds of businesses because we are testing their ability, effectiveness and qualifications to be in a bank.
Reverend Flowers: Precisely, and that is why the FSA did approve me at two different junctures.

Q949 Jesse Norman: You accepted that judgment.
Reverend Flowers: What else can I do, sir?

Q950 Jesse Norman: I suppose a degree of self-criticism might have prevented you from accepting their judgment. Over the years, and while you were chairman of the bank, the Co-op made significant donations to political parties, did it not?
Reverend Flowers: No, the bank did not. The group did.

Q951 Jesse Norman: The group did?
Reverend Flowers: Yes. The bank is utterly neutral in these matters. The group as a whole makes political donations that are voted on each year at the annual general meeting.

Q952 Jesse Norman: By the members of the group?
Reverend Flowers: Yes.

Q953 Jesse Norman: When we see £800,000 to—I think it said in the annual report—the Co-op and Labour Parties in 2012, those have all been voted and approved?
Reverend Flowers: They were specifically for 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.

Q954 Jesse Norman: It was important to you to support the Co-operative Party rather than the Labour Party?
Reverend Flowers: I believed that it was important to support the sister party, the Labour Party as well.

Q955 Jesse Norman: But the purpose of that donation was to support the Co-operative Party, it was not to support Labour.
Reverend Flowers: It was predominantly for the Co-operative Party. As a matter of course in General Election year, we made a one-off donation to the Labour Party. It is all very transparent; it is there in the accounts. My recollection is that during that last General Election the figure given to the Labour Party was about £60,000.

Q956 Jesse Norman: I have seen some information that suggested that the Co-op had given something like £6 million to the Co-operative Party and the Labour Party over the last 10 years.
Reverend Flowers: For goodness sake, if you add up the total figure the figure last year was—

Jesse Norman: I suppose over 10 years, £600,000, it would be—
Reverend Flowers: It has gone up each year, but last year the figure in the accounts was—this was a permissive figure, so it was not a figure that was actually given—the permissive figure, which the membership voted on in the annual report was about £1.15 million as a whole. That was for all political purposes, not just the Co-operative Party.

Q957 Jesse Norman: That is the cap and then the amount that is given is up to that level?
Reverend Flowers: Yes, and indeed we did not give up to the total cap.
Q958 Jesse Norman: Right. In 2011/2012, reading the Co-op accounts, it looks like the Co-op gave £50,000 to Ed Balls personally and £50,000 to his office. Is that right?
Reverend Flowers: My recollection is that we paid 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.
Q959 Jesse Norman: You knew about that and approved it as part of your role on the Co-op board?
Reverend Flowers: Yes.
Q960 Jesse Norman: I understand. Did the Co-op Bank make available lending facilities to the Labour Party and to the Co-op Party?
Reverend Flowers: I am not aware of any lending at all to the Co-operative Party. I would be because I was a member of the National Executive of the Co-operative Party.
Q961 Jesse Norman: You would have been on the other side of any lending?
Reverend Flowers: Yes, I am aware that there was none to the Co-operative Party. There was, as is a matter of record, lending to the Labour Party but it would be improper for me to tell you precisely how much, save to tell you that it has been consistently reduced as an overdraft over many years.
Q962 Jesse Norman: The suggestion I have seen in the press is that it is about £3.9 million in overdraft facility, somewhat less than that in the amount drawn down.
Reverend Flowers: As Mr Dobbs said, you might think that so I could not possibly comment.
Q963 Jesse Norman: Thank you. That sounds like an informative raising of the eyebrow. Thank you. Can I ask then, when you approved these, and by the way—
Reverend Flowers: Forgive me, we did not approve them. If there was any lending this was done commercially by executives and never by the board.
Q964 Jesse Norman: Right. Therefore, there would be question of a concessory rate or anything like that. It would just be normal business terms.
Reverend Flowers: Not as far as I am aware and, indeed, the amounts involved were so small compared with other lending that this would never have come anywhere near the board.
Q965 Jesse Norman: But possibly not small compared with the amount of the assets of the entity being lent to. It might be quite large from their point of view.
Reverend Flowers: It is hardly for me to say, sir.
Q966 Jesse Norman: Another highly eloquent eyebrow raise. Reverend, can I just ask you, if there had been a concessory rate it would have come to the board of the Co-op Bank presumably, because it would have raised the question of—
Reverend Flowers: No, it would have gone to the exposures committee.
Q967 Jesse Norman: Okay. That is helpful. thanks. But the facts are that £100,000 was given to Ed Balls and his office between them in the year 2011/2012 when you were chairman of the bank.
Reverend Flowers: Forgive me; this was not money from the bank. I make it clear. The bank has a very clear policy of political neutrality.
Q968 Jesse Norman: I understand. You were senior deputy chair of the group at the time.
Reverend Flowers: Precisely, and the group has a clear view that it will engage in political activity to support co-operative endeavour and co-operative values, and we see absolutely no reason why that should not continue.
Q969 Jesse Norman: That could potentially occur from any political party. You could potentially support the Conservative Party if it were sufficiently committed to co-operative values and the Rochdale Principles.
Reverend Flowers: I do believe in heaven, sir, yes.
Q970 Jesse Norman: Is that a polite way of saying that would never happen in reality, although it is a theoretical possibility implied by what I have just said?
Reverend Flowers: I have a lot of Conservative friends, but in my experience of them they have not been noted supporters of co-operation.
Q971 Jesse Norman: Although notionally open to all political parties, it is in fact reserved to the Co-operative Party and the Labour Party?
Reverend Flowers: It is a matter for the group board to make a recommendation to the membership at the annual meeting about how that money should be spent, and therefore hypothetically your statement is correct.
Q972 Jesse Norman: You are quite comfortable that all these transactions meet the Rochdale Principles of openness and transparency?
Reverend Flowers: Absolutely.
Q973 Jesse Norman: You are aware the Rochdale Principles were amended and the original principles included political neutrality?
Reverend Flowers: I do. They were amended in the 1920s for very good reasons.
Q974 Jesse Norman: It is only because they were amended that these transactions can have taken place and you were able to support them?
Reverend Flowers: The 1920s was a long time ago, but there was a lot of political conversation at the time about why this was necessary. We believe in supporting political friends in the same way that many other businesses have consistently supported their political friends, and we believe that the small amounts of money we give are small redress for the amounts given by other substantial donors.
Q975 Jesse Norman: These have not coloured your opinions in the dealings you have had with Labour politicians, or the lending decisions made by your colleagues?

Reverend Flowers: I have no part in lending decisions, and it would not colour them in any shape or form whatsoever.

Q976 Chair: Mr Flowers. I quite understand that you will have found today an uncomfortable experience. But I hope you also realise that a lot of people have lost a lot of money and the co-operative model has been badly damaged, one that while you were chairman, even while the bank was folding around you, you were trumpeting. I have one example of that in front of me now where you were suggesting that the co-operative model should step forward because, as you put it, “Against the backdrop of a world left financially and spiritually poorer by corporate greed and speculation, the co-operative business model has once again gained contemporary relevance”. But the truth is that your chairmanship of the Co-op has severely tarnished the co-operative model, hasn’t it?

Reverend Flowers: I do not think so, sir. I genuinely do not think so. Thank you for reminding me of my hyperbole, and all of us would doubtless sometimes have difficulty with having speeches that we made some time ago shot back at us to try to recall whether that was correct or not. I believe that the co-operative model has gone through a difficult period because of a range of different circumstances.

Q977 Chair: This was January 2012.

Reverend Flowers: Forgive me; we have discussed those circumstances in great detail in this Committee today. That does not mean that the model itself is bad or that it will continue to be a good model for future operation of businesses. That is still my view.

Q978 Chair: You have given a great deal of evidence today. It has certainly been colourful in places and of eyebrow-raising interest. Indeed, your eyebrows moved around a good deal this afternoon. There have been a number of—I hope you do not mind me characterising it this way—big contradictions in your evidence. One of the biggest, and perhaps not the biggest, is that you have, not initially but after a while, taken responsibility for this failure. You have said that you take responsibility and that is why you resigned, and that is a reflection of the fact that you bear responsibility for the failure of the Co-op. Yet you still think you are a fit and proper person to run a financial institution. I just want to give you one opportunity to think again about that reply before we close this afternoon, Mr Flowers.

Reverend Flowers: Forgive me; I think there is no contradiction between the two, sir. I think a responsible person of integrity, who takes responsibility when something has gone wrong, when it has happened on their watch, is trying to say something about what they believe is their integrity and their fitness to do something in the future. As it happens, the issue is entirely hypothetical because I can conceive of no way in which I, in my semi-retirement, would ever wish to be involved in running another financial service institution.

Chair: We realise this has been a bumpy ride and there may be things that you would like to clarify afterwards. If you want to, please put them down in writing afterwards. Thank you very much for giving evidence this afternoon, Mr Flowers.
Tuesday 19 November 2013

Members present:
Mr Andrew Tyrie (Chair)
Stewart Hosie
Andrea Leadsom
Mr Pat McFadden
Mr George Mudie

Mr Brooks Newmark
Jesse Norman, Teresa Pearce
Mr David Ruffley, John Thurso

Examination of Witnesses

Witness: David Anderson, former Chief Executive, Co-operative Financial Services, gave evidence.

Q979 Chair: Thank you very much for coming to give evidence this morning on this inquiry, which seems to throw up surprises every time we ask a few straightforward questions. I am going to begin with a straightforward question, which is, why did you leave when you did?

David Anderson: I left the group at the time of the merger with Britannia, and clearly there can only be one chief executive in a merged organisation. I had actually made it plain to the group board that I would continue as CEO—assuming they wanted me—if the merger did not take place. But it was my call during the conversations with Britannia that, if this was a merger of equals, and it was very likely that the Co-operative Group would want to appoint the chairman of the bank, that it was likely that Britannia would need to have senior executive representation, probably the chief executive, not least because they had to mobilise their staff to get members to vote in favour of the merger. So I made it clear I was prepared to step aside if that was the best thing for the transaction. I believed strongly enough in the transaction to do that.

Q980 Chair: So you did not feel put out?

David Anderson: To be honest, my thinking at the time was—Chair: You were expecting it.

David Anderson: Yes, I was expecting it. It was better for the group for me to step out as part of the transaction; it was going to be better for the group in the long term than for me to stay and the transaction not to happen. So I was not put out, no.

Q981 Chair: You thought Mr Richardson was the right man for the job?

David Anderson: I did.

Q982 Chair: Therefore, you would agree with the evidence that we heard from Mr Flowers on that point?

David Anderson: I don’t recall Mr Flowers saying anything about Mr Richardson’s fitness for the job, I’m sorry, Chairman.

Q983 Chair: He did discuss the senior appointments that were made in a room in Shanghai, if you recall.

David Anderson: Right. The—Chair: I do not know whether you have read his evidence. Perhaps I will not waste the Committee’s time by going through it all. Basically, you are saying that the correct decision was taken for the mutual.

David Anderson: I believe so.

Q984 Chair: Clearly, things have gone disastrously wrong. Do you think that you share any of the blame for that and, if so, which part?

David Anderson: To be clear, I was responsible for initiating the talks with Britannia about merger, so that is very clearly my responsibility. It was in keeping with the Co-op Bank Group board strategy at the time. Merging with a building society had been discussed; approaching building societies had been discussed. I set that in train. I was part of the evaluation of Britannia, so very clearly I have a role in that. What I think also influenced the downfall were a lot of things that happened after the merger, including problems that arose in both Britannia books and Co-operative Bank books, including significant management stretch created by merging the financial services business into the group, bidding for the Verde assets, and also difficulties that arose from changes in accounting procedures and regulatory views of capital. As ever, when something goes so disastrously wrong, it tends to be a series of things that come together to create the outcome rather than one thing.

Q985 Chair: You did not mention PPI there among the things that went wrong. There is £300 million, perhaps £400 million of provisioning there from PPI mis-selling. Who is responsible for that?

David Anderson: I did refer to problems that arose from the Co-operative Bank, and I was referring in that case to both PPI and to the IT write-offs that arose.

Chair: Fair enough.

David Anderson: As far as the PPI provisions are concerned, which I think now approach £300 million, the bulk of that selling took place in the early 2000s. When I arrived in the bank in 2005, my discussion with the board was that strategically the bank was too dependent on unsecured lending and the associated incomes, which included PPI. Although PPI continued to be sold on my watch, the numbers were something like 37,000 in the first year, for half of which I was there; 20,000 the next year; 11,000 the year after that. So we very severely ramped it down. In May 2007 we conducted some research, because obviously there was massive regulatory interest in PPI. We realised that there had been things to put right. We mailed 2,200 customers, 660 replied and we found nine cases
out of that sample of inappropriate selling. So I do not believe on my watch there was systemic PPI mis-selling, and the numbers of cases that took place during my watch, compared with the provisions, lead me to think that it must have been significantly more historic. I have not seen the details of those provisions because I have not been in the bank for four years.

Q986 Chair: Have you asked the question how many of those cases that you reviewed at that time have subsequently been identified as possible cases for compensation?

David Anderson: I do not have any access to the bank to ask that question now.

Q987 Chair: What we have found is that the banks’ view of what is deserving—I am talking about the banks collectively—and the regulator’s view often diverge about that, dramatically. As we saw in the evidence we took from Lloyds, for example.

David Anderson: Yes. I think what is absolutely crystal clear is that, even in those cases that we considered to be fine, there probably was not enough evidence retained to prove that there was suitable advice given to the customer. Under the new rules that came in in 2005—the COBS rules—we did choose to go an advised route. In 2006 we removed the financial incentives for selling PPI from staff, and in 2007 we introduced new ones that were based about service and customer care.

Q988 Chair: If we go hunting for it, are we going to find in the minutes statements by you making it clear that you wanted to bring PPI sales to an end, that you were worried about them, that you thought that there was mis-selling?

David Anderson: No, you will not find statements that I thought that there was mis-selling. I think in about 2007—

Q989 Chair: I am now just asking for something that supports the statement that you were ramping the sales down from the period you took over in 2005.

David Anderson: Okay. The numbers that I have just quoted are taken from the Co-op’s submission to the Parliamentary Commission on Banking Standards from October 2010. I did not have any access to those numbers from anywhere else, to be honest, so not surprisingly I was keen to try to find some evidence and I found those numbers in that. There were board discussions about PPI. I can remember one elected member being particularly concerned about it. I also had it raised with me at a Co-op regional board meeting in Huddersfield that I attended, and personally I was concerned. I was a newcomer to the organisation. I wanted to make sure we were doing it right. I specifically went into the call centre and listened to PPI calls.

Q990 Chair: So who was responsible for the PPI mis-selling in your view, in the Co-op? Who was driving the policy?

David Anderson: The vast bulk of the unsecured lending in PPI was sold in the early 2000s before I arrived in the bank, so it is difficult for me to say who was responsible for it at that time. Obviously, ultimately, the bank board, the CEO would be responsible.

Q991 John Thurso: Good morning, Mr Anderson.

David Anderson: Good morning.

John Thurso: Can we go back to the origins of the Britannia transaction? Neville Richardson testified that the first contact came from you to him, and I think you have just confirmed that.

David Anderson: It did.

Q992 John Thurso: Can you take me through why it was you made that call, and what was behind the decision to go and talk to him?

David Anderson: Yes. We had been reviewing the strategy for the Co-op’s financial services businesses all together—I was CEO for the insurance businesses as well as for the bank—and we had looked at the investments that were needed. We had looked at the continuously 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. Our plan was twofold. We had a kind of more organic view, which is, “Let’s work with the food retail business in the Co-op”. We opened branches in food stores and so on to try to develop that, but that was slow-burn and unproven. At the same time the Butterfield Act was becoming law, which for the first time allowed one species of mutual to merge with another. We were very interested in that and the board formed the view that it gave us the opportunity to be involved in consolidation in the building society sector.

I think the board minutes for May 2006 quote record the fact that I am going to a building society conference to make contacts, and obviously I was previously CEO at the Yorkshire Building Society, I knew virtually all the building society chief executives, I knew the sector well. So Britannia was seen as a very complementary fit in terms of distribution reach—the 254 branches—the expertise in mortgages and savings that would help take the bank away from the over-dependence of unsecured lending, which I described earlier, and give us scale to make the investment in IT that we needed.

Q993 John Thurso: It would be fair to say that with your board you had conducted a fairly rigorous, strategic analysis of the Co-op Bank and seen some fairly significant potential future weaknesses going forward, and identified consolidation as the strategic answer to that. Would that be an accurate summary?

David Anderson: One possible strategic answer, not the only strategic answer. Because those sorts of mergers can never be guaranteed, it was one thread that would be pursued if it became available. The main thrust was the organic route that we could control ourselves.

1 Witness correction: change “2006” to 2008.
Q994 John Thurso: When you made contact with Neville Richardson, that was with the complete knowledge and full support of your board?
David Anderson: There was knowledge I would talk to building societies. I would say my first conversation with Neville was probably before it was mentioned. I would have talked to the chairman about it within days of it happening, if not the next day—to be honest, I do not completely recall—and it would have been discussed at the next board meeting. It was then quite a slow burn because that first contact was made, I think, in May 2008 and it was July 2009 before the transaction completed. It was towards the end of the summer before any serious discussions took place. I met the Britannia chairman with my chairman—well, I had one more conversation with Neville, and then we met together with our chairmen. Then each organisation set up a small executive team to talk to each other.

Q995 John Thurso: Did it surprise you at all that Britannia was so receptive to your approaches?
David Anderson: Only to the extent of a natural caution that, if you ask a question like that and get a positive response immediately, you would naturally think, “Oh, why would that be?” But as we talked, in fairness, my analysis of their situation was that they would be facing some of the challenges that I knew other societies faced, and the attractions to building societies. I would say my first conversation with Neville was probably before it was mentioned. I cannot, I do not completely recall—and it would have been discussed at the next board meeting. It was then quite a slow burn because that first contact was made, I think, in May 2008 and it was July 2009 before the transaction completed. It was towards the end of the summer before any serious discussions took place. I met the Britannia chairman with my chairman—well, I had one more conversation with Neville, and then we met together with our chairmen. Then each organisation set up a small executive team to talk to each other.

Q996 John Thurso: At what point in the discussions with Neville Richardson did you start to decide—the two of you—that this was a deal you wanted to take back to your respective boards?
David Anderson: I would say the chronology was about September or something like that. The Co-op have kindly let me review the board minutes for 2008 so, as far as I could see, October 2008 was the first substantive discussion in the Co-op Financial Services boardroom about the merger. There had been mentions before then but not a proper case discussion.

Q997 John Thurso: In answer to one of the questions the Chairman put to you, you testified that when you left it was your analysis that, as the Co-op was going to have a chairman, Britannia should have the chief executive—which is a very normal thing in a merger, so I completely understand that—but also that you thought it was in the best interests that Neville Richardson take that forward. You said that going ahead with the deal with him was much better for the Co-op than not going ahead with you carrying on, which I think was not a criticism of yourself but rather an endorsement of your views on the deal. With hindsight, looking back, do you still take that view or have you considered what elements you might do differently?
David Anderson: Obviously, in view of events, I have agonised over that. I believe that the businesses, together, need not necessarily have led to the difficulties that we see now. I believe that they could have been managed in a successful way and that, separately, both the businesses would have had their own challenges. Obviously it is very difficult to unravel four years of history and try to work that out. So I cannot say, yes, one was obviously right and one was not.

Q998 John Thurso: Could I ask you a final question? Looking back, would it be fair to say that the need of the Co-op to do a deal was equally important as the need of Britannia to do a deal, so this was a merger in which both sides felt it was a good thing to do a deal?
David Anderson: I genuinely believe that to be the case. We always discussed it as a merger of equals, and there was no other narrative going on.

Q999 Andrea Leadsom: Good morning, Mr Anderson.
David Anderson: Good morning.
Andrea Leadsom: This is astonishing timing. You have just said that your first talks were in October 2008, at the height of the financial crisis. Does it not strike you—in hindsight or at the time—that that was a bizarre moment to begin the talk about a merger of two equally successful mutual companies?
David Anderson: The merger conversation had started in May, but I take the general point. We were already in crisis by then and we were evaluating where we were in that crisis. Clearly, we would not have gone into a transaction without being able to look very, very closely at the position that the other business was in. At that point, based on reported results, both businesses were doing quite well through this crisis.
had passed the stress tests from the regulator. So, yes, looking back I can see that it looks as though it was a strange time, but we knew that at the time and we tried to take all the possible steps to take that into account.

**Q1002 Andrea Leadsom:** Presumably you read the report in the *Financial Times*, of 18 October 2008, saying that Britannia’s profits had dropped by about 40% and that their arrears and provisioning were going up. Did that not make you worry, as a previously healthy entity, that actually you might be combining with the unknown at a time of absolute crisis never before seen in the markets? Did it not seem to you that that was a very high-risk strategy? What was your assessment of the reports in the *FT* at the time?

**David Anderson:** We were clearly able to look very closely at the trends in the Britannia books. We analysed those in great detail, so I knew a lot more detail than appeared in the newspaper. Our own loan book at the time was also getting worse—but we assessed that their capital position, combined with ours, put us in a better position than we were in on our own with all the other factors associated with merging.

**Q1003 Andrea Leadsom:** One director of the Co-op Bank said at the time, “Perhaps Britannia needs this a little bit more than we do”. Were you aware of that view?

**David Anderson:** No.

**Q1004 Andrea Leadsom:** Do you understand what was meant by it?

**David Anderson:** That question was asked in our board room quite clearly, in the sense that—as I answered in response to Mr Thurso—if you get a “yes” to a question like, “Are you interested in merging?” you need to be extremely cautious about why you have got a “yes”. So we were very keen to make sure that we understood what we were getting into. We asked KPMG to look at 10 different aspects of the Co-op’s loan books. In fact the commercial loan book appears now to be the source of most of the provisions for losses. Losses as yet have not really arisen. But the provisions had no arrears in it at the time, save for two cases of tenants that had gone bad. From memory, one was MFI and the other one—forgive me, I have forgotten for a moment, but there were virtually no arrears in that loan book at that time.

**Q1005 Andrea Leadsom:** So was there any encouragement whatsoever, from the Government or the regulator, for this merger to go ahead? Was there any view expressed in your understanding?

**David Anderson:** There was healthy scepticism from the regulator, who put us through very, very detailed capital planning calculations over an extended period, at times to the frustration of the team when we were kept being asked to run another set of stress numbers through the books. There was no encouragement from political figures directly to me.

**Q1006 Andrea Leadsom:** My last question. Whose interest was this merger in? You must surely have recognised at the time that it was an extraordinarily high-risk thing to do, at a moment of unprecedented crisis in the markets, to merge two entities where clearly the direction of travel for the banking sector was only going one way. Whose interests was it in?

**David Anderson:** We firmly believed it to be in the interests of the members of the Co-op who owned the financial services business. That was the analysis that we reached. It was the analysis that the advisers reached, and in fairness it was the conclusion that the Treasury reached three years, later because this is the post-legislative assessment of the Building Societies (Funding) and Mutual Societies (Transfers) Act, which was the Butterfill Act. It was done in October 2012. To quote what the Economic Secretary put before Parliament, “The success of the merger resulted in a strongly capitalised mutual business with the scale to offer its customers and members a full range of financial services products that are ethical, mutual and co-operative”. So for some considerable time afterwards, this did not look like a daft thing to do.

**Q1007 Andrea Leadsom:** So, with hindsight, do you still consider that that decision was the right decision, and is it just events since then that have led to a strange situation?

**David Anderson:** Clearly, it has not turned out as well as we would have wanted, and it has contributed to the situation that has arisen in the bank. I do not believe that on its own it has created the situation, and I—

**Q1008 Chair:** So it was the right decision in hindsight?

**David Anderson:** I believe it was the right decision to take at the time with the information that we had, and I cannot really say now what the full consequences were. Apart from anything else, I have not been on the inside of the Co-op’s books for four years so I do not know what has been done and not done to manage that situation.

**Q1009 Teresa Pearce:** Good morning.

**David Anderson:** Good morning.

**Teresa Pearce:** I would like to talk a little bit about the merger and the financial advice you received. We have heard that the Co-op’s auditors are KPMG.

**David Anderson:** That is correct.

**Teresa Pearce:** The Britannia’s auditors were PwC and JP Morgan were the financial advisers on the transaction. Is that—

**David Anderson:** To the Co-op, yes.

**Q1010 Teresa Pearce:** Yes. That is correct. However, when Reverend Flowers appeared before us we asked him about the due diligence on the merger. He said there were three due diligence reports, the first by Deloitte and the second by KPMG. Could you tell us who did the due diligence?
David Anderson: The bulk of the due diligence was done by KPMG. There was an initial process pre-January. There was an extra report prepared by Deloitte that, as far as I recall, was for the benefit of the trustees of the Co-operative Group pension scheme. It was designed to assess whether the covenant of the banking group, as a contributor to the funding of the pension scheme, was strengthened or weakened as a result of the transaction. Deloitte’s conclusion was that the covenant of the bank was unaffected. It basically says it has not changed. It says it is neither better nor worse.

Q1011 Teresa Pearce: So Deloitte did an asset due diligence?
David Anderson: Deloitte did an overview piece for one particular area.
Teresa Pearce: For one particular area.
David Anderson: KPMG did due diligence over 10 headings that we gave them to look into.

Q1012 Teresa Pearce: Right. So who scoped that due diligence?
David Anderson: We did.
Teresa Pearce: But when you say “we”—
David Anderson: The team within the Co-op Bank that was overseeing the merger, me and three senior colleagues.

Q1013 Teresa Pearce: It was scoped by yourselves.
David Anderson: Yes.
Teresa Pearce: When you buy a house, you have a valuation survey or a full structural. Was this a full structural due diligence or was it a valuation due diligence?
David Anderson: I think it was a full structural. It was described by JP Morgan as a significantly more complete piece of due diligence than they would normally see in a transaction between PLCs. There is a board minute to that effect. That is not just my view. Clearly it was their view as well.

Q1014 Teresa Pearce: Do you have any recollection of how much you paid for that advice?
David Anderson: I do not recall exactly.
Chair: I am sure it was a lot.
David Anderson: It would be in the hundreds of thousands of pounds, I would think, but probably not the millions.

Q1015 Teresa Pearce: KPMG as your auditors and the KPMG team that did the due diligence—were they completely separate?
David Anderson: It was a separate team. The benefit of having the auditors business do it was that, clearly, they could give us a very good insight as to whether there were differences in accounting policies between the two businesses that might lead you to end up with a different profit figure that you would want to understand.

Q1016 Teresa Pearce: This belt-and-braces due diligence that KPMG did, which cost a lot of money—what were the conclusions of the work?

David Anderson: The report that I have recall of basically provided an assessment of the underlying trends in the different components of the business. So it went across things like taxation, provisioning, accounting policies, the equality of the loan books, the trends in arrears. There were 10 topics of that nature, and I have a list of them. If you would like me to look for them, I have it just to hand.

Teresa Pearce: Perhaps you can send it to us later.
David Anderson: Okay. I will do that. I have a list of the 10 topics. It was a full piece of work. There was significantly less time pressure on this deal than is often the case because, at the time the due diligence was going on, the legislation to allow us to complete it was not complete. The statutory instruments that had to be laid before Parliament to implement the Butterfill Act—which was the Private Member’s Bill that allowed the transaction—still had not been laid at that point. So, although we were already doing due diligence and talking to the regulator, there was no certainty at the end of 2008 that the transaction could proceed because the legislation did not really exist to permit it.

Q1017 Teresa Pearce: When the due diligence report came back to the Co-op and you all reviewed it, apart from this one piece of work by Deloitte’s on the pension fund, did you instruct any further work, any drill-down?
David Anderson: With the big drill-down in the loan book that eventually seems to have turned out—forgive me for using that expression, because I do not know where the current provisions have come from except what I have seen reported, but it would appear to be the commercial loans in Britannia—the due diligence of that was followed up by our own team within the Co-op. In my view, this was a very, very experienced risk team, who we relied upon to put all our own corporate loans on the book, who were the people that reviewed the criteria that we used, and we sent them to look at the major loans in that Britannia book and the—

Q1018 Teresa Pearce: So when you got the due diligence back, you then sent your own risk team in to look at that aspect?
David Anderson: That is correct.

Q1019 Teresa Pearce: Did you look at any other aspects or was it just that aspect that concerned you?
David Anderson: No, we looked at other aspects. KPMG had not looked at the commercial book in great detail. We did that for ourselves. Other aspects that particularly concerned us were the nature of the securitisations, whether those held good to keep the assets away from the balance sheet and what the risks were associated with those; the nature of the intermediary lending in the mortgage book, which was originated through Platform; and the nature of the risk that was being created by the property company that Britannia was setting up, called Illius, which they were putting some repossessed properties into, which was something that I had seen done in the early 1990s in the building society. So there were a lot of other areas that were followed up in great detail. As I said,
we had time to do this because the time scale from start to finish was quite long.

Q1020 Teresa Pearce: Given what we now know, do you think there was too much reliance put on your financial advisers by the board?

David Anderson: No, we made the decision. The board made the decision. It was our responsibility. Clearly you are influenced by the advisers. There is no point in having them if you are not influenced by the advisers. We were influenced by the regulatory assessments. We were influenced by the advisers who were telling us this was a compelling transaction. We were influenced by the fact that reputable firms were involved at all stages, but we made the decision.

Q1021 Chair: Can I follow up one point you made there? You said that you sent your own team in to do the key due diligence on the quality of the loan book.

David Anderson: The detailed due diligence on the commercial loan book.

Chair: Yes, and also on the securitisation, so—

David Anderson: No, I think that was largely done by KPMG.

Chair: That was KPMG?

David Anderson: Yes.

Q1022 Chair: I see. On the due diligence on the commercial loan book, you sent in your own team, who at that time you had confidence in. But they did get it very wrong, didn’t they? A lot of that stuff turned out to be poor-quality.

David Anderson: 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. I think we were able to make £680 million-worth of fair value provisions against Britannia loans at the time of the transaction. That looked like a pretty solid insurance policy against problems that may arise in different parts of the book. From memory, about £300 million of that was for the commercial book and about £380 million of it was in the mortgage book. So we had been able to put significant protection in place.

Chair: I think Brooks Newmark has a few more questions in this very area.

Mr Newmark: Yes. Thank you for treading on my territory, Mr Chairman.

Chair: Opening it up for you, Brooks.

Q1023 Mr Newmark: There are about £970 million of loan impairments, of which roughly £560 million were distressed Britannia assets, and I think about £410 million were Co-operative distressed assets. In line with this, do you believe the significant impairments of the former Britannia assets raise questions over your advisers’ professional skills judgment?

David Anderson: I assume those numbers are across the 2012 year-end and the half-year of 2013 that you are talking about.

Mr Newmark: Yes.

David Anderson: I do not, no, because I believe that they looked at them in the context of the economics at the time. They stressed them in accordance with various things. Obviously the exact environment that occurred was not the one that we looked at, and the performance has been significantly worse. On their own, would those £550 million of impairments have brought down the bank? Definitely not, and I think I am correct in saying, from what I can see in the accounts, that only about £80 million has so far been written off, so the rest of it is loans that are impaired in the future. The reason that that suddenly leapt up in 2012 was a change in the accounting policy. If you look at the way that bad debts were provisioned for in the bank accounts in the years after the merger, there was—

Q1024 Mr Newmark: The change of policy was brought about by what, then?

David Anderson: I believe it was brought about by intervention by the regulator. I do not know that because I wasn’t there. But they started impairing at 30 days in the accounts instead of at 90 days. The very existence of loans means you get a funnel; loans start going a little bit bad, and then some of them correct themselves, but there is a funnel like that down to loans going bad. Moving from 90 days to 30 days would have produced a massive spike in provisions, and that is clearly an accounting policy that changes for the accounts at the end of 2012. I do not believe that the bank would have done that of its own accord, but I don’t know.

Q1025 Mr Newmark: What you are saying is that effectively the money was well worth spending on your advisers, because the stress testing they did on the balance sheet and the assets and everything, even with the benefit of hindsight, was sort of satisfactory?

David Anderson: I believe, yes. I accept that that may sound a ridiculous comment in view of where the bank is now. I do not think it would have been reasonable at the time to expect them to have identified all the things that have come together to create the situation that the bank is in now, and realistically—

Q1026 Mr Newmark: But don’t forget, this is not like 2008 or 2009, when effectively a catastrophic event took place, and therefore, I am not trying to second-guess. Due diligence was perhaps done in 2006, 2007 or early 2008 on what a balance sheet was like. This was effectively after a catastrophic financial event happened. You send in your advisers. The advisers do their stress testing on those assets, and the impairment of those assets, and still they really got it wrong. It is not that a massive event suddenly happened that they could not have predicted. The event had already happened.

David Anderson: £550 million of impairments sounds a lot. The net assets of Britannia at the merger were £1.6 billion, and the bank did not pay for those net
assets. The synergy benefits that the bank reports from 2010 onwards are £50 million a year. So there is a benefit coming through on the other side, and the gap between those provisions and those benefits—

Q1027 Mr Newmark: Yes, but that is 10%. The synergy benefits are still 10% of the distressed assets that you were acquiring.

David Anderson: But they will be there every year.

Mr Newmark: That is still quite a long payback.

David Anderson: It is a long payback, but it is not enough to bring down the bank, is my point. I fully accept that the deal turned out to be not as attractive as we thought it was going to be. Do not let me attempt to give the wrong impression. It clearly did not, but I do not believe it brought down the bank.

Q1028 Mr Newmark: All right. This is my last question, and I do not want to put words into your mouth. What is your view now of, first, the advice that you received, and, secondly, the advisers on both sides of the table, that is KPMG and PwC, who I guess were the auditors of Britannia—

David Anderson: Correct.

Mr Newmark: —and JP Morgan and Citi who were the advisers?

David Anderson: I honestly believe they did the job we could have expected them to do at the time.

Q1029 Mr Newmark: You are happy. No criticism at all, then? I mean, fair enough, if that is what you believe.

David Anderson: No, I believe that.

Q1030 Mr McFadden: Just to finish on this issue of the advisers, we have had a lot of witnesses—past and present—from the Co-op in the last month or so on this inquiry. One of the features has been the structure of the Co-op Group—the fact that it is a mutual, it is owned by its members, it has this big executive committee and so on. Did the professional advisers take any account of the Co-op’s specific model or did they give their advice as though you were just another high street bank?

David Anderson: There was significant cognisance of the co-operative model, because we considered the value for the members and the potential dilution of the dividend stream for members. So there was very clear understanding of who the owners were and what their interests were. There was a constant dialogue going on at the time about the capital position and our ability to raise more capital relative to other people. That was part of the board dialogue. I cannot specifically recall whether that was raised by the advisers or whether that was our own dialogue, but they would have been involved in that. They were in the conversations.

Q1031 Mr McFadden: Do you see what I am trying to drive at? Do you think KPMG understood and shaped their advice around the structure of a co-op that is owned by its members in a different way from, say, another high street bank that is owned by its shareholders?

David Anderson: I think it is important to understand the nature of what KPMG were asked to do. They were asked to investigate the books and to go into enormous detail in the areas that I have described. They were not asked to give a view as to whether this transaction was a good deal or not. That was the role of JP Morgan. They were the advisers. KPMG’s role was much more of a research type than evaluation.

Q1032 Mr McFadden: Perhaps I have mentioned the wrong advisers, then. Did JP Morgan understand the specific nature of a co-op and how that was different?

David Anderson: Yes.

Q1033 Mr McFadden: You believe they did. I want to talk to you a little bit about the wider implications of this for the mutual model. I will read out a quote: “Owing to the damage done by the credit crunch, people have been crying out for a new way of doing business with a financial organisation of substance that truly has their interests at heart”. You will recognise that.

David Anderson: I do recognise the quote. That is why I smiled. That was my quote.

Q1034 Mr McFadden: Yes, that is your quote. Where do you think the collapse of the bank has left the mutual model in financial services?

David Anderson: As I said before, a whole series of events have come together to cause that collapse. Some of it you would have to ascribe to governance issues. 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. I agree with the comments that Nationwide made when they announced their results this week. It is fair to say that the Co-op as a mutual bank was in a different position to raise capital from, for example, business societies going forward, and that was something that they were in discussion with. I think, the Treasury about. I am not sure. But they were trying to redress that position and get a specific way. It is a particular issue for co-operative banks in Europe. I believe that successful mutuals are a big part and an important part of our financial landscape and will continue to be so.

Q1035 Mr McFadden: Is it your view that the lessons that we learn from this inquiry should be focused purely on the Co-op Bank and the mistakes that it made—we have talked about Britannia, PPI, the Verde issue, the IT and all these things—and that there is no read-across to other mutuals in the financial sector?

David Anderson: Any time things go wrong there is always a read-across for every other organisation, but I do not think there is a read-across about the constitutional status. I think the lessons would probably apply to a proprietary bank just as much as they would apply to a mutual.
Q1036 Mr McFadden: The Co-op marketed itself as being different. To go back to your quote, that is what you were driving at—the Co-op said it was different. But the mistakes that it made were exactly the same as other banks—bad commercial loans, miss-selling of PPI, self-certified mortgages. You could go to many of the banks that toppled over in a financial crisis and it would be the same set of issues that caused big financial holes. In reality, how different was the Co-op Bank if it made exactly the same mistakes as other banks that got into trouble?

David Anderson: I think any bank that is in commercial lending is going to have some bad debts, so it is difficult to be different in that respect. I think the Co-op Bank owed an especial duty of care in the products it sold to its customers. I know everyone connected with the bank is deeply disappointed that the bank is caught up in that. I think the bank was fundamentally different in two ways. One was that it regularly turned down a large amount of business from particular types of counterparties that its customers said they did not want it to deal with—the armament sector, for example. That was very clearly a policy defined by the members that was delivered by the bank that made it different. So there were some key differences.

Q1037 Mr McFadden: Can that kind of thing survive in a structure where hedge funds are calling the shots rather than the Co-op’s members?

David Anderson: The bank needed to make a profit when it was run for itself. The hedge funds still need to make a profit. If the hedge funds remove that plank of the Co-op’s operation—the attempt to be more ethical—then they risk undoing what the bank stands for. I cannot say whether they will or they will not, or what commercial model they see. I am not party to that thinking.

Q1038 Mr McFadden: This is my last question. Richard Pym, the new chairman of the Co-op Bank, has stated that the new management team, “are planning to rebuild the bank into what it always should have been, and indeed, what it used to be”. That implies that the Co-op Bank had moved away from its mutual roots, moved away from the values that ought to have been having it. Do you accept that?

David Anderson: No, I don’t believe I do accept that. The bank always strived to be that. I don’t think that the Co-op, apart from mistakes, was moving inexorably to a field where they were doing things that they might not have done—as Pym says, they should have been doing them and had done in past years—and then got into very dangerous territory that was almost inexorably going to lead to what happened to the other building societies that took the same path, and—

Q1039 Mr Mudie: Do your best.

David Anderson: I do not believe there was an inexorable path. There was a significant change in the balance sheet because of the merger with Britannia, but the activities that had been undertaken in Britannia were severely curtailed under the bank’s ownership.

In a sense, those assets came with the deal, but there was not an idea that that was the business model going forward. There was an expectation that they could be managed successfully. It turned out to be incorrect, clearly.

Q1040 Mr Mudie: A second tiny question. Do you not think that the Co-op, apart from mistakes, was moving inexorably to a field where they were doing things that they might not have done—as Pym says, they should have been doing them and had done in past years—and then got into very dangerous territory that was almost inexorably going to lead to what happened to the other building societies that took the same path, and—

David Anderson: No, I do not. I beg your pardon; I didn’t mean to interrupt.

Mr Mudie: No, go on.

David Anderson: I do not believe there was an inexorable path. There was a significant change in the balance sheet because of the merger with Britannia, but the activities that had been undertaken in Britannia were severely curtailed under the bank’s ownership.

In a sense, those assets came with the deal, but there was not an idea that that was the business model going forward. There was an expectation that they could be managed successfully. It turned out to be incorrect, clearly.

Q1041 Mr Ruffley: Good morning, Mr Anderson. Turning your mind to the due diligence that KPMG and JP Morgan did on the Britannia balance sheet, what did they draw most attention to, to you and the rest of the board? What were they most worried about?

David Anderson: The highest-risk areas were seen in the intermediary mortgage area and the securitised assets, so the nature of the transactions that had been done to take things away from the balance sheet and whether those were robust.

Q1042 Mr Ruffley: Did the board have a discussion about that?

David Anderson: Yes.

Q1043 Mr Ruffley: It is after your time, but the financial statements for 2012, as we know, state that Co-op Bank’s impairment losses were concentrated in commercial real estate exposures, which originate predominantly from the Britannia business. What do you make of that statement?

David Anderson: Clearly there were more loans emerging from that relatively small part of the mutual model is one of modest yields and less risky business? You seem to epitomise to me a very good mutual or building society individual—very, very careful, very, very sensible, and not with the idea that the business has great profits and you have to be on any bandwagon that will deliver money.
The economic outlook produced the catastrophic result. I have tried to be consistent on that. The loan losses were worse than we expected. The economic outlook was worse than anybody expected. We were working off stresses off the Treasury projections for the economy at the time, and honestly I cannot recall what those were. I cannot go through that line by line for you.

Q1047 Mr Ruffley: I am sure other colleagues will want to pick up on that. On the negative fair value adjustments that you took, it was £867 million against the Britannia loan book. Is that figure correct? 
David Anderson: I do not recognise that figure. I think—
Mr Ruffley: It is in the 2009 financial statements. David Anderson: I recall the figure against the loan book being something like £680 million. There were some other elements about interest rate fair value adjustments that were valuing securities which had a different rate from the market rate. I think against the loan book the figure was in the 600s, but it was a big number.

Q1048 Mr Ruffley: Who calculated that figure? David Anderson: That would have been calculated by KPMG, because there is a very prescribed accounting approach to assessing what the fair values need to be on the merger, and it—
Q1049 Mr Ruffley: Was that discussed by the Co-op Financial Services board? David Anderson: Yes, in great detail.
Mr Ruffley: So it was minuted. David Anderson: Not just the board but the audit committee of the group, the group board and in fact the Co-op Bank risk committee. So there was a lot of committee and group discussion about these fair values and the risks associated with them, and whether or not even the existence of them suggested that this loan book was in trouble. Obviously at the time you could not fair-value the Co-op book. Because of the nature of the transaction, you can only fair-value the book that is being acquired, and that was—
Q1050 Mr Ruffley: No, absolutely, and the bigger the negative fair value adjustment the greater protection to your profit, which would obviate the need to take bigger impairments, so— David Anderson: Our motivation at the time was to try to make that as big as we possibly could in accordance with the rules that existed.
Q1051 Mr Ruffley: But would you say that you were insufficiently conservative in arriving at that number? David Anderson: I think we were as conservative as we were allowed to be by the auditors at the time.
Q1052 Mr Ruffley: Oh, so in coming to this figure you were very much led by KPMG. They gave you a figure, you discussed it, and they said it was— David Anderson: No, we calculated the figure and they made an assessment as to whether they thought the calculation was in keeping with the accounting regulations that were in force at the time. They did
not calculate the figure or profess it. Our financial team would have done it.

Q1053 Mr Ruffley: They blessed it?
David Anderson: Yes, they would have needed to for the merger accounts.

Q1054 Mr Ruffley: Yes. A final question, Chairman. In terms of the fair value adjustment, what proportion of that figure was to protect the bank against credit losses on the loan book and how much of it related to other variables, for instance the economic outlook and the outlook for interest rates in that economic forward look, there being a distinction between the two?
David Anderson: Yes, absolutely, my recollection is that there was around £300 million related to the commercial loan books, about £300 million related to the residential mortgage books and the remainder was about interest rate fair values.
Mr Ruffley: That is very helpful. Thank you.

Q1055 Chair: I want to come back to one comment you made a moment ago, that you were working off Treasury projections for growth. You were basically saying, therefore, that the message you were getting from the Government was that there was going to be a strong rebound, and you were using that as your base case.
David Anderson: No, there was a base case. I do not recall that “strong rebound” is a correct reflection of what we were being told at any other time. I think—

Q1056 Chair: I have the figures in front of me here—
David Anderson: Okay. I do not have those figures. Chair: I have just been given them, and they show a forecast in the March 2009 budget for a very sharp rebound in GDP to well above trend growth.
David Anderson: Our figures would have been from the end of 2008 rather than March 2009, because—
Chair: It is from the Autumn Statement.
David Anderson: I guess so.

Q1057 Jesse Norman: Mr Anderson, you have said that KPMG, Deloitte’s and JP Morgan advised you on the transaction. Could you give the names of the individuals who were leading those teams at each institution?
David Anderson: I believe it would be Tim Wise at JP Morgan and Simon Walker at KPMG. I did not meet the Deloitte team as they were working for the pension trustees rather than for the bank per se.

Q1058 Jesse Norman: Right. Thank you very much. Focusing on the impaired elements of the Britannia balance sheet, we have heard from Barry Tootell that there was particular failure and areas of risk based on the self-certified mortgage books—which I think you have mentioned—and also the distressed books received from General Motors, or GMAC. Can you just talk about the nature of those assets?
David Anderson: The GMAC loans were part of an origination deal that other lenders had been involved in as well. So GMAC originated the loans and then Britannia took them on to their book. By their very nature, they were less rigorous in the credit standards than the basic Britannia mortgage lending, so there was less proof of income, higher loan to values—that sort of thing.

Q1059 Jesse Norman: So these are car lease receivables that have been repackaged by GMAC and sold as an asset to Britannia.
David Anderson: I cannot answer that question.

Q1060 Jesse Norman: But that is how they come to be in the Britannia balance sheet, is that right?
David Anderson: I am not sure that they—
Jesse Norman: Britannia is not in the business of originating auto receivables.
David Anderson: I am not entirely sure they were car lease receivables, but the rest—

Q1061 Jesse Norman: But they were receivables, is that right?
David Anderson: They are receivables, yes.

Q1062 Jesse Norman: Right. But you did not look at what kinds of receivables they were?
David Anderson: The team would have done at the time, yes. I just do not recall that level of detail.

Q1063 Jesse Norman: How much did you in fact embed yourself in these different asset classes to satisfy yourself that they were as they had been represented to you?
David Anderson: I would be having almost daily discussions with the team involved, in the sense that we worked in an open-plan office. Barry Tootell was leading the due diligence, my desk was as far away from his as you are from me now, and he would be having a constant discussion with people over a prolonged period about what we were finding in Britannia.

Q1064 Jesse Norman: We know these things are very duff assets, and yet you seem unable to tell me what the character of this particular class of assets was.
David Anderson: Those assets have performed in line with the expectation that we had for them at the time, so the impairments that we made against them and the fair value is, broadly speaking, not off the Richter scale.

Q1065 Jesse Norman: So was Barry Tootell wrong to say that there were particular areas of risk in that area?
David Anderson: No, that is what we thought at the time. That is why we focused the due diligence in those areas. I think his answer was about why KPMG focused there and not on the commercial book. As I understand it, it is the commercial book that has since been the cause of the big problem, not those assets.

Q1066 Jesse Norman: Right. I understand. So you should have been more focused on the nature of the commercial book, and KPMG were not focusing on the commercial book.
David Anderson: No, the commercial book had no loans\(^4\) in it and we sent our own specialists in to assess it. Clearly, the performance of that book has not turned out as we would like. Could we have seen that at the time? I do not know. It carried on performing well for another three years. It had been audited by PwC for years before the merger. It was audited by KPMG for years after the merger apparently without deteriorating dramatically. It had been reviewed by the regulator. It had been reported on to credit rating agencies. Perhaps we should have seen what they didn’t. We did not have to take the risk, and the core of this is that question.

Q1067 Jesse Norman: You made a commercial judgment about the quality of those assets—

David Anderson: We did.

Jesse Norman:—and they turned out to be much worse than you thought?

David Anderson: Yes. But I do not believe they turned out to be bad enough to bring down the bank.

Q1068 Jesse Norman: You have described the due diligence as an outstanding exercise and—

David Anderson: JP Morgan made that assessment.

Jesse Norman: JP Morgan made that point, and then I am sure it was of great satisfaction to the auditors to have that noted in the board minutes. You do not think it is like the case when the fellow says, “The operation was a complete success but the patient died”? 

David Anderson: No.

Q1069 Jesse Norman: So it is a highly accomplished piece of due diligence that ends up with a £900 million hole in the balance sheet.

David Anderson: The £900 million is not connected with the due diligence. The £550 million write-off is connected with the due diligence. The fact that there were some write-offs is inevitable. So far only £80 million of those loans are actually losses, and £550 million on its own would not have created the problems that the bank has now. Clearly the loan book was considerably worse than we thought it was going to be. I would not represent it any other way, but I do not believe that it was sufficient to cause the situation that the bank now finds itself in.

Q1070 Jesse Norman: When you were working at the Co-operative, did you find yourself in any tension with Peter Marks?

David Anderson: No, not especially. I did not report to Peter Marks when I was in the Co-operative. I reported to the chairman of the Co-operative Financial Services business.

Q1071 Jesse Norman: So how would you characterise the relationships?

David Anderson: Normal business relationships. There were some things that we wanted to try to achieve together. We were both keen to get the financial services business more integrated with the group because, as I mentioned earlier, we saw an opportunity to work with the retail business and we launched joint stores.

Q1072 Jesse Norman: He was not driving change within the bank in any way.

David Anderson: No, he was not a member of the bank board at that time. The group finance director was a member of the bank board but the group chief executive was not, and we were driving the strategic agenda in the financial services businesses. When I say “we” I mean the Co-operative Financial Services team.

Q1073 Jesse Norman: As you look back at the committees that you attended while you were there, and the enormous numbers of people, in and around the bank, who in fact knew nothing about banking but were there because of the Co-operative’s own structure, do you feel that the politics of the Co-operative was in some way defective?

David Anderson: Do you mean the democratic structure rather than the politics? I mean basically the—

Jesse Norman: Both areas. I am interested in the structure of it and whether that was effective, and I am interested in whether or not it bred a kind of internal politicking that was contrary to the best interests of the bank and mutual members.

David Anderson: I do not believe that that existed at all in the banking board, because we had external professional non-executive directors. In addition to group board democratically elected members, we had five professional non-executive directors on the bank board. That made the boardroom feel like other boardrooms in which I have been involved, to be honest. The group board was different. It had two constituencies. It had its elected members from the democracy, and it also had the chief executives of the largest independent co-operatives, because they had a say in the group as well. That did sometimes create tensions in that boardroom, because there were effectively two groups in there. We did not have that issue in the bank.

Q1074 Jesse Norman: The factionism of the group did not extend to the bank?

David Anderson: No.

Q1075 Stewart Hosie: Mr Anderson, at the time of the takeover, what discussions did you have with the FSA regarding Britannia?

David Anderson: I would have had quite regular discussions with our supervisory team for the bank and then one or two conversations with more senior FSA people. There were some things that the FSA had to help us with in order for the transaction to proceed. For example, PIBS, permanent interest bearing shares—which were part of tier 2 capital in Britannia—did not count as tier 1 capital in the Co-op Bank. That was a significant barrier to keeping the capital ratio where we wanted it to be. The capital was the same the day before as the day after but it had a different treatment in the bank’s accounts. We agreed with the FSA eventually that they would view that capital in the same way as they had done before. So there was that type of nitty-gritty dialogue going on around the—

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\(^4\) Witness correction: change “loans” to “arrears.”
Q1076 Stewart Hosie: That is clearly a very specific technical point, but I understand why you raise it. In terms of the meetings, you said you met with the supervisory team and occasionally with more senior people. On the senior people, how many times would you and your senior management team have met with senior people in the FSA?

David Anderson: Personally, I think I can recall two or three meetings with senior FSA people during the course of the merger discussions. I know that, on an almost weekly basis throughout this period, the senior bank executives who were involved with the transaction were having conversations with the regulator, and probably on a daily basis at times.

Q1077 Stewart Hosie: That is really helpful. So the FSA were absolutely aware and familiar as this process of merger developed?

David Anderson: Definitely.

Q1078 Stewart Hosie: Who in particular did you meet at the FSA?

David Anderson: The bank’s team, so our own supervisory team, was headed by somebody called Steve Riding. The more senior people who I think I met would have been Simon Green, who was one layer above normal supervisory activity, and I think the most senior person I met was called Clive Adamson. I cannot tell you what his exact position was. I do not recall.

Q1079 Stewart Hosie: But you were happy enough that the people within the FSA were the right level of people for this merger?

David Anderson: There was no question that there was enormous regulatory involvement, because this type of transaction, by its very nature, had not happened before because we were using a new Act of Parliament. There was no reference point from previous transactions, so they had to be very, very closely involved. I would go as far as to say that I think it is likely that they were involved in helping to shape statutory instruments that went before Parliament, so that they fulfilled the requirements that they had from a regulatory purpose. So there was enormously close involvement.

Q1080 Stewart Hosie: I appreciate that. In terms of the nitty-gritty, then, what did they say to you or your team regarding the Britannia merger? Did they encourage it? Did they see the merger as a rescue, for example?

David Anderson: No. There was never any discussion of rescue from anybody that I was connected with or spoke to about the merger. I think it is fair to say they neither encouraged it nor discouraged it. My impression was that they were keen to make sure that we understood the risks. They were keen to make sure that we had done significant capital stress testing, and at times caused us frustration by asking for different stress tests, but they were not saying, “Yes, do this” or “Do not do this”.

Q1081 Stewart Hosie: In terms of them wanting to make sure you understood the risks, did they ever express any concerns to you about the acquisition of the Britannia assets or even asset classes within the total Britannia book?

David Anderson: “Concern” is an interesting word. I am sure there would have been conversations about, “We need to be sure both sides have done the due diligence properly”, those sorts of things. It was not concern in the sense of, “Do you know what you are doing?”

Q1082 Stewart Hosie: Just on that point, what would the FSA have had to say to you in order for you to say, “Hold on a minute, we are going down the wrong route here?” How large a warning would they have had to give?

David Anderson: That is a very speculative kind of question and I cannot say.

Stewart Hosie: I appreciate that.

David Anderson: Clearly if they had said, “No, we do not believe that you have miscalculated”. I mean, I’m sure we were showing them all kinds of numbers, so they would have been looking at those numbers. If they had raised concerns about those numbers, then that would clearly have been very important to us. We were not relying on the FSA to make this decision. This was our decision.

Q1083 Stewart Hosie: That is what I was going to ask. Are you sure the FSA were not saying these things? Because in all of the hearings we have had with core people, the impression that I have had is that the enthusiasm and determination to do this deal almost at any cost was incredibly strong. Could the determination to see this through have blinded people to some of the warnings that may have been given?

David Anderson: Or could it be that the attractions that were clear for both parties in the merger were sufficient for the regulator to be enthusiastic as well? Remember, our analysis showed that the combined entity was safer than either on its own. So if you were the regulator, that would be attractive.

Q1084 Stewart Hosie: Let me ask one final question. Apart from the issue of capital, which I understand, did the FSA attach any conditions to its approval for the merger, other than making sure that statutory requirements were met?

David Anderson: Not that I recall, no.

Q1085 Stewart Hosie: In hindsight, do you not think that is a bit odd given what has happened since, or is it the same answer in relation to the professional advice—that it was as good as it could have been at the time?

David Anderson: It had not occurred to me that they might attach conditions, so it is not a question I thought about. They could have had conditions about governance structures or perhaps raising capital levels to a different level, or those sorts of things. There was nothing of that type raised.

Stewart Hosie: Okay. Thank you very much indeed.
Q1086 Chair: Bringing all these strands together, in particular, you have stressed that you do not think that the impairments on the property book were enough to bring down the bank. In your view, what really did all but destroy the Co-op?

David Anderson: I said at the beginning that I believe it is a combination of things. Clearly the £550 million write-off is unhelpful. Clearly the management—

Q1087 Chair: It is a bit more than that, to be fair. It is a bit more than that. Wouldn’t you like to think of something a bit stronger than that, or a bit more accurate?

David Anderson: I do not believe on its own it would have brought down the bank, and I have made that—

Chair: I think you have.

David Anderson: But obviously it did not help. I believe the management distraction associated with the Verde bid was significant, and I had some experience of that directly as chair of the Reclaim Fund. Members of the Committee may know I am chairman of a wholly owned subsidiary of the Co-op, which is the Reclaim Fund, which is a banking utility to look after unclaimed assets. We had Co-op directors on there who were missing board meetings because of the pressure that they had to the point where, at the end of 2011, I asked for a different set of people to be put on to that board. So there was clear management stretch going on with everything they were trying to do. There were other big write-offs. We have talked about those on PPI and the IT. I believe the IT write-off was directly associated with the Project Verde bid, in the sense that the project was on track at the time of the merger. According to Mr Richardson it was on track at the time of his departure, but once you have chosen to use the Lloyds banking systems then clearly it becomes of no use. So that £300 million was a direct result of the Verde transaction. I think there were another £100 million of costs associated with Verde, so that bid clearly had a very big impact.

Chair: Yes, but not—

David Anderson: I do not believe on its own it would have brought down the bank, but you put it together with £300 million of PPI and £300 million of IT and £100 million of costs. The thing about those other costs is that they are genuine losses that have gone. The loan book is still a provision. Those loans have not actually gone yet.

Q1089 Chair: You have £300 million of PPI in there—perhaps it is more than that—which you feel was already on the books before you arrived, and for which you are not responsible. You feel that the property mis-valuation in the Britannia deal, the underestimation of the impairments, was reasonable. I think that was the word you used earlier.

Chair: But did you say, yes?

Chair: Yes, but not—

David Anderson: I do not believe on its own it would have brought down the bank, but you put it together with £300 million of PPI and £300 million of IT and £100 million of costs. The thing about those other costs is that they are genuine losses that have gone. The loan book is still a provision. Those loans have not actually gone yet.

Q1090 Chair: Provisions are provisions. This is a bank.

David Anderson: But the money is still there.

Chair: Well, the provisions are provisions. This is a bank. The provisions are extremely important, crucial tools for bank management and safety.

David Anderson: I agree.

Q1091 Chair: What I am trying to get to is: what proportion of this you do feel yourself to be personally responsible for? While you are thinking about that question, perhaps I can just say we have had a stream of people before us, and the Banking Commission spent nearly a year with a stream of people before it, saying, “Well, it was all the general responsibility of somebody, of a group, but it wasn’t any individual’s responsibility”. Individual responsibility was missing whenever we went looking for it. Nobody was prepared to take any. What I am asking you is whether you feel any personal responsibility for any specific parts of these things that have contributed to the severe weakness of the Co-op, and if so which?

David Anderson: I have made it clear that I feel as though I am responsible for initiating the merger of Britannia and overseeing the process by which that was evaluated. I do not believe the other elements of the problem can be associated with my tenure, in the sense that they happened after I left or before I started.

Q1092 Chair: You do not think that the team that you sent in to go looking for those impairments let you down? It was in 2009, remember, when commercial property was falling off a cliff.

Chair: They were looking at it early in 2009, the end of 2008. No, I do not believe they let me down.

Q1093 Chair: It was falling off a cliff actually from earlier than 2008.
**David Anderson:** I believe that they did—

**Chair:** Just to be clear—I am sorry to interrupt you—the correction in the property market began in 2007, didn’t it?

**David Anderson:** Yes, there is no doubt we were already seeing this growing through 2008, as were Britannia. I do not believe that that team let me down, in the sense that I believe they did as good a job as could have been done at the time, with great care and with the right motives. I think at the heart of all this there is nobody involved in that part of the story for whom this created any personal benefit. Quite the opposite, in the sense that most of the people involved were going to be putting their own jobs on the line if they found in favour of going ahead with this deal. So I do not think there were any perverse incentives going on. I think they were acting for the right motives and did as good a job as they could.

**Chair:** Thank you very much for giving evidence to us this morning. We are very grateful to you for your direct answers to the questions you have been asked.
Tuesday 3 December 2013

Members present:

Mr Andrew Tyrie (Chair)

Mark Garnier
Stewart Hosie
Andrea Leadsom
Mr Pat McFadden

Mr Brooks Newmark
Mr David Ruffley
John Thurso

Examination of Witnesses


Q1094 Chair: Thank you very much for coming in to give evidence today. Could you tell us what was KPMG’s role in advising on the Britannia merger?

Andrew Walker: Yes, I can. Our role was to perform work in 10 key risk areas. Those key risk areas were defined for us by the bank. We then subsequently went on to agree on more key risk areas where we looked at some further commonality of deposit account customers between Co-op Bank and Britannia, and we did some work on capital forecasts, which I think you have seen.

Q1095 Chair: Yes. How much were you paid, and how was your remuneration structured?

Andrew Walker: Our remuneration was a time-based remuneration, and for the due diligence it was—

Q1096 Chair: So you had no interest in the outcome of the deal?

Andrew Walker: None whatsoever, no. It was £841,000 for the due diligence work.

Q1097 Chair: Were there other things in the offing?

Andrew Walker: We did other pieces of advisory work, and I think the Committee has seen some of those reports. Those were all part of the transaction.

Q1098 Chair: What was the total remuneration to KPMG as a consequence of this deal and the associated work?

Andrew Walker: About £1.3 million.

Q1099 Chair: In a key piece of work you did on what is called Project Vintage Phase II—you will know exactly what I am referring to—you have said, “The capital position of the merged group should not be compromised either at day one of the merger or going forward as the adjustments unwind”. Do you regret saying that, given what we now know?

Andrew Walker: No, I don’t regret that. If I could spell it out, I think you have taken it—

Q1100 Chair: Do you think that is right?

Andrew Walker: At the time it was right.

Q1101 Chair: Yes, but you were not only talking about it at the time. You were talking about it going forward as the adjustments unwind.

Andrew Walker: In the capital projections report, which I think you are referring to, we were asked to examine certain parts of that report. Our role in that process was not to look at the underlying plans that were being put together by the bank. It was more to translate the plans that had been put together into what the capital position of the bank would be going forward on a combined basis, taking into account fair value adjustments and due diligence findings. From that exercise we could see that the bank was in excess of its capital requirements. Those have been discussed by the bank on numerous occasions, I believe, with the FSA during the process, and so our report was referring to that factual comment—that the bank remained above those headrooms in those circumstances.

Q1102 Chair: So it wasn’t a statement about the robustness of the deal as a whole.

Andrew Walker: No. It was for management to make that decision about the deal as a whole. Our role related to limited due diligence in those risk areas.

Q1103 Chair: Still, do you feel, looking at that due diligence now, that you wish you had done it differently?

Andrew Walker: No, I do not. We have looked back, as you would imagine in the circumstances. We have considered the due diligence carefully. I have asked other transaction services partners in KPMG—Mr Mead, to my right, did that exercise for me as well—and we concluded that it was a thorough piece of work. I think you have heard from other members of the support team who were there at the time who have referred to it as a value added piece of work.

Q1104 Chair: My last question to you before I pass examination over to Mark Garnier is whether you could perhaps just explain what the scope of the responsibility and the limits of responsibility really are for a firm such as yourselves in a major transaction such as this. To give a bit more substance to that question, it is not just technically, is it, that the responsibility for the decision lies with the board? It is in a very real sense their job to make sure they are capable of understanding the numbers that are being put in front of them. Am I right in thinking—I am half answering your question, but if I get it wrong I want you to correct me very rigorously—that your primary role is to make sure that the numbers in front of the board are correct, inasmuch as they can be made correct at the time of their being put together?
Andrew Walker: To an extent. Our primary role is to work to the key risk areas that we identified with management at the start of the deal and to seek out information from the target company in relation to that information, to challenge it, to look upon it sceptically and raise warning signals to the acquirer, which I believe is what we did on Britannia.

Q1105 Chair: Are you saying that the board ignored the warning signals?
Andrew Walker: No, I would not agree with that.

Q1106 Chair: Would you have done this deal if you had been the board?
Andrew Walker: I am not the board, so I don’t think it is my position. My position was to advise the board.

Q1107 Chair: A tough question, I agree—the sort of question you find yourself having to answer at the Treasury Select Committee that you don’t have to answer in the run of life. Have a go at answering it.
Andrew Walker: Mr Chairman, I don’t, in that circumstance, and it would be normal when we are doing due diligence, but in that case I did not see all the facts and circumstances that were laid out to the board in relation to that transaction. I did part of the due diligence in certain risk areas and reported on those to the board.

Q1108 Chair: But you got to know a lot about this deal. You were one of the people who knew a very great deal about this deal and were in a very good position to form assessments of this type. I am just asking you in all frankness, given the huge amount of information that you would have acquired—that you did acquire—at this time, whether you would have done this deal if you had been the board.
Andrew Walker: What I can say to you, Mr Chairman, is that looking back, I believe that the board was asking the right questions in terms of the risks. The risks that they asked us to look at were the right ones. From that piece of information I believe that they had the right level of information to make an informed decision on the risks available in the deal. But as I stress, there were other parts to the due diligence that was done, for example legal due diligence, that I didn’t play a role in, that would also inform their decision. So there are several other key things in the whole decision that I don’t see.
Chair: That is very helpful.

Q1109 Mark Garnier: Mr Walker, can I carry on with this but with some rather wide-ranging questions on your opinion of the management board? You made a very important point, which was that the evidence you presented to the board gave a lot of detail so that they were in a position to be able to assess the risk. Do you think the board collectively was able, or had the skill to be able, to assess the risk?
Andrew Walker: I reported more extensively to the audit committee, to be precise. There were joint audit committees of the banking group board and the Co-operative Group audit committee. I had most of my time in front of that committee, not so much in front of the board. If I could pass comment more from the context of my role as the audit partner after 2009, I took comfort from the fact that the board, which is a board of a regulated plc entity, had a significant degree of experience on it, including financial services experience. When I look back I can see that of the 26 directors who have been in post since 2009 on the bank board, 18 of those have financial sector experience.

Q1110 Mark Garnier: Does it not strike you as extraordinary that when you look at the current make-up of the board, of the 15 executive and non-executive directors of the Co-operative Bank only three of them have been in the institution since before the beginning of this year? What does that tell you about the previous experience collectively of the board and the fact that there seems to have been a major shake-up from the previous position to the current position?
Andrew Walker: From my position as auditor, I take comfort from the board as a whole. The board as a whole is an important part—

Q1111 Mark Garnier: I am pressing you to make, rather than a quantitative judgment, which is obviously what your job entails, a qualitative judgment. It is very important. The reason I am pressing you on this is that if you look at the two transactions together, the Co-operative Bank was increasing tenfold in size from pre-Britannia to post-Verde, if Verde had gone through. You will have read all the lurid headlines in the press—it isn’t just one individual, and I think that to a certain extent, in what we are talking about, that is rather irrelevant to the bigger-picture stuff. The bigger stuff is that you have some questionable expertise on the board. You have a lot of evidence that, for example, with the Project Verde deal two deputy chairmen of Co-operative Bank were appointed, who were insisted on by the regulator, who seemed to say that the Verde deal was a bad idea, yet it went ahead. What I am trying to get a flavour of you from you is—and please, Mr Hurst and Mr Mead, do leap in if you feel you want to join in this qualitative judgment on your client—whether they are actually capable of understanding collectively what you are saying and coming to a rational, sensible decision as to the future of this significant institution. Andrew Walker: If I answer first, I can then pass over to my colleagues. I am sure they will have some thoughts on this. Whenever I attended the board in my role as auditor, yes, I did get the impression that they collectively were asking the right questions and they were aware of the issues.

Q1112 Mark Garnier: Yet in the Verde deal, those who seemed to have, by the regulator’s understanding, significant experience in financial services, and who the regulator had asked to be appointed, Davies and Baker-Bates, voted against the Verde transaction, and yet the board voted in favour of the Verde transaction. It does not create an image of a board that collectively knows what it is talking about.
Warren Mead: If I may comment in relation to Project Verde, I was involved primarily in the independent assurance work that ran from October through to March 2013 and attended four or five boards during
that period, and I felt the quality of debate was very good. The board were asking lots of very sensible questions, and when I explained some of the risks that we identified in Project Verde, they understood them, took them on board and set the executive management the challenge of dealing with and mitigating those risks.

Q1113 Mark Garnier: What was the relationship between the board and the executive management, in your opinion? Was it a healthy relationship?

Warren Mead: I observed that from a limited capacity but, yes, it was a good relationship, one of mutual respect and challenge.

Jonathan Hurst: If I could comment very briefly, Mr Garnier, I would have had visibility at audit committees of the bank, not at the board, and those audit committees would have non-executive directors and management present. They were very open meetings, with never any flavour of items either being suppressed or people’s opinions being discarded. They were genuinely very open meetings with a sharing of views.

Q1114 Mark Garnier: Yet in the run-up to Verde there were questions about the fact that holes in management expertise had been allowed to build up in anticipation of new management coming in had the Verde transaction gone ahead. That is not a healthy in anticipation of new management coming in had the Verde transaction gone ahead. That is not a healthy in anticipation of new management coming in had the Verde transaction gone ahead. That is not a healthy increase its size tenfold during a period of severe stress for the banking industry, which has resulted in the thing blowing up. What culpability or what guilt does the management have in terms of being incompetent. Mr Hurst?

Jonathan Hurst: Can I clarify that you are referring specifically to the banking group?

Mark Garnier: Absolutely, yes.

Jonathan Hurst: My own view is that there were a number of interim management members as part of the team, and that is something that we brought to the attention of the board and the audit committee, because in those circumstances I think it is sometimes more difficult to get what I would call a proper team balance when there are a number of interims. In terms of those members of management who were permanent, I would support what Mr Walker has said. There is nothing what we saw—

Mark Garnier: In terms of the executive or non-executive management?

Jonathan Hurst: This is in terms of the executive management, I am sorry.

Q1115 Mark Garnier: What you are saying is that collectively, the board has appointed the right people, where they can, on permanent contracts, on to the executive management team.

Jonathan Hurst: That would be my view of the Verde bank at the time of the Britannia transaction. I think when the Verde transaction started to take place—and I suspect we will move on to that later in proceedings—that was going to create, and excuse my language, a very different animal. It was much more complicated. It was a significant carve-out, and in those circumstances quite rightly the board was looking at what its collective skills needed to be at both non-executive and management level.

Q1117 Mark Garnier: You referred to the executive management at around the time of Britannia, but what about the non-executive directors? They are the ones who were part of this decision. Were they up to the job of making a rational, educated and informed decision?

Jonathan Hurst: On Britannia?

Mark Garnier: Absolutely, yes.

Jonathan Hurst: On both, all the way through.

Andrew Walker: If I could comment on Britannia, because I observed part of that process. As I said, I went to the combined audit committees, and in particular the banking group audit committee was chaired by a very experienced non-executive director and had other FS-experienced, financial-experienced non-executives on the audit committee. I think that they had a full grasp of the issues we were talking to them about.

Q1118 Mark Garnier: Mr Hurst, you specifically talked about the executive directors. Specifically, what did you think of the non-directors, notwithstanding what Mr Walker has just said?

Jonathan Hurst: I would concur with Mr Walker’s view. In fact, I think the combined board after the merger took the best of the best, so it was able to bring in some of the non-executive directors who came with Britannia and supplemented that with those of the Co-operative Group banking board.
Q1119 Mark Garnier: What about prior to the merger, the ones who were making the decision as to whether to go ahead with the merger?
Jonathan Hurst: There was nothing that I observed that would have made me particularly concerned about their behaviour or their decision making.

Q1120 Mark Garnier: I am trying to work out if you are covering up your true feelings or whether that genuinely is your true feeling. Can you confidently say, hand on heart, that you thought that the management of the Co-op Bank, prior to the Britannia transaction, were sound, intelligent, knew what they were talking about and were in a perfectly reasonable position to be able to read a document such as this, which is quite a substantial document, and fully understand it and come to a proper decision?
Jonathan Hurst: I will give you a very clear answer of yes to that.

Q1121 Chair: It didn’t take us very long to discover that one of the people who was on the board was not up to it—admittedly later, but it didn’t take us very long—but you didn’t get any sense of any difficulties?
Jonathan Hurst: Are you referring to the Reverend Flowers?
Chair: Yes.
Jonathan Hurst: Clearly we were aware that he was not a banking expert, Chairman, and aware that his experience was in controlling boards. Was there anything that had been brought to my attention—and obviously we have debated this—or the attention of any of my colleagues in relation to any of the subsequently alleged behaviour? Absolutely not.

Q1122 Andrea Leadsom: Good morning. £1.3 million is quite a significant fee. Mr Walker, was any part of that in any way dependent on a positive outcome to the transaction?
Andrew Walker: No.

Q1123 Andrea Leadsom: It was presumably a very good deal for you to win. Was it material at that time during the financial crisis, when presumably business was thin on the ground? Were you particularly competitive? Would you say it is a normal price for a due diligence of that nature?
Andrew Walker: Yes, absolutely. We feel it was a fair price, and the bank felt the same. Co-op Bank for us is a relatively small part of a national financial services practice that we have, so it was not absolutely crucial that we won the piece of work either, but we were very pleased to do so.

Q1124 Andrea Leadsom: But it was a competitive price for that sort of piece of work, was it?
Andrew Walker: Yes.

Q1125 Andrea Leadsom: Did you at any point during your due diligence question the timing, as by the time of that merger it was known that we were in the throes of perhaps the biggest financial crisis ever? Did you make any recommendations to the board about the fact that this was a very uncertain time to be doing a transaction of this nature?
Andrew Walker: Yes, I think we did. We highlighted in our report warnings in connection with rising arrears in the non-conforming mortgage book of Britannia. We highlighted a number of treasury assets of about £100 million to weak counterparties such as Lehmans at the time and we highlighted some of the risks inherent in the securitisation structure that Britannia had that could trigger defaults in the securitisation structure. All of those are very much connected to the circumstances at the time.

Q1126 Andrea Leadsom: Did you at any point discuss with other partners or colleagues within KPMG concerns that you had about the transaction?
Andrew Walker: All our work in circumstances like that is reviewed by a second partner, who we call a concurring partner, who would have reviewed that work.

Q1127 Andrea Leadsom: In discussing with that other partner, did you express concerns about the transaction? Did you express personal concerns about it to that other partner?
Andrew Walker: About whether it should go ahead or not?
Andrea Leadsom: Yes.
Andrew Walker: As I explained earlier, it was not my role to do that within the transactions.

Q1128 Andrea Leadsom: No, I understand. Obviously you have reputation risk and so on, and I am sure with hindsight you probably wish you had strongly come out and advised against it, but I am asking you whether, at the time, within KPMG, you expressed reservations to colleagues?
Andrew Walker: At the time the discussion that we asked ourselves that question because it was not within KPMG expressing reservations, or would we express ourselves strongly come out and advised against it, but I am sure with hindsight you probably wish you had asked ourselves that question because it was not within the scope of our work.

Q1129 Andrea Leadsom: If we were to ask for it, would we find that there was a minute of a meeting within KPMG expressing reservations, or would we not find that?
Andrew Walker: No, there would be none. We didn’t ask ourselves that question because it was not within the scope of our work.

Q1130 Andrea Leadsom: You undertook due diligence in 10 areas for the Co-op.
Andrew Walker: That is correct.
Andrea Leadsom: Are you able to tell us what those 10 areas are?
Andrew Walker: I have a list, if you would allow me to just turn to that list.
Andrea Leadsom: If you have a list, then it probably does not need reading out. I was more interested to know whether you could actually recall the 10 areas than read them from a list. I am quite sure you can read them from a list.
Andrew Walker: Broadly, it was impairment of the loans and advances position. It was treasury assets. We looked at fair value in about four or five different areas—the fair value framework that was put in place to fair value those assets and liabilities—so that would account for about four of them. Taxation, pensions,
securitisation—I am just looking to see if I have missed any—underlying earnings of the bank and the fair value of the consideration for the deal, which was an imputed consideration where you have a merger of mutuals. As I said, subsequently we added to that one other area, where we looked at the commonality of the savings customers between Britannia and Co-op.

Q1131 Andrea Leadsom: Specifically what recommendations did you make to the board about impairments and also off balance sheet transactions?

Andrew Walker: I can’t recall any about off balance sheet transactions. A considerable part of the report was in connection with the securitisations that Britannia had at the time and Co-op did not do securitisations. That was of particular relevance to them and value to them.

Q1132 Andrea Leadsom: What recommendations did you make on securitisations?

Andrew Walker: Our role was to highlight where we felt that there were key risk areas in the securitisations and give an explanation of how securitisations worked in practice.

Q1133 Andrea Leadsom: Did you highlight securitisation off Britannia’s balance sheet as a key risk to the Co-op board?

Andrew Walker: To be clear, it was not an off-balance sheet transaction. The loans and advances, the subject of the securitisations, are on balance sheet.

Q1134 Andrea Leadsom: But the mortgages are effectively part of the securitisation. What recommendations did you make to the board about the securitised portfolio?

Andrew Walker: We highlighted areas where in particular one or maybe two of the securitisation vehicles, the more recent ones, were more at risk of triggering default or ratings downgrades, and we highlighted those issues and the implications of those to Co-op.

Q1135 Andrea Leadsom: What did you feel the implications of those greater-risk areas were?

Andrew Walker: The potential implication of triggering or hitting a trigger in a securitisation is that ultimately the whole securitisation has to be unwound and the proceeds of the securitisation financing repaid from the proceeds of the mortgage pools. That has not happened, but it was a risk that we pointed out.

Q1136 Andrea Leadsom: What about your recommendations on impairments?

Andrew Walker: I am particularly talking about the non-conforming part of the Britannia mortgage book, which was about £10 billion. We could see in that that arrears were increasing throughout 2008, which in the circumstances that you refer to was not wholly surprising. But we also did some very high-level projections of that looking forward, where we saw additional impairment risk from that portfolio to what Britannia was seeing at the time. We highlighted that to Co-op in our report, and that was factored into the fair values that were subsequently made.

Q1137 Andrea Leadsom: If you were to give us perhaps your top three concerns highlighted to Co-op at another place, what were they?

Andrew Walker: The top three would be the impairment one that I have just highlighted, the treasury assets and the securitisations areas. There were several other recommendations as well. The other thing I would say about the work that we did is that we did not do due diligence on the corporate part of the Britannia book because we were not given the access during the time. We recommended that that should be done as part of phase II.

Q1138 Andrea Leadsom: Are you aware that that was done as part of phase II?

Andrew Walker: That was done by Co-op.

Q1139 Andrea Leadsom: You have talked about impairments and securitisation. What were your recommendations on the treasury assets?

Andrew Walker: That they should make downward adjustments to them as part of the fair value adjustments.

Q1140 Andrea Leadsom: Do you feel that the Co-op accepted your advice?

Andrew Walker: Absolutely.

Q1141 Andrea Leadsom: Do you feel that at the time they took sufficient account of it in making their decision?

Andrew Walker: Yes. I presented my findings to the combined audit committees and they were discussed, and there was a good discussion on them, I think.

Q1142 Andrea Leadsom: Your own personal conclusion would have been, along with theirs, to go ahead anyway, having taken into account the concerns that you have raised.

Andrew Walker: As I have said before, I only see part of the information on that. So I highlighted the risks. They took those into account in making their decision.

Q1143 Andrea Leadsom: At the point where you left the transaction, if it was your money on the table and you were personally buying Britannia with your money, would you have been going ahead with it at that point, on the basis of the analysis that you had done?

Andrew Walker: I only did a very small part of the analysis, so I couldn’t make that decision based on the information I had available to me. If it was my money, I wouldn’t make that decision on part information.

Q1144 Andrea Leadsom: So you are not willing to say whether, given where you had got to, you would have at that point been minded to say yes or minded to say no. Would you have been firmly on the fence thinking, “I need more information”, would you have been thinking, “This is an absolute steal” or would you have thought, “I’m not going to touch this with a bargepole” at the point you were at?

Andrew Walker: It would be that the board should take in the information I have given them. As part of that information, I pointed out other areas to be done.
My advice would be that they should not have gone ahead with the transaction without having completed that additional work that I recommended.

Q1145 Andrea Leadsom: In hindsight, bearing in mind that we all learn from experience, in future days, if you were doing due diligence, might you be more inclined to be more assertive in the sense of, “At this point I wouldn’t be doing this transaction without X, Y and Z” or would you continue to say, “You just need to look at X, Y and Z before you make a decision?” Do you think that from the point of view of due diligence there is a lesson to be learned whereby there is some kind of qualitative view or advice to be given by advisers, rather than their simply laying out the facts, or do you think laying out the facts is perfectly adequate?

Andrew Walker: I think we have to bear in mind in this transaction that, as there are in many other larger transactions like this, there are other advisers whose job it is to do just as you have outlined. I think in this case it was JP Morgan.

Q1146 Andrea Leadsom: In your role you had absolutely no need or desire to express an opinion?

Andrew Walker: Correct.

Q1147 Chair: We know that there has been a sort of rail crash at the end of this line. What we are doing now is going back down this railway line to try to find the spot at which the sleepers were loose or something caused the train to come off the rails. What you are saying is that on your bit of work, checking the points or whatever you were doing, there was no problem. This deal, as far as you were concerned, was correctly analysed by you guys, and the right questions were asked by the board with respect to your part of this work. As far as you could tell, staring them in the face, they all looked pretty reasonable, bright guys who understood what they were looking at. Is there anything you want to say no to in that?

Andrew Walker: Without saying a double negative? As I said before, they asked me to look at certain areas should have been followed up as part of phase II.

Q1148 John Thurso: Can I ask a quick follow-up question to that? You quite correctly pointed out that you were doing a part of the overall advisory work and due diligence, and that JP Morgan were doing another part. Are you satisfied that all of the correct advisers were in place for all of the different aspects? Was there a legal adviser? In the answer you gave to Andrea Leadsom, you said that there were other areas that needed to be covered. Were you of the opinion that all of the areas were covered by somebody?

Andrew Walker: I didn’t see that work, so I can’t comment on whether all that work was done correctly or to an appropriate standard.
Andrew Walker: Yes. I think in all of those areas where I have recommended that follow-up work be done, it is my expectation that it was done.

Q1156 John Thurso: You state in the final executive summary under “due diligence”, under “status” that phase I is complete and so on. “The findings summarised in this report includes responses to questions raised by the CFS RMC”, which I assume is risk management committee.

Andrew Walker: Correct.

John Thurso: That was “on 31 October 2008 and the combined Claret group ARC on 3 November.” Presumably the draft report that you kindly gave us was what they were looking at in those meetings, and the final report is post those meetings.

Andrew Walker: Yes. During the phase of the due diligence, which was predominantly in the second half of 2008 and more towards the end of 2008, we attended a number of meetings to discuss status updates, and then we presented our final findings in a draft report in December. We subsequently finalised that draft report in March, but it did not change from the December one.

Q1157 John Thurso: You pre-empt the next question, which is, when you presented the original drafts for discussion prior to the finalisation, what were the material points that were asked to be looked at?

Andrew Walker: As follow-up areas? There is a list on the page. I think the most material of those was to perform a review of the watch-list items in the corporate book.

Q1158 John Thurso: Thank you. Three more areas, if I may. The first is in respect of the very helpful table you have in respect of the adjustment to earnings, which makes quite clear that—from memory—the £50 million half-year profit had something in the order of £25 million of one-offs, so that the underlying would be £25 million, and then benefited from a series of favourable impairment judgments and so on, which actually took the bottom figure into a loss, so that if you were looking at the underlying number you had a half-year loss. Is that a correct reading of your table?

Andrew Walker: I believe that is the case. Part of the scope of the role was that we were instructed to look at the underlying earnings of the society, and that is the output of that work.

Q1159 John Thurso: Having read a few of these things in my life, I found it a very helpful and well-constructed report, for what that is worth. Sitting on the audit committee, I would have asked a lot of quite searching questions as to the quality of the profits going forward, based on that table, and I would have asked quite a lot of questions of my board colleagues as to the advisability of a deal for buying a loss-making business. Did those discussions take place in your hearing?

Andrew Walker: In the audit committees that I attended, they understood all of those points. Subsequently I am sure, but I can’t comment on this because I didn’t observe it, that they took into account those risks against some of the opportunities in the transaction.

Q1160 John Thurso: Was there a discussion of the fact that the underlying earnings trend, adjusted to take one-offs out, had a half-year loss, and was that taken into account in valuing the performance going forward?

Andrew Walker: There are probably two parts to the question there. I can’t recall specifically having a discussion about it, but I only say that because it was almost five years ago. What I do recall, though, is that the specific findings of the due diligence were then taken forward and addressed in the capital forecasts of the combined business.

Q1161 John Thurso: I would have thought that when you are looking at a merger or a takeover or anything else, whether or not there is an underlying profitability or loss in a given time period is a relatively important question that you might expect the board to be giving you a bit of questioning on and even having discussion on among themselves.

Andrew Walker: I agree with the general comment, I just can’t recall the specificity of the conversation. I think there is one other important factor to bear in mind, which is that this transaction was against the background of economic projections of a recovery back to normal UK trading, normal GDP and normal interest rates by 2011. When you set this transaction in that context, those points were taken into account as well.

Q1162 John Thurso: Absolutely. I remember that period extremely well. We are in the period immediately following the rescue of RBS and the takeover by Lloyds of HBOS, and post the nationalisation of Bradford & Bingley. It is a period of extreme movement in banking at a time at which people are still saying that it is a financial problem and not yet an economic recession. I remember all that, so I am aiming off. I am saying that even in fairly ordinary times, taking a half-year statement at £50 million-plus and turning it into a significant minus is something I would want to ask a lot of questions about before I said I wanted to get involved with this business. That is why I am pushing you a little bit to try to find out what the board actually thought or did on this.

Andrew Walker: Forgive me. I can’t recall the specific discussions about that, but we presented the whole key findings to the board.

Q1163 John Thurso: You presumably still have your notes. You would have had your daybook and kept your own notes.

Andrew Walker: Going back that far, I am not too sure.

Q1164 John Thurso: If you ever happen to find them, I would be delighted to know what you thought at the time.

The second area that I wanted to ask you a brief question about is the comments you make about risk.
weights and capital. It makes it very clear that, even under moderate stress, there are significant potential problems around the future capital requirements. What discussions did the audit committee or the risk committee have in regard to that?

**Andrew Walker:** I think the capital position of the combined organisation received a great deal of focus by the bank. As a result of that and comparing the risk weights, which is the job that we did as part of the process, and looking at some of the stresses applied in the forecasts, we were very clear that the moderate stress was the right scenario to think about as the revised base case. That was accepted.

**John Thurso:** The moderate stress, going forward, became the base case.

**Andrew Walker:** That is my recollection, yes.

Q1165 **John Thurso:** That is quite a significant change to Tier 1 ratios.

**Andrew Walker:** It is, but I think in the circumstances that were rapidly evolving at the time we felt it more appropriate.

Q1166 **John Thurso:** I don’t want to put more words in your mouth, but I am getting the sense that if you had been asked for advice on this—you weren’t and I accept that—you might have wished your clients in the Co-operative to home in on capital and capital requirements going forward as a key part of making a decision.

**Andrew Walker:** I think they did focus on the capital requirements, certainly in the projections, and they had a number of discussions with the regulator. I wasn’t part of those discussions, but I am aware that those discussions took place in terms of assessing the headroom of the capital forecasts against the combined capital requirement of the two organisations.

Q1167 **John Thurso:** I have one last question, if I may. You have given evidence that is very loyal to your clients, as I would expect of a professional, which basically has said that it is all in there if you choose to read it, but the decision was theirs, not yours, and you were not an adviser on that. You were there to illuminate the risks. As the Chairman said, we know where this all ended up, and we know the quality of some members of the board. What we are really trying to find out, looking at advice one might give on governance in the future, is whether or not the people to whom you were reporting had the technical skill, ability and experience to understand what you were saying to them. When I read this I said to myself, “If I was on that audit committee, I would ask a lot of very searching questions, and I would need a lot of persuasion before I did the deal”. You are saying that they had a discussion, but they carried on. I now ask the subjective question: to what extent do you think, as so often happens, that this board was captured by deal-itis, and that the desire to get the deal done was taking them further than they might naturally and cautiously have gone before the deal kicked off?

**Andrew Walker:** I think the board set out to examine the risks of the deal and the opportunities in the deal.

I have very clearly highlighted some of those risks in my report. I had confidence when I was presenting to the audit committee members of that board that they were aware of what I was telling them and were asking pertinent questions about those risks. I can’t comment on the subsequent discussions at the board, because I didn’t attend them.

Q1168 **John Thurso:** Every good partner has a good feel for the board and the committee he is talking to, and relationships are well formed. Did you at no time feel, “This is beginning to gather a pace that maybe it shouldn’t, and maybe people should be asking me a few more questions about some of these things I am raising”?

**Andrew Walker:** I think at the time I was asked the right questions during my presentations.

**John Thurso:** How very loyal.

Q1169 **Chair:** Did you get a sense at all that some members of the board were more doubtful than others?

**Andrew Walker:** I can’t recall that.

**Chair:** It is a very straight bat indeed we are getting this morning.

Q1170 **Mr McFadden:** What is due diligence?

**Andrew Walker:** It is an examination, to a prescribed scope, of particular areas of work. It is for us to request the right information about those areas, to examine that and to report on what we see as the key factors and issues coming out of that information. It is not to recommend a deal specifically.

Q1171 **Mr McFadden:** A client asks you for due diligence because a deal may be costly. Is it fair to compare this to a potential house buyer commissioning a surveyor to look at a house? They may want to buy that house, but they want you to tell them whether or not the roof is about to cave in.

**Warren Mead:** Do you mind if I pick that up? I am a transaction services partner. I often hear the analogy that we are the surveyors of a house and the investment bankers are the estate agents, and you are going to extend the analogy.

Q1172 **Mr McFadden:** I am asking you, is that the right analogy? I want to understand what due diligence is, what it can be expected to do and what it can’t be expected to do.

**Warren Mead:** Due diligence is to highlight the key risks and opportunities in a transaction.

Q1173 **Mr McFadden:** Is the house purchase analogy a fair one, or do you think it is not relevant to think about this?

**Warren Mead:** I think it is a helpful analogy but it is perhaps an oversimplification.

Q1174 **Mr McFadden:** Let’s look at this in terms of some of the specifics. This transaction resulted in a £550 million hole in the purchaser’s balance sheet. When you were looking at the numbers, how much
did you look at the commercial property and non-standard mortgages that contributed to the lion’s share of that hole?

Andrew Walker: The £550 million you refer to is the subsequent impairment that arose from that book over and above the fair value adjustments. The lion’s share of that did come from the corporate book. As I think I mentioned earlier, we did not do due diligence on that part of the book.

Q1175 Mr McFadden: Why didn’t you do that?
Andrew Walker: Because at the time we were not given the access to the files and the personnel we needed to complete that work.

Q1176 Mr McFadden: The Co-op would have liked you to have done this but you couldn’t get the information from Britannia. Is that what you are saying?
Andrew Walker: That is correct, but they subsequently went on to do that piece of work themselves.

Mr McFadden: The Co-op?
Andrew Walker: Yes.

Q1177 Mr McFadden: This is important. You are saying that you did not do due diligence on the part of Britannia’s asset base that contributed the lion’s share of the £550 million hole in the Co-op balance sheet that subsequently appeared as a result of the transaction. Is that what you are saying?
Andrew Walker: To be very clear with you, we were given some initial information in the initial management presentations by the Britannia management team to the Co-op management team that we attended right at the outset of the due diligence process. That was limited to an analysis of the top 10 counterparties in the corporate book, and it was a confirmation that at that time there were no arrears in the corporate book. Subsequent to that, we weren’t given any further information, so no, we did not do due diligence.

Q1178 Mr McFadden: How uncomfortable were you about this? Given that other banks around this time had commercial real estate exposures that were turning bad in a very dramatic way—if you look at RBS and HBOS, for example, they were losing billions on commercial property—you are asked to do a due diligence job, and you don’t have the information on the commercial property aspect of the potential purchase. How loud were the alarm bells that set ringing?
Andrew Walker: We pointed out that that work needed to be done.

Q1179 Mr McFadden: That is a very mild way of putting it, given what was happening elsewhere in the banking system.
Andrew Walker: In the circumstances, there is not much more I could have done other than to point out, “You need to do due diligence in this area and I recommend you do it or somebody does it”.

Q1180 Mr McFadden: You say that the Co-op subsequently did the due diligence on the commercial loan book themselves. Did they come back to you and ask you to review that, or did you have any further involvement in that?
Andrew Walker: No.

Q1181 Mr McFadden: Did you ever see the work that they did?
Andrew Walker: No. There was no KPMG report on that, and I didn’t see any subsequent Co-op reports to the board.

Q1182 Mr McFadden: What is the value of due diligence if you don’t have access to the data that you need from the business potentially being purchased?
Andrew Walker: The value of the due diligence we did was that in the areas where we were able to do work, we did an in-depth analysis. It just so happens that we were not able to complete some areas of the due diligence and scope.

Q1183 Mr McFadden: The Co-op didn’t pay anything for this deal. It was called a no consideration deal. Did that influence your judgment about the risks in any way?
Andrew Walker: Not at all.

Q1184 Mr McFadden: Looking back on this, this deal resulted in a £500 million-plus hole in the Co-op’s balance sheet. How do you feel about the work done on this? If we go back to our house purchasers analysis, if I went ahead with the purchase and I suddenly found I was left with an enormous repair bill because of structural faults, I would feel pretty annoyed at the people I had asked to look at the purchase. How do you feel about that?
Andrew Walker: I think if I step back and look at the facts of this book—I am able to do this because of the involvement as the auditor subsequently—and in particular if we pay attention to the problem assets, just singling out the top 10 on the watch-list, which add up to about £1 billion or £950 million, 80% of those exposures don’t mature until 2015 or beyond, and they are usually loans to single purpose vehicles that let a commercial property. Alternatively, the leases on those properties may not be due for renewal until 2015 or beyond. So when we look at this in 2008 or 2009 against the context of a full economic recovery projected by 2011 or 2012, looking at assets that don’t mature until 2015 or 2016, it is a reasonable expectation that those would be capable of being refinanced at those points in time.

Q1185 Mr McFadden: You are blaming the lack of economic recovery for this black hole?
Andrew Walker: That is a contributory factor to the situation.

Q1186 Mr McFadden: Does this explain why the hole in the Co-op’s balance sheet emerged later than other banks who were doing the big part of their write-offs earlier in 2009?
Andrew Walker: What I have done in looking back—and we do this as part of the work at the time of the
audit—is to benchmark the Co-op Bank’s impairment charges and their impairment provisions, including the benefit of the fair value adjustments that were set aside at the merger as well.

Q1187 Mr McFadden: But the fair value adjustments were an underestimate, as things turned out.
Andrew Walker: They were reasonable estimates at the time those adjustments were made.
Mr McFadden: But they proved to be £500 million.
Andrew Walker: They were reasonable estimates at the time those adjustments were made. If I could just finish on the benchmarking point, aside from Royal Bank of Scotland, which actively pursued an exit strategy of its non-core business, Co-op Bank had a reasonable level of impairment coverage when you compare it to other peers. It had the highest level of impairment cover plus its fair value during 2009, 2010, 2011 and 2012. I certainly don’t share the view that Co-op was behind others on its impairment.

Q1188 Mr McFadden: If it had all this cover and it was in such a healthy state, why did it fall over?
Andrew Walker: In 2012 there were essentially two things that happened. A number of the larger exposures that were going through refinancing and renegotiating discussions either hit some form of problem or it became increasingly likely that the commercial real estate markets were not going to recover in the near term. The FSA subsequently wrote a letter to UK banks to confirm their view, or the FPC’s view, of the likely prospects for the commercial real estate market, which was to effectively say “Don’t assume that there is going to be any recovery in these markets as a permanent state of affairs.” Taking those two factors together, the Co-op Bank evaluated its individual provisions at the end of 2012 and arrived at a large number, but it was correct to be recorded at that time.

Q1189 Mr McFadden: I will just finish with this. You have said it was all reasonable at the time and you couldn’t predict the failure or the delay in securing any economic recovery. Does that mean that if you were doing this exercise today you would take a different view, a more conservative view of commercial property assets, based on the specific failures in that market and based on the economic situation in recent years.
Andrew Walker: Can I clarify which exercise you are referring to?
Mr McFadden: If you were looking at commercial property now, would you take a more conservative view of it than you would have done five years ago because of the factors you have just cited to me? In other words, have KPMG learned from this, and would they shoot lower on the potential value of these assets in the future?
Andrew Walker: I would say two things in response to that. I don’t have the benefit of hindsight when I am doing my work. I have been back and relooked at the work, and I have asked other people to do so, and indeed the bank has asked independent advisers to look at its 2012 financial statements and the impairment positions in particular. The conclusions from those look-back exercises are that the accounts were appropriately stated at the time.

Q1190 Chair: Was there any work that you think should have been commissioned by the Co-op that was not commissioned?
Andrew Walker: In relation to anything in particular?
Chair: You said that you advised them to do some key work on commercial real estate impairment, and that they did that subsequently. I am asking you whether you asked them to do all the work that you think, on the basis of what you saw, they should have done.
Andrew Walker: I am not in a position to instruct them to do work, so I recommended that they complete particular areas.
Chair: I was talking about asking or suggesting.
Andrew Walker: I didn’t make any recommendations to that effect.

Q1191 Chair: None at all? So was there any work you think should have been commissioned that was not commissioned? It is the same question that I have just asked.
Andrew Walker: As I said earlier, I felt it important that they completed the work that I said should be completed to complete the due diligence exercise.

Q1192 Chair: Right, and that did complete it? That is what I am asking. That is exactly what I am asking. Are you confident that everything you asked for, once done, did complete the due diligence?
Andrew Walker: I was not asked to go back to do an exercise to confirm that it had all been done.

Q1193 Chair: I will ask it again. When you came to them and said, “Our advice is that you should do this very important bit of due diligence that has not yet been done”, was there also in the back of your mind any other area that you thought required attention that you did not alert them to at the time?
Andrew Walker: My report contained a couple of pages—forgive me, I can’t remember exactly which ones—where I pointed out additional work that should be done as part of phase II, and the most important one of those was corporate.

Q1194 Chair: Are you confident that that list was comprehensive?
Andrew Walker: Yes.
Chair: Okay. We have got to the answer.

Q1195 Mr Ruffley: Mr Walker, the major loan impairment losses emerged in 2012 and the first half of 2013. On a point of information, you gave an answer to Mr McFadden that seemed to suggest that Co-op Bank was not any different from the average of all other banks when it came to impairment losses. Is that true, or would you say, on the other hand, that the majority of loan impairment losses of other banks took place before 2012?
Andrew Walker: 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.

Q1196 Mr Ruffley: Some of the evidence we have received is to the effect that the regulator and its higher regulatory capital requirements became a problem for Co-op more than other banks. Is that true?

Andrew Walker: It is certainly the case that the capital requirements for Co-op Bank were increased, and they were informed of that as part of the normal capital assessment exercise that the FSA runs. That happened in January. So at that point there was a shortfall against the FSA’s capital planning buffer. I can’t comment relative to other banks, because I don’t see other banks’ capital requirements. It is a confidential matter.

Q1197 Mr Ruffley: In calculating the impairment provisions, can you just take us through how that is arrived at? That essentially is a number generated by the bank and then you take a look at it.

Andrew Walker: That is correct.

Q1198 Mr Ruffley: In relation to the bank’s capital position as it was summarised in the financial statements of 2012 to 2013, were KPMG issuing any warnings?

Andrew Walker: In the 2012 financial statements, when we were doing the audit it became apparent in January that there was a capital shortfall against the FSA’s capital planning buffer of approximately £1 billion. At that point, going concern was a heightened risk as part of the audit for us. We concentrated initially on liquidity, because liquidity is the first thing for us. Any loss of customer confidence and withdrawal of deposits from the bank was the primary risk that we focused on first, and we were comfortable by the time we signed off in March that the bank had built up a considerable liquidity war chest, as it were, to insulate itself against any potential impacts like that.

We then concentrated on the capital actions, and the bank had agreed at the request of the FSA to draw up a capital action plan to close that capital gap. It was under a project called Project Pennine. We examined the actions within Project Pennine and the forecasts that were put together to support it. Although Project Pennine was not due to complete until the end of April and be presented to the FSA at that point, it was in a relatively advanced stage when we signed off, and the board had scrutinised the actions in that plan. I was comforted as well by the fact that the FSA were meeting with Co-op’s management weekly to discuss that plan in particular. An additional part of my procedures was to have discussions with the FSA around that plan and the risks within it, and seek their views on the capital position of the bank.

Q1199 Mr Ruffley: Barry Tootell’s 20 March 2013 overview in the 2012 financial statement said, “Our balance sheet remains strong”; yet shortly afterwards Moody’s downgraded the bank and the £1.5 billion shortfall was laid bare for all to see. You signed off on those accounts, didn’t you, Mr Walker? Why were you so completely wrong about the scale of the bank’s problems?

Andrew Walker: To be very clear, I do not sign off on the chief executive’s report or the chairman’s report or the business and financial review.

Mr Ruffley: You sign off the accounts.

Andrew Walker: I check that they are consistent with the accounts and, in doing so, when we first read the drafts of those reports, we effectively asked for a rewrite, because they were not reflective of the circumstances in the accounts. The references that were made—

Mr Ruffley: You asked for a rewrite in relation to what particular element of the draft statement?

Andrew Walker: We asked that optimistic references or references to strength in the bank overall were removed. I think what was left was references to the liquidity position of the bank and the core bank as being the stronger areas of that bank, and we felt that was consistent with the financial statements.

Q1200 Mr Ruffley: Could I just be clear what your status is in this process? I am reading here from the Barry Tootell statement: “Our balance sheet remains strong,” and “The bank’s underlying financial strength remains intact.” Did you challenge that drafting and, if not, why not?

Andrew Walker: We did challenge the aspects of the drafting, as I said, and we asked for substantial rewrites of that. I think that those—

Mr Ruffley: But what about those two statements? Let’s just focus on those two statements. Did you allow that to go out? Well, manifestly you did, but without any protest at all?

Andrew Walker: Those two statements were consistent with the projections that I was seeing and looking at, at the time, as part of the audit for the core bank, which was profitable, and the capital and liquidity positions of the bank. The liquidity position, as I have said, was robust and the capital position at the time I signed off was 9.2%.

Q1201 Mr Ruffley: When precisely was the decision taken, to KPMG’s knowledge, to pull out of Verde?

Warren Mead: If I may answer that, my understanding is that the decision was taken in a board meeting in April 2013.

Q1202 Mr Ruffley: Were you party to that decision?

Warren Mead: I was not at that board meeting, but I had attended—

Q1203 Mr Ruffley: Were you asked to give advice prior to that meeting?

Warren Mead: Yes.

Q1204 Mr Ruffley: What advice did you give?

Warren Mead: We reported to the board in March 2013. The Co-op had set itself 15 objectives for the transaction and our advice was that they did not meet those objectives.
Q1205 **Mr Ruffley**: Which were the main sticking points, from your point of view? What were the big ones? Don’t go through all 15. What were the showstoppers, if I can put it that way?

**Warren Mead**: In my mind there were four showstoppers. The first was an ongoing reliance on Lloyds’ IT platform for 10 years. Outsourcing your IT platform to a competitor for 10 years is a fairly uncomfortable position. The second was around the risks of integration. It was going to be a hugely complex task to bring the two organisations together. The third was around conduct risk and, in particular, the view that there were legacy conduct risk issues in the book that were being transferred that could not be fully mitigated through indemnity. If you brought all of those things together, it was just too high-risk for the capital that the combined group would have had.

Q1206 **Mr Ruffley**: What discussions did you, Mr Walker, or you, Mr Mead, have, in the time you at KPMG advised Co-op, with the regulator—the FSA and then the PRA—specifically on the capital position?

**Andrew Walker**: During the audit I met with the FSA, over the course of 2012 and 2013, seven times.

Q1207 **Mr Ruffley**: Who at the FSA?

**Andrew Walker**: With the supervisor at the FSA, the bank supervisor.

**Mr Ruffley**: Who was?

**Andrew Walker**: Andy Cope, and colleagues of his. Specifically towards the end of the audit, when we were focusing on the capital position, we met three times during February and March.

**Mr Ruffley**: What did the regulator say to you on those occasions?

**Andrew Walker**: The regulator had two principal concerns at that stage. Bearing in mind that the Pennine capital action plan was not due to be delivered to them until the end of April in its final form, clearly, as I said, they were very aware of what was going into Pennine and the actions in it. They had two principal concerns, the first of which was that the bank should be prepared to take what they called dial-turning actions to improve their capital position; for example, the sale of the general insurance business, which the group then went on to do. Secondly, they were concerned that the group, which they do not regulate directly, was in a position to take more radical action should that become necessary. They received confirmation, as I understand it, from the group that they were prepared to do that as a last resort.

Q1208 **Mr Ruffley**: Did you get the impression that Project Pennine, which was in prospect, was not only giving you comfort but giving the regulator comfort?

**Andrew Walker**: Yes.

**Mr Ruffley**: That everyone’s eggs were in the Project Pennine basket?

**Andrew Walker**: Correct.

**Mr Ruffley**: That was not probed, other than to say, “This is a plan that is going to be activated by Co-op?”

**Andrew Walker**: To correct you on that, absolutely it was probed by us. As part of the audit process we assessed the viability of each one of the individual capital actions in that.

**Mr Ruffley**: Why do you think it did not come off as a plan?

**Andrew Walker**: Several parts of the capital action plan are still in train. The sale of the life and savings business was completed. The sale of the GI business was embarked upon and offers were invited for that business, The bank has started to actively deleverage its corporate book. On all of the three principal actions that we looked at, we have seen substantive progress at the time we signed off and subsequently.

**Mr Ruffley**: Yet there is still a £1.5 billion capital hole.

**Andrew Walker**: There are two events that happened after I signed off, to be very clear. One is that new management came in. They started to pursue an exit programme of their non-core business more aggressively, and to do that, they set themselves additional provisions, because they were going to get out of those corporate exposures at a greater discount. The impairment provision for that was about £250 million. Secondly, the regulator revised its expectations of core Tier 1 capital for Co-op Bank, as it did for all other UK banks. As part of that the capital requirement changed as well. Those two circumstances happened after I signed off the 2012 accounts.

**Mr Ruffley**: No one saw that regulatory change coming?

**Andrew Walker**: The regulator did not say that to me. I think those changes stand out from the Financial Policy Committee meeting in late March, and the findings of that were not known to me.

Q1209 **Mr Ruffley**: I just wish to ask one technical question. It bears on the answers you gave at the start of my questioning and the end of Pat McFadden’s questioning. It is about the question of the peak of impairment losses, and our supposition that the peak was higher for other banks and that your peak came after the other banks—that you were an outlier. I am told that your answer includes fair value adjustments. You cannot explain, or you have not explained, why the actual profit and loss impairment charges occurred later at the Co-op than at other banks.

**Andrew Walker**: I do not necessary agree with that assertion. As I explained earlier, in the benchmarking that I have done against other UK banks of a similar peer group to Co-op Bank, they also incurred significant impairment charges against their corporate books, in particular in 2012.

Q1210 **Mr Ruffley**: You stand by the KPMG statement that basically there were no alarm bells ringing. Co-op was not in any different a position when it came to impairment losses from the average of all other banks. That is what you are saying.

**Andrew Walker**: Against the banks that I had been able to benchmark Co-op against.

**Mr Ruffley**: Just remind us which banks those are.

**Andrew Walker**: They were Nationwide, Santander, Clydesdale and RBS, from their public financial statements.
Q1211 Chair: Can we just go back to the questions that Pat McFadden was asking earlier, which seemed to be pretty important? You presumably asked for access to the Britannia corporate loan book. Did you?
Andrew Walker: Yes.
Chair: On what grounds were you told that information was being withheld?
Andrew Walker: There were certain elements of the transaction that simply meant Britannia did not have the capacity to have people coming into the premises to do work, or it was from a confidentiality and sensitivity point of view. I don’t know of any other reasons beyond that why we were not given access.

Q1212 Chair: The papers were scrambled or, alternatively, were in a mess, so they did not have them sorted into neat files for you. That seems to be the first point. The second point is that there might be confidentiality concerns, but there was a confidentiality agreement in this deal. There must have been a sign-off that access to all information required to do the deal would have been provided. Correct?
Andrew Walker: If I may just—
Chair: Just clarify that point first. Correct?
Andrew Walker: I believe there were the appropriate confidentiality undertakings on the table, but when you have—
Chair: That would have covered this.
Andrew Walker: If I may, when you start to spread out a due diligence exercise more widely and start to speak to more junior members of the management team, confidentiality becomes a particular risk.

Q1213 Chair: You are buying this outfit, or at least you are merging with this outfit. You want to know everything that you reasonably need to know about this. That is a central thing you reasonably want to know. You are not suggesting to me that this could be withheld, are you?
Andrew Walker: No, I am not.
Warren Mead: Sorry, may I come in, Mr Chairman.
Chair: You have wanted to come in three times. Now we will let you in.
Warren Mead: Thank you very much. It is very standard in due diligence processes for information to be released in phases, so often you will get some more high-level information at the start. When you get further in the process—
Chair: But this is not being released in a phase. This is being withheld.
Warren Mead: I believe it was released to Co-op later in the process.

Andrew Walker: That is correct, as part of phase II.

Q1214 Chair: How hard did you press to see this yourself?
Andrew Walker: We pointed it out in our report.
Chair: How hard did you press?
Andrew Walker: Other than pointing it out in our report and spelling that out for management, no further.
Chair: Not very hard.
Andrew Walker: I think you have to set this in context—the initial information we had been given around the counterparties and their arrears, and the fact that this was £2 billion of a £24 billion book.
Chair: It is a pretty important corner of this book, don’t you think?
Andrew Walker: I agree with that, but that is why I flagged up that more work needed to be done.

Q1215 Chair: Even at the time you thought that, never mind what has happened subsequently. You were the financial advisers. What discount did the Co-op receive for the incompleteness of the due diligence on this point in the deal?
Andrew Walker: As in consideration?
Chair: Yes.
Andrew Walker: There was no consideration paid.
Chair: None whatsoever?
Andrew Walker: No. It was a merger of two mutuals.
Chair: No, but there would have been a value written in for this.
Andrew Walker: I did not do the business case for the merger. I just did the due diligence towards it.
Chair: You do not know?
Andrew Walker: I don’t know I am afraid.

Q1216 Chair: Were you satisfied with the Co-op’s decision to conduct the due diligence on Britannia itself on the corporate loan book?
Andrew Walker: The corporate credit team in Co-op already had a book of a similar nature, and the people who were the corporate credit officers in that area of the bank subsequently completed that work. I had no reason at the time to doubt their capability to do it.
Chair: You think they had the requisite expertise?
Andrew Walker: They had the right experience to be able to do that piece of work.
Chair: Okay. Well, we are still looking for those loose sleepers. Thank you very much indeed for coming to see us this morning. We may need further information, which we hope we will be able to obtain in written form. With colleagues’ agreement, I intend to go straight on to the JP Morgan hearing. Thank you very much indeed.
Examination of Witnesses

Witnesses: Tim Wise, Managing Director, UK Investment Banking, JP Morgan, and Conor Hillery, Managing Director, UK Investment Banking, JP Morgan, gave evidence.

Q1217 Chair: Thank you very much for coming to see us this morning. First of all, can you tell us what a fairness adviser is, for those who may not have been through this experience? Some of us have and some of us have not.

Tim Wise: The fairness opinion was part of our overall advice. Our overall role was as a financial adviser, and essentially that is to advise on the financial terms of the transaction, taking into account the management’s judgment on commercial matters. Sometimes, as part of that, you are asked to give a formal fairness opinion and sometimes you are not. In this case, we were asked to give a fairness opinion. Essentially, what that fairness opinion says, based on the management’s view of the commercial opportunity, the management and board’s commercial assessment of the future and the terms of the transaction, is that those are fair from a financial point of view for, in this case, the Co-op.

Q1218 Chair: How much were you paid for this work?

Tim Wise: Our fee on this was £7 million, which was paid as £2 million on announcement and then a further £5 million on completion.

Q1219 Chair: So you had an interest in the deal?

Tim Wise: Like all advisers, in any participation in a deal you have an economic interest in the deal, yes. We certainly had an interest.

Q1220 Chair: You were not sitting there neutrally giving the advice. You were thinking, “There is £5 million riding on this”.

Tim Wise: No, I think that is not a particularly fair way of characterising our role. Clearly that is a significant fee and there is no other way of looking at that.

Chair: Most people would consider £5 million a pretty significant fee.

Tim Wise: Yes, and I accept it is a very significant fee, but that is the way that the industry works, and that is—

Chair: I am only picking you up on this because it is understatement like that that people outside this place find pretty astonishing, frankly. £5 million is a shed-load of money for advice, isn’t it?

Tim Wise: As I have said, it is a very significant fee. It is the way that the industry works and clients work with the industry in terms of—[Interruption.]—

Chair: Sorry about this noise. It will only last a few seconds. As a matter of fact, I have tried hard to get these tones adjusted in this room at this time, but unsuccessfully. I have been told that that requires a very significant fee as well. Do carry on.

Tim Wise: I think I did use the words “very significant”, so I hope that was not an understatement. It is a very significant fee, and the way that clients choose to pay us, whether it is M&A transactions or capital markets transactions, is based on the transaction happening. That is the way the industry works, and that is the way clients choose to pay us.

In terms of the integrity of our advice, the clarity of our advice and the honesty of our advice, that is something that is absolutely fundamental to the way we work and the way the vast majority of the industry works. Frankly, a lot of professions work that way. People get paid if something happens.

Q1221 Chair: Just going back to that first question, you had a considerable financial interest in seeing the completion of this deal, didn’t you?

Tim Wise: Yes, absolutely. If the deal does not happen we do not get paid. If the deal happens we do get paid. That is a fact.

Q1222 Chair: Therefore you like to see the deal done, and it is asking for the objectivity of a saint, is it not, not to be biased in thinking, as you prepare this advice, that you would like to see a particular outcome over another?

Tim Wise: No. I have alluded to the economic fact that you have stated, but the fact is there are many more occasions when we advise clients not to do deals than do deals, whatever the economic consequences for us. One’s reputation and integrity and ability to stay in business, whether it is individually or corporately, is absolutely dependent on doing objective advice based on integrity and fairness, so there are many times when one does not advise that. I can’t deny the economic reality of it, but what I would assert very strongly, and I think I could prove in numerous occasions or if one talks to clients, that we are prepared to do a lot of work advising a client not to do a deal and receive no remuneration.

Q1223 Chair: When people go to firms like you they obviously want good advice. They also want it to be known that they have you working on the case, and your fees reflect the fact that there is some value in your brand, wouldn’t you say?

Tim Wise: Yes. I think it is probably almost a given, though, that if a company, in this case, of this size and importance doing a deal of this size and complexity and importance is going to go to a firm of high standing and reputation, I would not claim that we are the only one who could fit in that category.

Q1224 Chair: Do you think it might enhance the long-run reputation at the top of this industry—the advice industry in which you work, with respect—if fees were not contingent on a particular outcome where you are advising specifically on whether to do that transaction?

Tim Wise: I think that is a very fair point to raise, and what I would say is that it is not generally in our gift to decide how we are paid. It is the client who engages us and determines how to pay us.

Q1225 Chair: Are you saying that the Co-op said, “We’re only prepared to hire you if we are allowed to pay you £5 million if we pull off the deal and nothing if we don’t”? 
**Tim Wise**: No, what I am saying is that how they paid us was absolutely in line with industry practice.

**Q1226 Chair**: I know you began with that, but I am not asking that question. I have asked you the question: do you think we—perhaps we in this Committee or perhaps you in the industry—ought to reconsider whether this is a sensible way to provide remuneration for fairness advice and other parts of the financial advice you gave?

**Tim Wise**: Yes, I think it is a perfectly fair and open discussion to have.

**Chair**: I am asking your view. I am asking you to discuss it.

**Tim Wise**: Yes, okay. There have been times when clients have said to us, “What we would like to do is pay you on just a retained basis and, regardless of whether there is an outcome or not, we will pay you” that does happen from time to time. I have to say, it is not in the generality of cases. One of the problems is that, when it has come to the client finally deciding how they want to pay us, they would rather pay us on this basis, and quite often they tend to restate from paying us a significant fee for something that does not happen. It is as much, if not more, in the client’s gift and the corporate’s gift as to how they pay us than it is in ours. But do I think it is a debate that should be had more broadly? Yes, I am sure it will be a debate that is had more broadly.

**Q1227 Chair**: That comes back to the point you made a moment ago when I said to you, “Is it the Co-op’s fault that this transaction had its remuneration biased in this way?” You did not want to say yes to that, but you appear to be saying yes to it now.

**Tim Wise**: No, I am not saying that. I am saying that, between the two of us, clearly we are both complicit in how we are paid. There is an engagement letter that it takes both of us to agree, but I am saying that how we are paid is not entirely within our gift, across the board or in respect of this transaction. It is a two-way agreement.

**Q1228 Chair**: I have been involved in hiring fairness advisers. What goes on is that somebody comes to you and says, “We want you to give fairness advice on X”, and you say, “Okay, this is the fee”. Isn’t that what happens?

**Tim Wise**: Just to be clear about the process of this transaction, the fairness opinion and the—

**Chair**: That was only part of the fee.

**Tim Wise**: Also, it came late. In fact, the decision on giving a fairness opinion came after we had discussed fees. The fee was not specifically related or attached to the fairness opinion.

**Q1229 Chair**: Even for the wider advice, it is quite likely that, although there will be a discussion about fees, and possibly a bit of to-ing and fro-ing, and giving the board comfort by shaving a little bit off to make them feel happy, broadly speaking, you say what your fees are and they try to amend them. Isn’t that correct?

**Tim Wise**: There is a process of negotiation that will differ from transaction to transaction.

**Chair**: Is what I have said correct?

**Tim Wise**: Yes. In this case, I cannot recollect every detail of the fee discussion.

**Chair**: They do not come to you with a proposed fee structure in the first part of this discussion, do they?

**Tim Wise**: In this case what happened was that they said, “Give us some reference points for comparable deals and what might be a fair range”. We discussed a fair range and they then came back to us and said, “Okay, we have looked at the evidence, and we have looked what is paid elsewhere. Here is the fee we are paying you”.

**Q1230 Chair**: Can I turn to the due diligence? Was it your job specifically to identify all the due diligence that needed doing and to advise the Co-op to do that effect?

**Tim Wise**: No, it wasn’t. It was principally the Co-op’s job to decide the due diligence, but we were very much involved in reviewing the scope of the due diligence that was undertaken.

**Chair**: I did not say to decide. I said to advise.

**Tim Wise**: Yes. We helped advise them on what the scope of their due diligence should be.

**Q1231 Chair**: I will go back to the question I just asked—this is hard pounding so far. I am asking you whether you considered it to be your primary responsibility to make sure that you advised them on all the areas of due diligence that they should cover and to make sure that they were aware of those.

**Tim Wise**: No, I do not think the starting point for the due diligence process and the scope of it was ours. That was the Co-op’s, but we played a material part in talking to them about that and advising them on that scope and giving them a view on whether that was the appropriate scope.

**Q1232 Chair**: I have your engagement letter of 19 January 2009 here in front of me, and I am looking at paragraph 1.1, third tiering “In conjunction with the company and its other professional advisers determining the overall scope of an appropriate due diligence exercise in relation to Britannia Building Society.” Do you think what you have just said to me is entirely consistent with what is sitting there on the engagement letter?

**Tim Wise**: I think it is consistent with that, yes. I think it is a combined effort in terms of deciding the scope of the due diligence.

**Chair**: Your job is to identify the due diligence that needs to be done, isn’t it?

**Tim Wise**: Yes. I think if the due diligence has large gaps in it we are answerable for that.

**Q1233 Chair**: Do you think the due diligence had large gaps in it in this case?

**Tim Wise**: No, I don’t think it did, actually.

**Q1234 Chair**: Where was the loose sleeper?

**Tim Wise**: Where was the loose sleeper at the time or where has the loose sleeper turned out to be? Clearly, the loose sleeper has turned out to be in the commercial loan book.
Q1235 Chair: How vigorously were you pressing for that to be examined?
Tim Wise: That was a very important part of the scope of the due diligence as, I think, has been discussed in this Committee before and as David Anderson discussed. That was looked at in detail by the Co-op.

Q1236 Stewart Hosie: Mr Wise, can you describe in your own words precisely what the role of JP Morgan was, as agreed with the Co-op, in relation to the Britannia deal?
Tim Wise: Yes. Our overall, over-arching title is that we are the financial adviser. In the scope of that, we are advising on the financial terms. We are advising on the negotiation, and obviously the terms include both the consideration and the dividend and member loyalty schemes. We have discussed the due diligence process. We are not primarily responsible for undertaking due diligence, but we are responsible for reviewing it and guiding on the scope of it.

Q1237 Stewart Hosie: Were you mandated to give a final decision, a final opinion to the Co-op of whether to go ahead with this transaction?
Tim Wise: No, that is not part of the mandate to give that advice on that decision. Ultimately that is a commercial decision for the board. Our advice relates to the financial basis of doing the deal.

Stewart Hosie: That is the advice that you did give, you believe?
Tim Wise: Yes. Essentially the core of that advice is contained in the fairness opinion.

Q1238 Stewart Hosie: Indeed. In the engagement letter of 19 January that the Chairman referred to, which you signed, the services are, as you describe them, “advising and assisting in the negotiations with Britannia including the tactics to be adopted in relation to the negotiations, providing advice in relation to the valuation of Britannia Building Society, helping determine the overall scope of an appropriate due diligence exercise, reviewing, in light of the knowledge of the transaction, due diligence that has been undertaken, participating in that review having regard to the directors’ commercial assessment of Britannia Building Society.” That is quite a chunky piece of work. Could that be interpreted, do you think, in any way as you providing more than you believed you were providing to the Co-op?
Tim Wise: No, I think that is a good and accurate description of what we did.

Q1239 Stewart Hosie: When we get to the conclusion of this letter—again, this is dated 19 January, so I am assuming the date is wrong—it lays out four points that you note: a description of the work you have done, a page and a half of the caveats explaining how you are not responsible for anything, and then a one-sentence paragraph that reads, “On the basis of and subject to the foregoing it is our opinion as at the date hereof that the terms of the proposed transaction are fair from a financial point of view to Co-op.” That is effectively giving the Co-op the green light to proceed, isn’t it?
Tim Wise: You talk about the page and a half of caveats, which are fairly important in terms of the commercial assessment. That is effectively saying that, if you have sufficient confidence in your commercial assessment and the projections, the financial terms of this transaction and what that effectively means—because there was no consideration—for the value that is going to be created for the Co-op and its members, is of an order where we think that the transaction is fair and in your interest to do from a financial point of view.

Q1240 Stewart Hosie: The Co-op brought you in at a significant fee in order to make a series of judgments. Clearly the caveats are important from a commercial point of view, and clearly it is the decision for the Co-op board to make, but when JP Morgan, with their reputation and their large fee, are around the table and saying, “This deal makes sense”, that is more than simply saying to Co-op, “This is our opinion and you now make a decision”. That is effectively you rubber-stamping this deal and saying, “Yes, it is safe to proceed”, isn’t it?
Tim Wise: I do not want in any way to minimise the influence we can have or the importance of our advice, but I do think that you have to take, fundamentally and seriously, the point about the commercial judgment. I don’t think you can gloss over that and, in some way, spread our role into effectively substituting ourselves for the board and management in making that commercial assessment. That is a commercial assessment that they have to make. I think that the scope of our role and the scope of our advice is precise, and I think the analysis of it lives or dies on the basis of that letter.

Q1241 Stewart Hosie: Perhaps, but not necessarily, in the case of this engagement, are you ever concerned that senior people who engage you are substituting your advice for their own commercial judgment?
Tim Wise: That is a very difficult question to answer across the board, but, no, I generally don’t. The vast majority of our clients are going to be extremely senior, experienced, responsible, professional people who are going to see our advice in the proper context. Certainly in this case, the management team of Cooperative Financial Services were, in our view and opinion, an experienced, objective, dispassionate, competent and professional team. I think they genuinely did understand the risks, and I think they genuinely understood the role they were taking on and the decision they were taking on, and they went about it in a very thorough and rigorous way.

Q1242 Stewart Hosie: Did you see any confusion or conflict between the role you undertook and the role KPMG undertook?
Tim Wise: No, I don’t think so. They are quite distinct, although they join in several places. One of the important points to make about the KPMG advice is that it is not a complete certificate of health. Again, it is not substituting for the commercial judgment. Effectively, the commercial judgment and the due diligence, as I think has been said to you by a couple of people who have been before this Committee from
the management team, is their role. KPMG are supporting, guiding and assisting them in that role. Our job then is essentially to look at the output of the management’s view of the business and the management going forward as assisted by KPMG. We do not feel, in practice, that the roles do conflict. They are fairly complementary.

Q1243 Stewart Hosie: Particularly on the Co-op management side, then, were you not at all concerned on reviewing the due diligence, which was one of your tasks, that the review of the commercial loan book was undertaken by Co-op management internally and not by another external? Did that not cause you any concern when you did that review?

Tim Wise: No, that genuinely did seem a sensible way of doing it. Again, as I think has previously been discussed, on the commercial loan book, it was the Co-op management and the Co-op team that had the real expertise in that area. One of the reasons that they asked KPMG to focus so hard on the specialist mortgage area was because they had a lesser level of expertise in that area. I think it was the right thing to do, and it is a sensible thing to do, for them to send their own teams in to look at it. A lot of the decisions around something like that are going to be based on a particular view of credit risks and the markets they are operating in. The Co-op management team was always going to have better view on that than KPMG probably could.

Q1244 Mr Newmark: I just want to focus a little bit more on what Mr Hosie was saying about your role versus KPMG’s versus the company’s, in drilling down and understanding what is on the balance sheet. I have spent 20-odd years in the City, and at the end of the day you guys, the advisers, see all the cards. Your job is to see all the cards that are there. Internally, were you doing a lot of your own work in running the numbers and understanding the balance sheet on both sides of the equation, and in understanding where the impairment was, if there was any impairment. Or did you completely outsource that and have no guys running the numbers internally?

Tim Wise: We ran a lot of numbers and analysis leading into both valuation and, very importantly, capital modelling. Conor, do you want to talk about what we did in terms of the analysis and valuation, and also the stress testing?

Conor Hillery: Yes. To underpin our advice, in particular the view that we gave as to the fairness of the financial terms of the transaction, we did extensive valuation work. The purpose of that work was to help us assess and advise the management team on the value creation from this transaction. We used several approaches in doing that work. Some of them took reference from public benchmarks, valuations of listed banks and similar transactions in the sector, but where we spent most time in our valuation was on reviewing the business projections and the business plan prepared by management. Our objective was to come up with a view as to the economic value that would create if it was delivered.

To your point, we reflected extensively before we did our valuation work on the findings of management and the findings of KPMG. The approach that we took to valuation was forward-looking, assessing the plans that the management team felt that they could deliver. Our approach was forward-looking so that we could take account of what we felt were the key sensitivities and stress scenarios to this business plan, drawing on KPMG’s work.

Q1245 Mr Newmark: But KPMG, according to them just before you, were only looking at a small piece of the pie. You guys were looking at the whole pie, I am assuming. Correct?

Conor Hillery: Correct. In doing that we drew on KPMG’s work and, very importantly, the management team’s assessment of the prospects of the business. We did not restrict our work or focus to the plans that the management team had come up with. We challenged those. We felt that they should be stress tested very conservatively.

Q1246 Mr Newmark: I am curious on the stress testing. The sense that I got was that the Co-op management were dead keen to do this deal. This was going to make them a very big organisation compared with where they were before. I am sure they were focusing on the synergies, the upside and everything else. You guys as advisers are not simply stress testing the P&L, but looking at the balance sheet and understanding the downside. On one side of the equation you had management who, my gut tells me from all the conversations we have had, were dead keen to try to make this deal work for them somehow. Then you guys were there, I hope, to act as a form of caution by saying, “Given the work that we have done, what we see from what you guys are doing and what we have seen from what KPMG are doing, these are the downside risks”. I am curious: did you drill down on to that yourselves, or were you relying on the information that management were feeding on one piece of the balance sheet and KPMG on the other side?

Conor Hillery: The management team and KPMG reviewed the P&L projections and the balance sheet and we did, as we always do, rely on their commercial assessment and their view of the prospects, the profitability, the balance sheet and the capital position of the business. But, we felt very strongly that we did need to take account of the views of management and KPMG, and indeed of our views, in the prevailing economic environment, as to what the risks around the implementation of this business plan and merger would be. To that end, we focused particularly on impairment levels, because we felt that that was where the greatest downside risk to this transaction was. We thought carefully about how we would reflect that in our work, not just in the valuation but also in stress testing the capital position of the combined business. What we felt it was prudent to do was to rely on objective tests—a stress scenario that was based on a formulation devised by the Bank of England and the FSA, and a more extreme, severe scenario that followed the Bank of England’s definition of a stress scenario. We felt that those two scenarios were the
best way of reflecting the downside risks to the business, because they—

Q1247 Mr Newmark: I hear what you are saying. I am trying to understand what went wrong, given what we have seen with the benefit of hindsight, on both bits of the balance sheet, which got highly impaired from where you started. I am trying to get an intellectual bridge analysis from you, from all the stress testing that you did, of what happened in reality. What happened in reality was effectively that the mortgage book and the commercial book were a lot worse, and ended up being a lot worse, than you guys, who had the big picture, saw. Did you see it? You gave the green light in the end, notwithstanding all the caveats that you had in there. At the end of the day, from what I saw that you wrote, you gave the green light that this was an okay deal to go ahead and do.

Conor Hillery: Maybe I could just put that in—

Mr Newmark: I am trying to understand that link between the stress testing you did—the analysis you did on top of what KPMG and the management team did on the balance sheet—and what actually happened. At the end of the day, I appreciate that it was the management of Co-op’s ultimate decision to make the decision. Looking at the competency of management, they were good, but you guys are pretty smart and you are paid a lot of money really to drill down and say, “Hey, hold on a second”. I do not quite get the sense that you did that at all.

Conor Hillery: Maybe I can just put in context the level of stress testing that was done to take account of the detailed review of the business. Management’s base plan assumed impairment levels for the four-year period to the end of 2012 of just over £200 million. The moderate stress scenario, which we anchored our valuation work on, assumed almost a doubling of the level of impairments—getting on for about £400 million—and the severe stress scenario implied impairments consistent with an impairment level of over £700 million. At that time—

Mr Newmark: Remind us what happened in the end. What was the ultimate—

Conor Hillery: I do not know the precise breakdown of the impairment levels, but the actual impairment levels coming from the Britannia book would have been somewhere in between the moderate stress scenario and the severe stress scenario.

Chair: It was about £500 million.

Tim Wise: Yes. Clearly subsequent factors and events have compounded that, but the work that we did, which we anchor on the moderate stress scenario, did project the creation of economic value. The capital projections showed that the pro forma business would remain adequately capitalised during the period modelled, albeit that the capital ratios would be at a weakened level. That capital modelling was the basis of discussion with the regulator and with other parties who obviously took a keen interest in the output of the work undertaken to stress test the capital position and the resilience of the combined business.

Q1248 Mr Newmark: Notwithstanding the point that the Chairman made, which is one half of that equation, there were two halves of that—that is the balance sheet and the assets of the Co-op. You must have been looking at the balance sheet, effectively making a merger analysis, showing both balance sheets together.

Conor Hillery: Yes.

Mr Newmark: The stress testing that you did showing the merged entity showed a much bigger number than you guys ultimately saw, even in your stress testing. Am I right?

Tim Wise: Just to go to your point about—

Mr Newmark: Hold on, Mr Hillery is nodding. Things were a lot worse.

Conor Hillery: The numbers I was giving you were the impairment scenarios for the Britannia business. We also looked at—

Mr Newmark: I understand that, but you do a merger analysis as well.

Conor Hillery: Absolutely. The combined business plan and stress testing around that did look at the capital impact of the various scenarios on the combined business. To put that in context, the actual experience was about £1.1 billion over the period we were reviewing, and the scenario that we had run implied a level of impairment of about £1.3 billion.

Q1249 Mr Newmark: At the end of the day do you think, given the analysis and stress testing that you did, that giving the green light was the right decision?

Conor Hillery: Based on the environment at the time, and having taken a prudent view of what we felt were realistic adverse scenarios—in particular the moderate stress scenario, which was based on projections by the Bank of England in November 2008 and assumed an economic downturn in 2010 but some recovery thereafter—we felt that that scenario supported a transaction on the terms that—

Q1250 Mr Newmark: If you are a shareholder, do you think you feel you got value for money from you guys?

Conor Hillery: In hindsight, clearly not. Based on the advice that we gave at the time, which ran various scenarios on a prudent basis, we felt we gave very professional and prudent advice. That advice just—

Mr Newmark: Absolutely. The combined business analysis as well.

Conor Hillery: I would not say it was not value for money. I would say that based on the advice that we gave—

Q1251 Mr Newmark: But you were rewarded, as Tim Wise said earlier, you were rewarded on success. At the end of the day you made a bet. You gave the green light because you thought that given your analysis, notwithstanding what happened, this was the right thing to do. But you have said with the benefit of hindsight that it probably was not the right thing to do. Shareholders did not get value for money, did they?

Conor Hillery: I think it would be unfair to look in isolation at the impairments that have contributed to the position that the Co-op group is in now. The reality is that there were a series of events and costs to the Co-op group that emerged subsequent to this transaction and were unrelated to it.
Mr Newmark: Yes. I am looking up to that point in time.

Chair: Just go through those.

Conor Hillery: They relate to a combination of things.

Chair: Are you talking about the IT, or are you talking about—

Conor Hillery: IT, PPI—and in my understanding those costs were in the order of £650 million.

Q1252 Chair: Do you agree with the conclusion of the regulator that the Britannia overhang was absolutely crucial to the severe weakening of the Co-op’s position that led directly to the need for capital injections?

Conor Hillery: I think it played a material part in it, but the Britannia deal, taken in isolation and based on the advice we gave at the time and the modelling we were doing, demonstrated that the combined business could withstand a level of impairments under quite significant stress scenarios.

Q1253 Chair: You already knew they were going to be pretty stressed, didn’t you, because global markets were distressed, to put it mildly, in 2009, weren’t they?

Conor Hillery: Yes, the outlook was very uncertain at that time. That is why we focused our work on what we felt was the right scenario, which was a stress scenario that assumed an economic downturn for a period of another year.

Q1254 Mark Garnier: Can I just go back to your fee structure again? I want to be absolutely clear. You were paid a £2 million retainer to start off with, on the signing of the intention to go ahead with the deal, plus a further £5 million that can be properly looked at as a performance fee on the completion of the Vintage transaction. Is that right?

Tim Wise: Yes, the second bit of £5 million was paid once the transaction completed.

Q1255 Mark Garnier: If it did not transact, then you would not receive the £5 million?

Tim Wise: We would have received £2 million, yes.

Q1256 Mark Garnier: You would have just received the £2 million. Subsequent to that, what other fees have you received from the Co-operative group for any other transactions or any other advice you might have given?

Conor Hillery: We have not provided any corporate finance advice since. Our funding and capital markets colleagues have worked with them on some transactions in that area.

Mark Garnier: There is an ongoing relationship between JP Morgan and the Co-op?

Conor Hillery: JP Morgan has been active in advising them on some normal flow business when it comes to funding and capital markets.

Q1257 Mark Garnier: The basis of a lot of the questioning that is going on is this. Have you been steering Co-op towards a transaction that they perhaps should not have taken in order to try to make a fee that was two and a half times the base fee? Your incentive is two and a half times the amount just to sign the original contract.

Tim Wise: I am not sure that is quite the right way to characterise it, because our advice effectively ceased on the point of announcement. Our advice was given at the time of announcement.

Q1258 Mark Garnier: You were quite keen that an announcement was made. You will see there is an incentive. There was an incentive for JP Morgan Cazenove, in order to get £7 million as opposed to £2 million, that an announcement of a transaction or an intention of a transaction was to be made. Is that right?

Tim Wise: To be clear, what was going to happen between announcement and completion was that the regulator had to give its final approval, which obviously we had no real participation in.

Q1259 Mark Garnier: Your fees carved out any risk of a regulatory hurdle?

Tim Wise: No, they did not. We received the £2 million, but we would not have received the subsequent £5 million if the deal had not happened for whatever reason.

Q1260 Mark Garnier: Sorry, I am a bit confused. It is completion of the deal, not the announcement of the deal?

Tim Wise: On the announcement of the deal, we received £2 million.

Mark Garnier: On the announcement of the deal you received £2 million and on completion you received—

Tim Wise: I think it is right to characterise the fee as a £7 million fee.

Q1261 Mark Garnier: Sorry, just ease back a little bit. There had to be an announcement of the deal before you received any money at all?

Tim Wise: That is right.

Q1262 Mark Garnier: To a certain extent, this was speculative. How speculative was it?

Tim Wise: Sorry, speculative in what sense?

Mark Garnier: When you were engaged, had the deal been announced?

Tim Wise: No. We were engaged in June 2008 and the deal was announced some seven months later.

Mark Garnier: In order for you to get anything at all, the deal had to be announced.

Tim Wise: In order for us to get anything at all the deal had to be announced.

Mark Garnier: Okay, so it was speculative.

Tim Wise: In terms of our work.

Q1263 Mark Garnier: To receive the first £2 million you had to have the announcement, and then for you to receive the remaining £5 million the deal had to be transacted. Is that right?

Tim Wise: Yes. We did not receive anything if the deal was not announced. If it was announced and did not complete, we received £2 million. If it completed we received a further £5 million, to give £7 million.
Q1264 Mark Garnier: You have to make a profit on that, but it could have cost you £1 million or £1.5 million for the work done on a speculative basis within the department that you guys run.

Tim Wise: It would have been a material amount of outlay, yes.

Q1265 Mark Garnier: The reason I ask this is because clearly there is a big incentive for a transaction to be announced, and when you look at the Claret Financial Services Report produced by you guys, at page 3 it says, “A combination of complementary businesses will benefit customers. Introduction.” This is point one on the first page. “Vintage represents a one-off transformational opportunity for Clarét. Shares strategic vision, purpose and values between two groups; becomes number two mutual in banking sector; total loans and advances of £34.5 billion; enhanced financial services offering customers,” and so on. That does not sound like a very impartial document to me. That sounds like a real sales tickler.

Tim Wise: In terms of the commercial logic, which is what you are referring to there, we believed at the time, and management believed at the time—and general comment was at the time—was that the commercial and strategic logic for the transaction was compelling. You can quibble with the precise way of describing it but, if you look at the facts of the combination and how it fulfilled the very clearly stated strategic ambition of Co-op, it was a very compelling deal. I think the superlatives, or however you characterise it, are justified in the strategic logic. When it comes to the financial analysis and the stress testing, which we were referring to earlier, they were extremely dispassionate and rigorous and conservative. We did not use a base case. We used a stress case, which was an FSA one-in-25 case. I think the financial analysis goes against that partial view.

Q1266 Mark Garnier: In answer to questions from Mr Newmark you said you used a moderate stress test, I think. Shall I go through the pre-tax profits underlying under the moderate stress? 2006 actual, £164 million; 2007 actual, £115.2 million; 2008 estimate, £88.1 million; 2009 estimate, £28.4 million; 2010 estimate, £38 million; 2011 estimate, £96.5 million; 2012 estimate, £146.9 million. According to your chart you have a 14% compound annual growth rate between the 2008 estimate and the 2012 estimate, and that is on a moderate stress test. You still stand by that?

Tim Wise: By those figures?

Mark Garnier: Yes. You are happy with that?

Tim Wise: You cannot be happy with the outcome or the way it has gone, and there are obviously a number of factors that have gone into that, but in terms of the analysis that we did at the time, based on the projections at the time and using a stress test that we felt was conservative, yes, we absolutely stand by what we did at the time.

Q1267 Mark Garnier: The reason I am pressing on this is because when you merge the two businesses together, you have a lot of different things that are going on, and one of the things that is pretty clear is the overview of the lending mix and the overview of the relative capital requirements. On the lending mix, you have 45% of the loans of Britannia coming from member business, but I think that less than 10% of the capital requirement comes from member business. So the relative capital required is over 90%. You are bringing what is quite a subjective and risky amount into the merged group, and you are doing it at a time when Bradford & Bingley and HBOS are going bust. There is quite a lot of evidence out there that this type of lending is extremely dodgy. Discuss, Mr Wise.

Tim Wise: You are absolutely right to point to the environment, and I recognise that that is a view not just given with hindsight. A lot of people held a valid view at the time about the risks and whether this was the time to do a deal or not, but I think you also have to accept that there were a lot of banks run by highly professional and credible people who took a different view. What I think we should not have any disagreement over is your point that it was a very heightened risk, and you had to take account of that. Clearly a lot of economic and credit data was trending in the wrong direction.

The reason why this took so long—and it was abnormally long in terms of due diligence and stress testing—was to take account of those points. Can we say that we ran a severe stress test scenario that was consistent with what has happened, and therefore say, “Didn’t we get it right?” We can’t say that. We did not use that as our core case. We used a moderate stress scenario that clearly undercooked the eventual impairments, but it was looked at very, very materially. We tried as best we could to run stress scenarios in keeping with FSA and Bank of England scenarios. To your point, the £9 billion of specialist lending was absolutely the area of focus. That was the biggest area of concern for the Co-op board, and that was the biggest area of stress testing. In fact, as has been pointed out in this Committee, the stress testing on that book has turned out to be significantly over-conservative. It is the corporate book that has given rise to all the problems.

Q1268 Mark Garnier: Let’s look at another area, because we are trying to create a package of good reasons to go ahead with the merger, and I am finding it quite difficult to find any really good reasons, but we will come to that in a minute. Let’s look at the second negative, the wholesale funding problems within the market. Wholesale funding is today’s big issue. Britannia is bringing back £9 billion worth of wholesale funding, compared with Co-op, which has about £1.6 billion of wholesale funding. Your Vintage, representing a one-off transformational opportunity for Clarét, is a one-off opportunity to ship in £9 billion of wholesale funding, which has brought down Northern Rock, for example. Why would increasing the wholesale funding requirement on this business by a factor of six be a good idea?

Conor Hillery: The due diligence looked at the composition of the funding structure. Relative to the funding structures of a lot of other banks at the time, Britannia was relatively conservatively funded. 50%
of the funding was from retail deposits, about 25% from corporate deposits and then the balance, as you referred to, from wholesale funding in the market.

Q1269 Chair: All the other banks were in deep trouble as a consequence of the wholesale funding dependency, weren’t they? Just as you were advising this bank to—
Conor Hillery: Many banks were, but I think we took some comfort from the more conservative funding structure of Britannia’s balance sheet, a large quantum of which came from retail and corporate deposits.

Q1270 Mark Garnier: Sure, but we are talking about the interests of the Co-operative members, aren’t we? This is the key thing about it. You are recommending to Co-operative members that they go ahead with this transaction. As I said, and I will keep repeating it, it “represents a one-off transformational opportunity for Claret”—to put it into less sneaky-beaky words, the Britannia transaction represents a one-off transformational opportunity for the Co-op, and so for the Co-operative members. I fail to understand how shipping in £9 billion-worth of wholesale funding against the wholesale funding requirement of £1.6 billion is good news for the Co-operative members.

Let’s look at something else that is important for the Co-operative members and do this side-by-side analysis. Britannia has 2.8 million members; Co-op has 2.1 million members. We agree with that; it is in your report. Co-op represents 43% of the membership of the combined group. Yet when you look at the dividend being paid, Co-op represents 68% of the combined group, so this is a significant dilution for Co-op members in just the dividend alone. How is that a “one-off transformational opportunity” for Co-op members?
Tim Wise: In terms of the dividend, the way it would have worked out, in terms of the calculation and why it was changed, was that Britannia members, relative to Co-op members, would have suffered a dilution in terms of what they got as a dividend per member.

Q1271 Mark Garnier: Alright, well, let’s look at profit before tax. In 2007 Co-op has 70% of the combined group—that is an estimate—in 2008, 79%; 2009, 76%; and the NAV 75% in 2007 actual. Whichever way you turn it on its head it is a—
Tim Wise: But I do think you have to look at the economics from two standpoints.
Mark Garnier: So dilution is a good idea?
Tim Wise: No, I think you have to look at the economics from two standpoints. One is from the group’s value-creation point of view, and in that context they did not pay anything. They did not pay anything for the business. It did not really matter if one was worth 50 and the other was 50—one could be worth 75 and the other is worth 25. The fact is that the Co-op got the benefit of the 25 or the 50. It did not really matter. What mattered was whether it took on board a balance sheet that would hole it below the waterline, and of course so it does with the impairments.

In terms of the benefits per member and the dividend payments, your point is absolutely right—it was about whether the new dividend payment structure would benefit or dilute one party versus the other. That is really the point about dilution from the Co-op member point of view.

Q1272 Mark Garnier: You would agree there was a dilution.
Tim Wise: In terms of overall value, no. In terms of overall valuation, fundamentally—

Q1273 Mark Garnier: They have effectively a smaller share of an enlarged group. If you are a Britannia member, you are doing extraordinarily well out of this transaction.
Tim Wise: That scheme is very complex, and what it is based on is a hypothecated approach to getting dividends out of the bit that you will relate to as a customer. In terms of the dividends they got, it was in relation to—

Q1274 Mark Garnier: Is this the discounted dividend valuation?
Tim Wise: No, that is not. That is the overall valuation of the business. That dividend related to their dealings with the financial services business. In that context, the Britannia members were actually going to suffer a dilution relative to Co-op members in terms of their payment per member, which is why there was an £11 million top-up in 2010 and 2011 to take account of that.

Q1275 Mark Garnier: What was good about this deal?
Tim Wise: With hindsight or based on our advice at the time?
Mark Garnier: Based on your advice at the time, and we will come on to hindsight in a minute.
Tim Wise: I think it revolved around two things. One was the commercial strategic logic, which you have referred to.
Mark Garnier: This is going from 100 to 350 branches?
Tim Wise: Yes. There was a very complementary product fit between the two in terms of savings and mortgages on the one hand and unsecured on the other hand, and in terms of branches, so the distribution and product fit was good. There was obviously a point that a number of people had made about having a larger-scale financial services business was going to make investment that much easier to spread across the business.

Q1276 Mark Garnier: This is the increase in the value from synergies, the increase in the earnings from—
Tim Wise: Yes, and then the significant—
Mark Garnier: Wouldn’t that be locked down as £70 million?
Tim Wise: £70 million in terms of costs, yes. We kind of ignored the revenue side, but the cost was key.
Coming back to our role, of course, the significant benefit, which has turned out to not be the case, was the value creation. There you can have the debate
about the level of stress testing and the level of foresight at the time.

**Q1277 Mark Garnier:** And in hindsight?

**Tim Wise:** With hindsight, would you have done the Britannia deal and has it benefited Co-op?

**Mark Garnier:** In hindsight, what were the good things about the deal?

**Tim Wise:** I think the strategic logic still holds water, for what you regard as being worth, and there will be deals done in the future that are based exactly on that type of strategic logic in terms of complementarity, benefits for customers, broader product range and so on. Economically, clearly that has not stood the test of time. Demonstrably it has not stood the test of time, although I would say that is quite a long period of time.

**Q1278 Mark Garnier:** What has happened, though, in terms of the economics, was all known at the time. This is what we are all collectively really struggling to understand. You have a huge amount of evidence, an absolutely colossal amount of evidence around. The wholesale funding markets are screwed. You have the banking system as a whole in real, real trouble. We have had enormous great groups going bust, bailed out by the taxpayer. Nothing has materially changed. We are just emerging from this financial crisis. We have another financial crisis coming at us around the corner in the form of the euro crisis, and the European banks are all about to go bust. Clearly we weren’t going to know all of that at the time, but nonetheless there was an enormous amount of writing on the wall. You’re banked and you know what the wholesale funding markets look like on an hour-by-hour basis. You really do know this.

The key problem that we as a Committee are finding is that when you look at your fee structure, it is hard-wired to get an announcement of a transaction. If you are then lucky and the regulators approve this transaction, you then get the transaction going through. But you are hard-wired on a speculative bit of work, because to get any sort of payment at all, an announcement or an intention to go ahead with the transaction has to be made. This is at a time when we know that banks are still potentially going bust. We know there are a huge amount of problems. You come up with a statement saying that this "represents a one-off transformational opportunity" for Co-operative members. Some of your analysis that you do is, frankly, heroically optimistic under your moderate stress test. You are looking at the stress test at a time when other banking groups are increasing their provisions for bad loans and the Britannia is not. The Britannia is very, very marginally making any difference. It does not make any sense.

**Tim Wise:** Can I just put a bit of context around the moderate stress case, which clearly undercooked the eventual position, exactly as you said?

**Q1279 Chair:** Before you do that, Mr Wise, could you just say whether there is anything that you have just heard from Mark Garnier with which you want to take issue?

**Tim Wise:** I think what I would take issue with is that the decision made at the time and the assumptions that we made were in some way reckless, that in some way we ignored the economic environment around us at the time and did not take account of the fact that the Britannia had within its books the potential to suffer significant stresses over the coming period. I think you can argue about whether we got it right—no, you don’t have to argue whether we got it right, because demonstrably, like a lot of economic commentators, we did not get it right, so we don’t argue about that. But the argument has to be about whether the position we took was reasonable at the time. I am not going to rely on the severe stress case, even though it was almost completely in line with what happened, because we did not base it on that. That was run for prudent purposes, although I think it does say something about the mindset of us and the company that we ran that. I have not seen that level of severity run on any other deal I have worked for before, so it says something.

But let’s go to the moderate stress case. The moderate stress case was all about impairments, because I think everybody agrees now, and everybody agreed then that it is about impairments. It was entirely consistent with the FSA’s stress case, the one-in-25 stress case. The economic assumptions about interest rates and inflation were different from what happened, but essentially it was based around inflation going up and interest rates going up and causing a significant drop in house prices, leading to impairments. I don’t think it really matters whether economists got it right or wrong five years ago. What matters is that we took a stress case that carried in it significant impairments. We ran a stress case based on the base cases, and we doubled the level of impairments. Our base case was a doubling of the level of impairments over the four-year planning period for capital evaluation purposes in the Britannia book. That was undercooked, but it was not for want of prudence or rigour of going about it, and it was consistent with the FSA and Bank of England stress scenarios at the time. They were not enough.

**Q1280 Mark Garnier:** You have just described a stress test that looks at increasing interest rates, yet interest rates are still at a 300-year low and still this problem has come through. What good is a stress test?

To ask this a slightly different way, you can produce a 1,000-page document looking at all this kind of stuff. You can run the numbers any way you like. We all know, any of us who have worked in the City, how you can construct anything—accountancy is an art form. We get that; we understand that. What was your finger-in-the-air judgment at the time, just from looking around your dealing room—you may have a Chinese wall—and seeing what was going on in the wholesale banking market, and seeing what was going on in the other banks? JP Morgan is still with banking analysts. What was going on elsewhere, and what general impression were you getting? Did anybody at some time turn around and say, “Look, guys, this looks rubbish, we shouldn’t be doing this”? Or did you just absolutely resolutely stick to the completely bogus and failed models from which you
can construct any argument you like, and ignore your own personal gut feeling?

Tim Wise: No, we didn’t. Just one point on the interest rate assumption, which was obviously wrong. The problem with running a low interest rate assumption is first that it would have gone against what the Bank of England and FSA were suggesting, which with hindsight really would not have been a good idea. Secondly, it would have kept the lending impairments low. We went with something that kept the impairments high, because that was clearly the sensitive bit.

In answer to your specific question, as I said before, there were people who had shied away from doing a deal at the time, and there were plenty of people who thought it a highly opportune time to do something. The gut feel and the intellectual view were pretty much the same—it was a case of significantly heightened risk. What you had to do was downside protect yourself as much as possible. The first thing we did was not pay any consideration. Two years before, the Nationwide, when it merged with Portman, paid out £500 million and there was an expectation early on in the discussion process there would be a payment to Britannia members similar to that. There was no payment.

Secondly, there was the stress testing. Of course, with the benefit of hindsight that stress testing was too aggressive, but at the time, based on some good evidence and data from elsewhere, it felt like a sensible stress case to use. We tried as hard and prudently as we could to model something that we thought reflected a sensible stress scenario at the time.

Q1281 Andrea Leadsom: Mr Hillery and Mr Wise, why are you both here to talk about this transaction? Were you both jointly accountable for it or was one of you taking the lead role?

Tim Wise: The former.

Q1282 Andrea Leadsom: You were both jointly responsible for that. Why is that? What is the procedure that means that you have two—I believe you are both called managing directors of UK investment banking.

Tim Wise: It was a large, significant and complex transaction, so it merited having a team that reflected that.

Q1283 Andrea Leadsom: How many managing directors of UK investment banking are there?

Conor Hillery: About 25 to 30.

Q1284 Andrea Leadsom: And they are all the directors that are managing the UK investment bank, so it is management by a very large committee.

Tim Wise: I am afraid investment banking titles have finally gone, and so there are all sorts of factors beyond your control. There are all sorts of factors that have come in five years later, and there has been a significant change in the capital and balance sheet. If a transaction has gone wrong and you have been involved, however much you plead at the time that your advice was extremely rigorous and prudent, if it goes wrong I think inevitably you are going to suffer personally. It is just a personal point of view, but you are going to suffer some personal reputational damage. I think there is a huge downside personally from being involved in transactions that do not go well.

Q1285 Andrea Leadsom: I am not really interested in whether it is unfair. Is it true? Are you going to tell me that there was a downside? If so, what is it exactly?

Tim Wise: I think that on the reputational downside for us as individuals, time is going to tell. Clearly there is significant potential for reputational downside if you are involved in a transaction in which, however much you plead, there are all sorts of other extraneous factors, beyond your control. There are all sorts of factors that have come in five years later, and there has been a significant change in the capital and balance sheet. If a transaction has gone wrong and you have been involved, however much you plead at the time that your advice was extremely rigorous and prudent, if it goes wrong I think inevitably you are going to suffer personally. It is just a personal point of view, but you are going to suffer some personal reputational damage. I think there is a huge downside personally from being involved in transactions that do not go well.

Q1286 Andrea Leadsom: Mr Hillery, clearly £7 million is not a payment for the hours spent, unless you are earning vast hourly rates. It is clearly a success fee basis, isn’t it? Clearly, as we know, investment banking is incentivised by the money, and that has always been the case. Having spent time in that industry myself I am perfectly relaxed about that. But would you agree, Mr Hillery, that the problem in this case is just that there is no accountability? You have had an enormous fee that bears no relation whatsoever to the time spent by any one individual, and it has everything to do with the fact that you made this transaction happen.

On the financial upside, there was no equal and opposite financial downside. Although Mr Wise points to potential reputational damage, it is hard to imagine that the investment banking sector could have done more damage to itself than it has in the last few years anyway, but can you point to where the financial downside is for you?

Conor Hillery: I will answer first on the general point, and I will come back to your specific question. In terms of accountability, we are accountable. We are here today.

Andrea Leadsom: Financially accountable.

Conor Hillery: In terms of our advice overall, we are here today and we put our name publicly to these transactions.

Q1288 Andrea Leadsom: I am asking specifically about financial accountability. Mr Wise has already mentioned reputational accountability, but I am asking
about financial accountability. You have a £7 million upside. What is the financial downside?

**Conor Hillery:** The fee that we earned for this transaction was based on the advice that we gave at the time, which we felt was fully justified by the complexity of the deal, the extent of work that we did, the seniority of the team and ultimately the terms of the transaction that were agreed and structured at the time in the light of the prevailing environment.

Q1289 Andrea Leadsom: So there is no element of success fee in there; it is all the hourly rate for the time spent, is it? It is not a success fee, in your opinion.

**Conor Hillery:** As has been mentioned earlier, the fee is linked to the successful conclusion of the transaction.

Q1290 Andrea Leadsom: So it is a success fee. We have just heard from KPMG that they earned £1.3 million, which they argue was for the time spent at the hourly rate. You are not suggesting that £7 million was time spent at an hourly rate. You are acknowledging that that was a success fee.

**Conor Hillery:** It took account of a range of factors, including the amount of time that we had committed to it, but ultimately, yes, it was only payable on the successful agreement of the transaction.

Q1291 Andrea Leadsom: Yes, Can you tell me, did you at any time talk to the regulator? Clearly the £5 million, the second fee, was dependent on the regulator agreeing and approving the transaction. Were you at any stage involved in discussions with the regulator during their decision-making process?

**Conor Hillery:** We had no discussions with the regulator. One or two of our team may have attended some meetings at which the management team discussed the transaction with the regulator, but we had no direct interaction with the regulator.

Q1292 Andrea Leadsom: So there would be absolutely no merit in us Investigating whether there was any attempt to persuade the regulator to approve this transaction?

**Conor Hillery:** No.

Q1293 Andrea Leadsom: You said that part of your rationale for advocating the Britannia merger was that scale was increasingly important in the current environment. Presumably you were already at that point of discussing all the arguments about “too big to fail” and the problem that we had with too many large banking organisations. Can I specifically ask whether you evaluated the implications of “too big to fail” in the context of this merger and whether it would tip that organisation over the edge into the “too big to fail” bracket? Did you do any due diligence on that point?

**Conor Hillery:** We were not focused specifically on the “too big to fail” scenario. Ultimately, this combined business was still a relatively modest financial institution in the scheme of things.

Q1294 Andrea Leadsom: You would not have considered that it was getting into the area of being systemically important as a result of this merger. Did you consider that at all?

**Conor Hillery:** That is not something that would be a particular area of focus for us. We were focused on stress testing the capital resilience of the business under the various scenarios and in projecting the value that would be created for the members under the various scenarios.

Q1295 Andrea Leadsom: At the time, were you aware that this whole discussion about taxpayer bailouts and banks being too big to fail was a problem for the British economy?

**Conor Hillery:** Yes, very much so. That was after the period when several of the banks had been recapitalised, not in the UK but globally.

Q1296 Andrea Leadsom: You did not consider, however, whether there were implications for this merger from that systemic risk that we were seeing and that taxpayers were having to bail out at that time?

**Conor Hillery:** What we took account of was the resilience of the balance sheet under various scenarios, which I think goes very much to the point that you are making. We wanted to get comfortable and to review the pro forma projected balance sheet of this business over a period of several years into the future, under several scenarios. Those were the scenarios that were discussed with the Bank of England and with the FSA. That stress testing demonstrated a resilience of the combined business under the moderate stress scenario, and indeed under the severe stress scenario it still projected a healthy level of capitalisation for the combined business.

Q1297 Andrea Leadsom: Going forward, then, if you were to advise on a bank merger, would you consider “too big to fail” and the implications around systemic risk, and the potential for taxpayers having to bail out that transaction, or would you not see that as any concern of yours?

**Tim Wise:** No, I think it has to be some concern of ours, but I think fundamentally that has to be an issue for the regulator and the regulatory authorities. As we have said, and as Conor has said, in the context of this transaction I really don’t think that was a relevant consideration. Obviously when you look at the independent—

**Andrea Leadsom:** I am not really asking you whether it was relevant so much as whether it was something you did consider and then ruled out.

**Conor Hillery:** No, we didn’t.

**Andrea Leadsom:** You did not consider that.

**Tim Wise:** No, we didn’t, and clearly the Independent Commission has talked specifically about the Co-op as enlarged, and specifically about the right size for challenger banks and the benefits for the economy of having the right-sized challenger banks in the banking system. This was clearly well short of a challenger bank, so I do not really think in this context—

Q1298 Andrea Leadsom: My point, Mr Wise, is precisely that: are you concerned about what is good
for the British economy? Mr Hillery has said that you did not consider the issue of “too big to fail” and what was right for the British economy. You did not consider whether in fact it would be good to have this merger for the sake of having more challenger banks and so on. What I am asking you is, did you consider it in the context of, “How does this work in the British economic context, is this good for the economy or is it merely a transaction that is about shareholders and matching up of assets and a good marketing story?” In the future, bearing in mind that you have just been burned, will you consider what works in the context of the British economy? That is incredibly important, wouldn’t you agree? Or do you think that advisers have nothing to learn from the financial crisis?

Tim Wise: No, I think they have plenty to learn from the financial crisis in the context of their prescribed role as financial advisers. We are engaged by our clients and we are asked to do things for those clients as set out in our engagement letter. That is what we do, and that is the nature of any client-advisory relationship in any sector. Clearly the broader structure of the regulatory structure of banks is something that our bank, particularly given its status, spends a huge amount of time on. I don’t want to delude you about the broader macroeconomic role we play. We are advisers to a company, and they engage us to carry out a specific role and specific parts of that role, and that is what we do. It is really in their gift to decide what we do; it is in our gift to decide how we then do it properly.

Q1299 Andrea Leadsom: So our advice to regulators needs to be to not really look at the due diligence as anything more than the numbers, and that it is for them to consider the implications for the wider economy.

Tim Wise: Yes, I think due diligence on a transaction revolves around the commercial aspects, the financial aspects and the legal aspects. In terms of the broader fit within the economy, the sort of animal you are creating and what further systemic ramifications arise from that, I think that probably is more of an issue for the regulator.

Q1300 Mr McFadden: Mrs Leadsom read out a slide from your papers saying that scale was increasingly important in the current environment. Scale is of course, in a way, what eventually brought the bank down. We have talked about Britannia for the whole session. Did JP Morgan advise the Co-op on the Verde deal?

Tim Wise: No, we did not. We were advising Lloyds on the Verde deal.

Q1301 Mr McFadden: You advised Lloyds on the Verde deal. If you were advising Lloyds on the Verde deal, did you play any role in warning them about the problems that your former client, in this case the Co-op, might have in conducting that deal?

Tim Wise: No, we did not.

Q1302 Chair: You have told us today that you got the money if the deal came through; you have also told us that your advice was completely unaffected by the fact that your remuneration was biased in that way. That is correct, isn’t it?

Tim Wise: That is correct.

Q1303 Chair: Would you have given the same advice if, for example, in 2009 you had been told, “You can get your money in 2014”?

Tim Wise: If that was the basis on which they decided to pay us, I think we would have argued fairly strongly that that was not a fair basis on which to pay us, but if that had been the basis of payment we would have given exactly the same advice.

Q1304 Chair: And what if it had been contingent on your advice being right, and you would have got more if it had turned out right and less if it had turned out wrong? How about that?

Tim Wise: That is a perfectly plausible and maybe in some cases a thoroughly sensible thing to do, having a portion of the fee that is dependent in that way, but the fee structure would not have any impact on the advice we give and never does.

Q1305 Chair: In that case it strikes me that you should support a fee structure such as I have just suggested to you.

Tim Wise: Whether my personal view is going to have any impact in the broader world, I don’t know.

Q1306 Chair: This is an opportunity for it to have some impact, isn’t it? It is not just us having a quiet conversation here—there are a few people listening to it. What do you think?

Tim Wise: My problem with your proposal is that, although I think it is perfectly acceptable and sensible to try to have some of the fee aligned to the outcome for the stakeholders and your client I find it more difficult when we look at the detail. My problem with having something where you get paid several years later, and trying to reference that to something, is that your fee is almost certainly going to be determined by things that are outside anybody’s control. You are either going to make out—

Q1307 Chair: But your job is to offer advice on the balance of risks on those very things. That is why you are collecting this money, isn’t it?

Tim Wise: I think fundamentally we have to be paid for the role that we play, the advice that we given, and the content we give, which, as I have said, is completely impartial and regardless of how our fee structure is. That is how you get paid. If people think it would be helpful to say, “Regardless of that, we want to have some participation in the long-term economic outcome”, then, fine, that is up to the broader market and to clients to decide. The problem with it is that I think you are going to come up with some very, very unusual results, and it could end up with people being paid a ridiculously large amount for things that have been absolutely nothing to do with them and do not relate to them.

Q1308 Chair: Do you think in all sincerity, after all the exchanges we have had today, that a fee structure like this is perfect in every respect, or do you think
that a fee structure such as this for your industry is something that really does need to be looked at now?

Tim Wise: I think perfect in every respect is quite a high test.

Q1309 Chair: You have not shown us even a smidgeon of doubt about whether the way that these fees are structured is flawed.

Tim Wise: No, because I suppose I have complete confidence in our firm and our individual personal integrity. I know that is just an assertion, and people can believe it or not believe it. I have complete confidence.

Q1310 Chair: You have to have a lot of confidence, because people do respond to £5 million-worth of incentive, don’t they? If you were looking at a deal in any other context and you noticed £5 million on one side of the deal and zero the other, you would keep alert and take a close look at the advice, wouldn’t you?

Tim Wise: I am afraid I do have complete confidence in my own integrity and impartiality. The vast majority of clients would have exactly the same confidence.

Chair: I think the overwhelming majority of the British population would have trouble believing that, whether or not it is true.

Tim Wise: That is a fair observation.

Q1311 Chair: I am not casting aspersions on your integrity, but I am saying that when people do offer huge bonuses or huge remuneration to go in one direction and then asked to offer impartial advice on whether to turn left or right, they tend to look to see whether turning one of those directions gives them the bonus.

Tim Wise: I am making an assertion about myself, you are making a generalised point based on observation, which I think is entirely fair. I am not going to disagree with external perception. Fee structures have often been negotiated, people have looked at this particular issue and the potential dynamic between giving impartial advice and something that is success-related. If you are asking whether I think it is a debate that needs to be thoroughly aired and needs to be justified, I completely agree that it does.

Q1312 Chair: You made the important point that you would suffer reputational risk if you kept on offering advice to do deals that keep on going turtle up. What reputational risk do you think JP Morgan has suffered as a consequence of being part of this deal?

Tim Wise: The broader JP Morgan I genuinely do not believe has suffered reputational damage as a result of this deal. It is very difficult now in this extremely febrile atmosphere, where so much has gone wrong and it has so many controversial ingredients, to bring any balance to this debate. It seems to me that the common perception is that all the problems at Co-op are down to, frankly, the Britannia loan book and therefore the people who did that at the time must have been blind to the risk. The first is clearly a significant exaggeration. There are a huge number of factors that have gone into it. I think the second is plain wrong.

Q1313 Chair: If you have followed our earlier hearings, I think you would struggle to support what you have just said. We have looked at a good number of other aspects of the weaknesses in the Co-op.

Tim Wise: I agree this Committee has not. I am just saying I am afraid a lot of people take their views from what they read in the paper. I am saying there is a disproportionate view as to what had been the contributing factors. That is not to back away from the fact that the Britannia and the Britannia loan book was the significant factor when you added the additional capital strain. But I think if you look at the work we did at the time and the role we played at the time, and if people are prepared to look at that, there is no reputational damage.

I made the point earlier about the personal reputational damage, because I think that is slightly different. I don’t think JP Morgan will suffer any reputational damage. Whether we will suffer individual personal reputational damage, a bit like the full Co-op story, time will tell.

Chair: Thank you both very much for giving evidence. It has been extremely interesting, occasionally enlightening. We may want to come back to you for more, but in the meantime you have had to wait some time and you have been on for some time. Thank you very much indeed.
Tuesday 7 January 2014

Members present:

Mr Andrew Tyrie (Chair)

Mark Garnier
Stewart Hosie
Andrea Leadsom
Mr Andrew Love
John Mann
Mr Pat McFadden

Mr George Mudie
Mr Brooks Newmark
Jesse Norman
Teresa Pearce
Mr David Ruffley
John Thurso

Examination of Witness

Witness: Clive Adamson, Director of Supervision, Financial Conduct Authority, and former Director, Major Retail Groups Division, Financial Services Authority (2008–2011), gave evidence.

Q1314 Chair: Thank you very much for coming to give evidence to us this morning. If we include the Treasury Select Committee, there are now no less than six inquiries running into the Co-op, as I understand it; three triggered or being run by the Co-op: one by Sir Christopher Kelly, one an internal inquiry into inappropriate behaviour and one an independent review commissioned by the Treasury for which we still do not have terms of reference or even, as far as I am aware, an individual to run it, plus now the enforcement investigation that is taking place through the FCA. There has been quite a lot to investigate, hasn’t there?

Clive Adamson: Indeed there is, yes.

Q1315 Chair: One part of it is that the appointment of Mr Flowers now looks an extraordinary decision. Do you regret having approved Mr Flowers?

Clive Adamson: I stand by the decision that I made at the time, Chairman. I am as surprised as all of us as to the events that unfolded around Mr Flowers’ apparent misdemeanours, but perhaps for context I can take you through, if it would be helpful for the Committee, as to—

Chair: We will do that in a moment. I just want to clarify whether you regret it and whether you think it was a mistake. From what you have just said, it sounds as if you do not regret it and you do not think, given the way you were going about things at the time, that it was a mistake.

Clive Adamson: I do not think it was a mistake in terms of the decision that I made at the time with the information I had. No, I do not.

Q1316 Chair: We will come back to that in a moment perhaps as well. I asked Paul Flowers some very basic questions about the bank that he was chairman of. This had nothing to do with the subsequent revelations, but his answers to those questions were enough to make it clear that this man was unlikely to be suitable to run a bank. Did you try asking any straightforward questions?

Clive Adamson: During the meeting I had with him in May 2010, which was just before his appointment, I did indeed explore his experience together with why he was being put forward by the Co-op to be the chairman. Just to put it in context if I may, the 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. 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.

Q1317 Chair: It is helpful to have someone in charge as chairman who has a rough idea about the organisation he is running; by which I mean a rough idea of the order of magnitude of its size, for example, which after several years in the job, he did not.

Clive Adamson: In front of this Committee, I am as surprised as you were by the answers he gave. I can tell you at the time I saw him in 2010—

Chair: He did know?

Clive Adamson: He was certainly much more cogent. The individual that you had in front of you is not the individual that I saw in 2010. He was much more articulate. He was more cogent. He did appear to grasp the issues around the firm at that point.

Q1318 Chair: Can we go back to the first appointment in 2009? This was in the summer of 2009.

Clive Adamson: Correct.

Chair: This is only nine months before he was subsequently appointed chairman. Was there any intimation that he might be a successor for the chairmanship at that time?

Clive Adamson: No, there was not.

Chair: You were identifying him just as a possible non-executive and no more?

Clive Adamson: Correct.

Q1319 Chair: Who within the FSA conducted those interviews and what was their level of seniority?

Clive Adamson: That was conducted by two individuals, one individual from the supervisory team at the time. The second was an individual from our authorisation division.

Chair: The names are?

Clive Adamson: I would have to come back to you with the names. I can tell you the levels, if I may. The levels were what we call associate levels.
Chair: Relatively junior?
Clive Adamson: That is indeed relatively junior.

Q1320 Chair: What sort of questions were these people asking? Do you know what they were?
Clive Adamson: Yes. There is a note of that meeting, which I have reviewed.
Chair: I think the Committee had better see that note.
Clive Adamson: Indeed, yes.
Chair: You reviewed that, did you?
Clive Adamson: I looked at that and it was one of the reasons I decided that I wanted to personally see Mr Flowers at the time of his chairman’s appointment. 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.

Q1321 Chair: Do you think that the process that you put in place nine months later was more rigorous?
Clive Adamson: Certainly I felt the meeting I had with him with two colleagues was more rigorous. The purpose of that meeting was to explore essentially how he would run the board, what his relationship with the CEO would be like and what the major issues facing the firm were at that time. I felt we did cover the ground. We also covered his lack of banking experience and that was the point he agreed he would appoint two deputy chairmen.

Q1322 Chair: Was that vetting process unanimous? How many of you were there?
Clive Adamson: In the 2010 meeting?
Chair: Yes.
Clive Adamson: There were three of us at that meeting.
Chair: Were you unanimous in your conclusions or was there dissent?
Clive Adamson: We were, yes.

Q1323 Chair: Have you read the recommendations of the Banking Commission in this area?
Clive Adamson: I have, yes.
Chair: Do you agree with them?
Clive Adamson: Completely.
Chair: You would acknowledge now in retrospect that the approved person’s regime is a busted flush and not worth—
Clive Adamson: Yes. I think, notwithstanding—
Chair: A “box-ticking exercise” we described it as.
Clive Adamson: I would describe certainly at least part of it as a box-ticking exercise. I think we were learning the mistakes of that process during the course of 2009–10. We did make improvements to the process, but we completely acknowledge that further improvements should be made and, therefore, accept the recommendations of the Commission.

Q1324 Chair: At the time the Commission started looking at this, you had had this under review in the FSA for three years and nothing had borne fruit from those internal reviews, had it?
Clive Adamson: Some things have borne fruit. In 2010 we did make enhancements to the process so that more senior individuals from the organisation were required to attend interviews of senior individuals being appointed. That is one of the reasons that I did the interview at the meeting in 2010.

Q1325 Chair: Before I go too deep perhaps into the Banking Commission recommendations to which I might return in a minute—I know other colleagues will want to come in on this process of appointment—I just want to ask one further question. What checks do you think should be for the firm to make and to what extent are you relying on them having done this? When we see this paperwork, are we going to see evidence that those checks were done and that you had made sure that they had been done?
Clive Adamson: There are lessons to be learned from what happened. To specifically answer the question, we would expect firms to conduct their own due diligence in order for them to recommend to us the candidate. In this case, as I said earlier, I am disappointed some of the events that have surrounded Mr Flowers. At no time did anybody, whether within the firm or whether in public life, who knew the individual or indeed his other associations ever alert us to some of his misdemeanours.
Chair: I was not discussing the misdemeanours. I am just discussing his general suitability. After all, it did not take us very long as a Committee to discover that he was unsuitable to run a bank. I am asking you whether you saw evidence that those sorts of checks had been conducted by the Co-op.
Clive Adamson: As far as I am aware, we did not see evidence.
Chair: You did not?
Clive Adamson: We did not see evidence. The types of checks that we did at the time, and indeed do now, are around criminal records, past regulatory history—
Chair: This is all box-ticking stuff, isn’t it? This is, “Is there something really serious?” Yes, you have to go through those hoops, but what we want to know is a qualitative judgment, isn’t it? “Does this guy cut the mustard? Does he have much of a clue about how a financial organisation works?”
Clive Adamson: Yes, indeed, and that was the judgment that I stand by that I made in May—
Chair: A qualitative judgment, even though it was completely wrong?
Clive Adamson: It was a qualitative judgment from the information I had, yes.
Chair: But you do agree it was completely wrong?
Clive Adamson: I do not agree it was wrong with the information I had at the time. I think with some of the things that have subsequently emerged that were certainly unknown to us—
Chair: Okay, but the information you were getting was this box-ticking stuff, wasn’t it? It was a sort of “rubbish in, rubbish out” operation to produce the qualitative judgment?
Clive Adamson: The content of the meeting I had with him was not box-ticking. That was substantive.

Q1326 Chair: You do not think that you had a misjudgment when you were cross-examining him in that meeting?
Clive Adamson: No, I did not. As I said, the individual that you had in front of you during your investigations is not the individual I saw in 2010.
Chair: He had managed to forget a good deal about the bank over the three years that he was chairman. It is an extraordinary state of affairs that you are asking us to believe, but I will leave it there for a moment.

Q1327 Mr Ruffley: What strikes me is that the trouble with the Co-op emerged not in 2008–09 when the crash occurred. If 2008–09 told us one thing, it was that the people in charge of major financial institutions quite often did not understand risk at all and did not understand some of the products they were selling. Given that, Mr Adamson, when you were approving the appointment of chairman of the Reverend Flowers, could you just give us a list of the technical questions that you were asking that satisfied you that he knew what he was doing? Just give us a list of the questions that you asked in the interview.
Clive Adamson: I asked a number of questions. They were partly, as I said earlier, around his view of the board and how he would run the board, his relationship with the chief executive, the—
Mr Ruffley: No, sorry, I will make myself clear: technical questions about banking and financial services. What questions about his technical expertise; not his governance capabilities, but what he knew about the subject.
Clive Adamson: We discussed the key issues facing the Co-op Bank at that time.
Mr Ruffley: Which were?
Clive Adamson: They were around capital, integration risk and transformation risk. He appeared to be on top of the concept. He agreed that he was not on top of the technical detail.
Mr Ruffley: When he was not on top of the technical detail, did that not make bells ring in the regulator’s head?
Clive Adamson: No, it did not.
Mr Ruffley: Why not?
Clive Adamson: The reason is that the main purpose that I felt he was the right person at that time was in terms of his ability to run a somewhat large and unruly board. The fact that he was deficient in technical banking experience and financial services experience was completely recognised by me and by him. That was the reason we asked and he agreed for two deputy chairmen to be—

Q1328 Mr Ruffley: Yes. On that point, obviously you would have seen quite a lot of appointments of chairmen and deputy chairmen of a non-executive kind across a range of financial institutions. How many of the appointments you saw in other financial institutions, other than the Co-op, were as technically deficient as the Reverend Flowers, in your experience? Was anyone quite as ignorant of technical matters as him?
Clive Adamson: No.
Mr Ruffley: No. So he was the worst of the bunch?
Clive Adamson: Yes.
Mr Ruffley: You knew that at the time, presumably?
Clive Adamson: Yes.

Q1329 Mr Ruffley: Just so I am clear about this, how many times did you interview the Reverend Flowers for the chairman’s job?
Clive Adamson: Once.
Mr Ruffley: Just once. Did anyone else interview him before that one occasion that you were present?
Clive Adamson: No.
Mr Ruffley: How long did the interview last?
Clive Adamson: It was, from my memory, about an hour, hour and a half.
Mr Ruffley: So three of you were interviewing him for an hour and a half?
Clive Adamson: Correct.
Mr Ruffley: That was it? There was no written information or written questionnaires that he answered at all?
Clive Adamson: No. That was completely in accordance—and bearing in mind that the fact of having the meeting itself was well beyond our requirements at the time.
Mr Ruffley: There is a full transcript of that interview, is there?
Clive Adamson: There is.

Q1330 Mr Ruffley: Good. We will be getting that. On the question of approving the appointment of someone like the Reverend Flowers, as a regulator didn’t it occur to you to check up on how he was doing and, if so, how did you do that after the original approval?
Clive Adamson: At the time we did not formally supervise individuals and clearly that is one of the recommendations of the Banking Commission that we fully support. There were a series of meetings with him in the normal course of supervision of that firm.
Mr Ruffley: Which you were present at or other colleagues and other parties of the FSA?
Clive Adamson: Mainly colleagues. I was present at a small number of them.

Q1331 Mr Ruffley: You said you would do no formal checks, but you would informally check that the guy you waved through in April 2010 was not completely hopeless or incompetent?
Clive Adamson: Correct.
Mr Ruffley: You formed a view on an ongoing basis that this guy was probably okay. There was nothing that he did after you had approved him that suggested he was incompetent, so far as your colleagues informed you of their dealings with him?
Clive Adamson: Correct. Indeed, at one of the meetings I attended in February—

Q1332 Mr Ruffley: The impression I am getting is that the FSA regulation—and hindsight is a wonderful thing—was not very rigorous. Could you tell me on how many occasions you vetoed/rejected a nomination put forward by a financial institution for a non-executive chairman, non-executive deputy chairman or non-executive director? How many occasions did you veto? What percentage of the cases in front of you would have been vetoed by your panel?
Clive Adamson: From 2008 to 2011—
Mr Ruffley: Your time there, yes.
Clive Adamson:—approximately one in 10 applicants for those SIF positions withdrew. To be clear, they were withdrawals during the process. From the three-year period thereafter, that became one in five.

Mr Ruffley: After you left and changes were made?

Clive Adamson: I did not leave, to be clear.

Mr Ruffley: Sorry, moved posts.

Clive Adamson: What we are talking about is application to the FSA during that six-year period. So in the first three years is one in 10 was withdrawn. What happens, if I can just amplify what I mean by that, is that the application process starts with a formal application. On some occasions candidates are subject to an interview. If, as a result of either their formal application or the first interview, we are not content we then proceed to a second interview at which there could be a formal declination. In virtually all, if not all, cases if we are minded to refuse, candidates withdraw from the process rather than subject themselves to being declined. That is why I refer to the one in 10 withdrawing for the first three years.

Then, as the process did get tougher—notwithstanding the Committee’s views here, I would submit that the one in 10 withdrawing for the first three years.

Mr Ruffley: Thank you.

Q1333 Mark Garnier: Good morning, Mr Adamson.

Clive Adamson: Good morning.

Mark Garnier: Just to put this in context, can you remind us how much the haircut is for the savings bondholders of Co-operative Bank as a result of the—

Clive Adamson: As a result of the restructuring?

Mark Garnier: Of the restructuring, yes.

Clive Adamson: Yes. As I am sure you are aware, it is quite a complex restructuring.

Mark Garnier: Yes, but if you are an innocent customer of Co-operative Bank and you have bought some of these savings bonds, how much will you have lost?

Clive Adamson: Depending on which particular bond you hold, in most cases the retail bondholders, to distinguish them from the institutional bondholders—

Mark Garnier: Sure, I take that point.

Clive Adamson: The retail bondholders, in my view, received as best a deal as we could get for them.

Mark Garnier: How much did they lose?

Clive Adamson: Again, depending which one they are in, most of them retained their income for 10 years and then suffer a haircut thereafter.

Mark Garnier: So they are pretty unhappy? They will be looking at you as responsible for their losses? They will have made losses, yes.

Clive Adamson: Yes, and—

Mark Garnier: No, that is fine. I just wanted to get the context of this, to remind people that there are individuals out there who have lost money as a result of it all.

Clive Adamson: There are indeed, but they have also retained a high level of income for the next 10-year period.

Q1334 Mark Garnier: Getting back to your role in this, it is very interesting hearing your earlier evidence about the process that you have gone through in order to appoint the Reverend Flowers first as a non-executive director and then as the chairman of the bank. As a member of the Banking Commission, I have come across various people in anecdotal conversations who talk about how tough the regulator is in terms of appointing directors and that it is a pretty gruesome process going through your approvals process in order to become a non-executive director of a bank, yet it seems extraordinary that the Reverend Flowers, just to be a non-executive director, had two relatively junior individuals interview him. Is that normal?

Clive Adamson: At that point, in 2008–09, that was normal.

Mark Garnier: 2009 I think it was.

Clive Adamson: That is why we improved the process from 2010.

Mark Garnier: Fully two years after the banking crisis erupted, you were still having an inappropriate process of interviewing?

Clive Adamson: Yes, I think I would agree that it was not as strong as it should have been.

Mark Garnier: Two years after we were seeing HBOS collapse, RBS collapse, you still felt it was appropriate to have juniors interviewing non-executive directors?

Clive Adamson: Yes.

Q1335 Mark Garnier: Okay, that is fine. Even despite all the arguments about corporate governance of banks, all of that, still two years after that?

Clive Adamson: Yes, I agree with that. I would also say that our primary focus was improving firm supervision rather than supervision of individuals during that first period.

Mark Garnier: Yes, but a lot of us would have regarded corporate governance as part of firm supervision. Holding the whole edifice together is important through corporate governance. Anyway, you then went on with your specific interview with two colleagues. I want to be clear about this: you talked about the Reverend Flowers was happy to have these two non-executive vice-chairmen sitting beside him, sort of buffering between him and the knowledge he needs.

Clive Adamson: Yes.

Q1336 Mark Garnier: What was the form of that conversation? Did you say to him, “You have to have this” or was it a suggestion, that you said, “We think you should have this”?

Clive Adamson: No, it came out of the discussion that we had about his lack of experience and it was an agreement by both of us that he would appoint the two as deputy chairs.

Mark Garnier: He would appoint two deputy chairs?

Clive Adamson: Yes. He did not resist it.

Mark Garnier: But it was his choice who they were?

Clive Adamson: I cannot recall precisely the form of words, but it was an agreement between the both of us that it would be appropriate.
Mark Garnier: But who decided who they were? This is quite important because you have chosen a couple of people, one who has banking experience and the other who has insurance experience. Was he given the job of finding them? Was the board given the job? Did you guys pick a couple from—
Clive Adamson: No, he suggested them.

Q1337 Mark Garnier: He suggested two individuals. What also perplexes me about this is that this is a man who clearly has no idea how the bank works. He obviously was a teller at some point in his youth. Clearly he does not know anything about financial services institutions and particularly banks, but you liked him because he had a good way of controlling an unruly board. What you are suggesting is you are putting a powerful individual with a strong character in charge of quite a large board, which by the fact that it is large and unruly is likely to be slightly uncoordinated in its approach to things. What you are doing is you are saying you need somebody of strength of character to take over and run a board. Would you agree that if you have somebody with a strong character, that person can shepherd an unruly board into a corral and get them to follow a line of thought? You would agree with that? You are nodding.
Clive Adamson: They could do, yes.

Q1338 Mark Garnier: You would agree with that. How on earth is it sensible to have an individual that clearly knows nothing about banks and yet has a strong character and personality, without the knowledge of knowing how a bank works or what a bank even does given some of the evidence he was giving to us, he was then in a position to be able to drive that board forward in a direction that he felt was worth taking and where the board would not necessarily be able to gather itself together to resist his will? You would agree that was a problem?
Clive Adamson: It could have been. It could have been a problem. If I can also—
Mark Garnier: But I want to know why you thought it was a good idea to put the board of this organisation into that situation, where somebody of strong character but no knowledge was allowed to drive that organisation’s direction.
Clive Adamson: At that point, the problem with the board was its somewhat large and unruly nature and I think that is what we were looking to Mr Flowers to correct.

Q1339 Mark Garnier: But would it not have been better to raise the point that he did not know what he was talking about? The further evidence we have had suggests that, when we are talking about the purchase of the 632 Project Verde Lloyds’ branches, Baker-Bates and Davies were against that. The two individuals who you approved presumably as the vice-chairmen, in order to support an ignorant chairman— I am sure he is clever in other respects, but on this particular subject he does not know what he is talking about—voted against something that clearly was not, in their opinion, a good idea and yet you were quite happy that these two individuals were overruled.

Clive Adamson: You are referring to events now in 2012, I think—
Mark Garnier: Yes.
Clive Adamson:—where it is indeed the case that those two individuals did vote against the Verde transaction.
Mark Garnier: But doesn’t it illustrate the point I am trying to make, which is that, where you do have expertise, it is ridden over by somebody who has the strength of character in order to be able to drive his own agenda forward, as opposed to the collective agenda of the board?
Clive Adamson: I think just because two voted against does not necessarily mean that the board should not—
Mark Garnier: The two good ones voted against it. The two ones who knew what they were talking about voted against it.
Clive Adamson: The two with the most experience, yes.

Q1340 Mark Garnier: It is a pretty sorry state of affairs. Just one final quick line of questioning, if I might. Of the directors of the most recent board, which is obviously now only 10 people and they are much rulier, seven of them have been started since May last year, so they are all pretty much brand new, and only three of the old ones. Of the five senior management team—five of them again started last year—interestingly, three have contracts for services as opposed to employment contracts. What do you make of that structure of new and also the slightly unusual employment terms for three of the five senior management?
Clive Adamson: I am not aware of their employment terms. That is new information for me.
Mark Garnier: But what would it say to you as a regulator if three of the five senior management team are on contracts for services as opposed to more traditional contracts of employment? What would that say to you about the view that the senior management team or people going to work for this bank have of that organisation?
Clive Adamson: I am not sure I would draw particular conclusions from that. I think perhaps it is worthwhile—
Mark Garnier: Isn’t it your job to draw conclusions from clues that are out there in terms of how an organisation is run?
Clive Adamson: Our job is to draw conclusions about the effectiveness of the board and the senior management team, and indeed about the capital position of the firm as the prudential regulator.

Q1341 Mark Garnier: Part of that though has to be the longevity of the people who are working there. Surely what you do not want to see is a high turnover of senior managers within these organisations, because you get lack of continuity.
Clive Adamson: Correct.
Mark Garnier: If three of the five senior management team are on contracts for services as opposed to employment contracts, which could have a year-long notice period if they wanted to leave, whereas a contract for services may have a far shorter one, does that not suggest to you that some of these
senior managers are quite nervous about working for this organisation and want to make sure that they have a quick parachute.

Clive Adamson: It may suggest that. Equally, it may not suggest that.

Mark Garnier: Has nobody looked into that?

Clive Adamson: As far as the FCA is concerned, we have not. You would have to ask the PRA whether they have.

Mark Garnier: I think probably we ought to. Thank you very much.

Q1342 Chair: From where did you glean the information that the board was unruly?

Clive Adamson: It was a result of the fact that it grew to 22 at the time of the merger with Britannia. There were a series of new members being put on the board from Britannia’s side as well as the Co-op’s.

Chair: It is not just numbers, is it? Other big banks have very large boards. I can think of one or two that are up in the 20s.

Clive Adamson: There were very few certainly of the size of the Co-op Bank at that time, which was still a medium-sized bank. It was certainly not a large bank.

Chair: So by “unruly” you should have said “over-large”?

Clive Adamson: It was over-large, correct.

Chair: Not unruly?

Clive Adamson: I think it was difficult to manage because of the two sides being put on there and bearing in mind that some of those did not have financial services experience.

Chair: Your solution to this unruly or excessively large board was to put a financial illiterate in charge of it, wasn’t it?

Clive Adamson: There were three solutions, if I may suggest. First was the judgment that Mr Flowers was the right person at that time, with the information I had; the second was the appointment of the two deputy chairs; and the third was an agreement that the board was too large at the time of the merger and would over time be reduced in size. That did indeed—

Q1343 Chair: Yes, but the first of those fits the description I have just given, doesn’t it? Flowers was the right man for the job. One of your solutions was to tame this unruly board by putting in a financial illiterate as its chair, a man you knew to be financially illiterate at the time.

Clive Adamson: As I said earlier, Chairman, it was agreed with him that he did not have sufficient financial services experience. So that is the case, yes.

Chair: At the time, it did not ring alarm bells with you, three years into the financial crisis?

Clive Adamson: As a non-executive chairman, given what we were looking for at the time, that was the decision and judgment I made.

Chair: We know that. Can I go back to the question that I asked at the beginning? I asked you at the beginning whether you now think that that was regrettable and you said “no”.

Clive Adamson: I certainly think as of today he would not be approved because we would look for more experience.

Chair: That is not what I asked at all. I hope that if I took this decision I would regret it. It looks pretty catastrophic, but you do not seem to be regretting it.

Clive Adamson: To be clear and to answer the question, I do stand by the judgment I made. I think it was the right judgment at the time. Do I regret what subsequently happened? Yes, I do.

Chair: The information you had at the time was that this guy was pretty hopeless on the financial literacy front and that you had what you have described as an unruly board to handle. You are telling us that one of your solutions, which you are still standing by on the facts you had at the time, was to put this man in charge.

Clive Adamson: Yes, I am. Just to be clear of the reasons for that, his role was non-executive chairman. He was not running the bank. That was the role of executive management. I did think he had sufficient governance experience to be able to run the board with the help of the deputy chairmen.

Q1344 Chair: Was the issue of systemic risk high in your mind? Were you thinking, “Is the Co-op Mutual structure an appropriate one for institutions that carry systemic risk”?

Clive Adamson: Not explicitly at the time of that appointment, no.

Chair: Don’t you think it should have been, nearly three years into the financial crisis, seeing what had happened after Northern Rock, Lehman Brothers, RBS and HBOS?

Clive Adamson: We were certainly concerned about the risks posed by the merged group. Yes, we were.

Q1345 Chair: It does seem an extraordinary state of affairs, even in normal times, to put a man who does not have the knowledge to understand the subject matter as your solution to a problem of running a medium-sized bank with an unruly board. In these extraordinary times, frankly it seems like a negligent decision, a very poor decision indeed, that you took.

Clive Adamson: As I said—and I am happy to be responsible for the decisions I made at the time with the information I had—I felt that was the right decision.

Chair: To be clear and to answer the Chair’s question, the information I had—I felt that was the right decision.

Q1346 Mr McFadden: I want to go back to this issue of the two deputy chairmen or vice-chairmen. You said in response to Mr Garnier’s question that this idea came out of the discussion. I would like to explore that a little bit more. Did the FSA, as it was then, insist on the appointment of deputy chairmen with greater banking and financial experience as a condition of approving the appointment?

Clive Adamson: It was not as explicit as that. Just to remind the Committee, the context of that meeting was not a formal approval meeting, because at that time that was not required. At the time, I went beyond what was required to request to have a meeting with Mr Flowers. It was an agreement between us that he would do so, as opposed to part of a formal process.
Mr McFadden: But whose idea was it? Was it the regulator’s idea or did the bank offer this up as a way of kind of sweetening the pill of their suggestion of someone who did not have banking experience? Whose idea was it?
Clive Adamson: As I said earlier, it was a mutual agreement that came out of the discussion.
Mr McFadden: But it must have been someone’s idea to have these two guys. Was it your idea or was it the Co-op Bank’s idea?
Clive Adamson: It was not the Co-op Bank’s idea. In recollection, it came from Mr Flowers’ idea, because he recognised that he did not have sufficient technical experience. I think, as he has disclosed to the Committee, he put that agreement into practice afterwards. He viewed it as an agreement that would be necessary.

Q1347 Mr McFadden: Does that not ring alarm bells? Surely if you need two people with banking and financial services experience to justify this course of action, shouldn’t that have rung alarm bells with the director that you need this insurance policy, rather than appointing somebody who would not need such an insurance policy and in whom you could have confidence, as the regulator?
Clive Adamson: Again, I do not think so. Again, the context at the time of why he was put forward by the Co-op Group out of five candidates to be the chairman, there was no hiding the fact that he did not have sufficient technical experience. There was no hiding of that. The discussion was around how that could be mitigated.

Q1348 Mr McFadden: Following the appointment, what contact or discussion did you have with these two deputy chairs? Did you meet them?
Clive Adamson: Personally I did not, no.
Mr McFadden: Between the two of you, the Co-op Bank and the regulator, you have decided that the appointment of Rodney Baker-Bates and David Davies as deputy chairs will help to compensate for the chairman’s lack of banking experience, but then you never met them?
Clive Adamson: No.
Mr McFadden: Did you have any other contact in written terms about their view of how the bank was going or any discussion?
Clive Adamson: No. I do not think that would be unusual. We would expect all the individuals on the board, including deputy chairmen if they were appointed, if they do have concerns to raise them directly with us. That did not occur until Mr Baker-Bates came to see me in 2012.

Q1349 Mr McFadden: I am going to come on to this. We have already heard that these two voted against the Verde deal. When did you become aware that the two people who were on the board specifically because of their banking experience voted against the Verde deal?
Clive Adamson: In July 2012. Mr McFadden: In July 2012, Rodney Baker-Bates left the group around that time, is that correct?
Clive Adamson: Correct.

Mr McFadden: Did you conduct an exit interview with him?
Clive Adamson: I did not, but I believe there was an exit interview conducted for him.
Mr McFadden: Who conducted the exit interview with him?
Clive Adamson: Members of the supervisory team.
Mr McFadden: Were you given a report on that discussion?
Clive Adamson: I believe I was, yes.

Q1350 Mr McFadden: Did he make clear in that discussion or in any other subsequent discussion with you that he thought the Verde deal was a huge mistake?
Clive Adamson: In my personal meeting with him in July 2012, he did think that the Verde deal was a step too far, yes.
Mr McFadden: How did he put it; “a step too far” or something worse?
Clive Adamson: I am trying to recollect the words he used. He certainly viewed that it was too far for the group. Given everything else going on at the group at that time, it was a mistake.

Q1351 Mr McFadden: There are two conversations. There is an exit interview with members of your team and there is also a meeting between you and Rodney Baker-Bates. The meeting between you and Rodney Baker-Bates, at whose instigation did that—
Clive Adamson: That was his instigation.
Mr McFadden: It was his instigation. Not only did he go through the normal exit interview, he asked to come and see you specifically to express his concerns about the Verde deal?
Clive Adamson: Correct.

Q1352 Mr McFadden: The Verde deal was then allowed to run on for a further nine months or so after that discussion.
Clive Adamson: Correct.
Mr McFadden: Why was that allowed to happen? What action did you take in response to him going out of his way as he is leaving to come and express his concerns?
Clive Adamson: To be clear, we felt at that time—and the context is that, at that point, the Prudential Business Unit had taken over the lead for the Verde transaction—neither the PB or the PRA or us in the FCA ever saw a business plan or formal proposal to us for us to formally consider for the Verde transaction.

Q1353 Mr McFadden: I think people listening to this would find it unusual at the least, if not more than that, that a director, who is on the board specifically because of his banking experience, leaves the board, comes to the regulator at his own instigation and says, “I am very worried about this deal” or something along those lines and your response is not to do anything about that.
Clive Adamson: Not quite. The issues he was raising were exactly the issues that Mr Bailey, who was leading at that point in the Prudential Business Unit, had communicated clearly to the firm would need resolution before either we or the PRA can formally
consider it. The five issues that Mr Bailey raised, quite correctly, were around the capital position, the liquidity position, management stretch, integration and governance. Mr Baker-Bates raised nothing other than issues that were already being expressed by Mr Bailey to the firm.

Q1354 Mr McFadden: I just want to explore this. What did you do after the meeting when he told you this? Did you have a discussion with Mr Bailey? What happened after he flagged up these concerns to you?

Clive Adamson: I think Mr Baker-Bates also had the same conversation with Mr Bailey. As far as I am aware, it is exactly the same conversation.1

Mr McFadden: He is blowing the whistle as loudly as he possibly can. He has come to see you and he has come to see Mr Bailey to express his concerns about this deal and yet it was still allowed to run on until the Co-op put itself into a very difficult position nine months later.

Clive Adamson: The issues he raised were no different from the concerns that Mr Bailey was expressing to the firm that had to be satisfied before either or both the two regulators would consider the transaction.

Q1355 Mr McFadden: David Davies left later in 2013. Did you have any discussions with him on his departure?

Clive Adamson: No.

Mr McFadden: Did he have an exit interview with members of your team in the way that Rodney Baker-Bates did?

Clive Adamson: I cannot recall. I would have to confirm that to the Committee.

Mr McFadden: Just to go back to this issue of the whole appointment of Mr Flowers and these two point men, wing men—whatever you want to call them—as deputy chairs. Is this a feature of duals where you have elected boards, you have member ownership and other specific features of the model, or is this something that you would consider in a “mainstream” high street bank, which we should, of course, acknowledge have also had spectacular failures with very different models of corporate ownership? Would you have appointed a chairman of Lloyds, HSBC or any of these banks who didn’t have banking experience with these two similar vice chairmen? Was that something you would have considered then?

Clive Adamson: I don’t think it is a particular feature of duals. I think what is somewhat unusual of the Co-op governance structure was partly the member representatives and partly the dual board structure of the group board and the bank board. We have cross-membership between them, so that was somewhat unusual.

Q1356 Mr McFadden: Has such a model of approval by you been done elsewhere?

Clive Adamson: Specifically what?

Mr McFadden: I mean, in banking terms, a non-experienced chairman compensated for by a deputy chairman with experience.

Clive Adamson: I can’t recall any other direct examples.

Mr McFadden: Thank you.

Q1357 Chair: Nuclear power stations have a good deal of risk about them, don’t they? Would you put a chairman in charge of an unruly board that was trying to run a nuclear power station who didn’t know anything about nuclear power?

Clive Adamson: I think it would depend upon the circumstances.

Chair: You might?

Clive Adamson: We might, yes.

Chair: We will draw our conclusions from that.

Q1358 Mr Newmark: If we can go on to the Britannia merger issues and focus a little bit on that. When did the FSA first become aware of the intention of Britannia and Co-op Bank to merge?


Q1359 Mr Newmark: David Anderson, the former chief executive, told this Committee that he made the first approach to Britannia about a possible merger. Did he discuss this with the FSA first before making his approach?

Clive Adamson: I am not aware that he did. I was informed in August 2008 by the Britannia chief executive.

Q1360 Mr Newmark: Before approaching a bank that was potentially having huge problems, you are saying the Co-op itself did not seek to just have that discussion with you first? It is just a point of clarification, that is all. That is what you are saying?

Clive Adamson: I don’t think they approached me first. As I said, the Britannia CEO informed me first very shortly after—

Mr Newmark: When did the Co-op have a discussion with you then?

Clive Adamson: I think it was very shortly afterwards that both chief executives came to see me.

Mr Newmark: But the first point of contact was effectively Britannia?

Clive Adamson: Correct.

Q1361 Mr Newmark: What did the FSA understand to be the rationale behind the merger when the two chief executives came to speak to you?

Clive Adamson: The rationale for the merger was both boards thought it would be a good strategic fit and what that meant was in terms of branches, the customer base and the range of products. It was also felt that to have a somewhat larger mutually-owned bank would be beneficial for the market.

Q1362 Mr Newmark: Barry Tootell told us that one director of the Co-op had said at the time of the merger, “Perhaps Britannia needed this a little more than we do”. Were you at all aware of this view?

Clive Adamson: I wasn’t aware of that view has been expressed by that individual. Certainly our view—

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1 Clive Adamson has subsequently confirmed that Mr Baker-Bates met junior officials within the Prudential Business Unit of the FSA but did not meet Andrew Bailey.
Mr Newmark: Effectively, instead of two negatives equalling a positive, your view was two positives equalling a double-plus positive?

Clive Adamson: Not quite. Our view was that the merger did make strategic sense. We did think that Britannia was running a higher risk business model and we did think it would be safer as part of a larger group.

Q1363 Mr Newmark: But there were some suggestions in the media when the merger between the Co-op and Britannia was announced in 2008–09 that it was a rescue operation of Britannia. You are saying that was not the case from your view.

Clive Adamson: It certainly was not in our view a rescue. If it had been a rescue it would have been treated differently. In our view, it was a merger proposed by two boards of directors. It was the case—

Mr Newmark: Yes, but there were problems with Britannia.

Clive Adamson: It was running a high risk model.

Mr Newmark: It was running more than a high risk model. There were problems with the balance sheet and so on, or not in your view?

Clive Adamson: Perhaps I can explain some of the background as to what we thought of the merger and how we assessed it, if that would be helpful, Chairman?

Mr Newmark: Yes, and just put it in the context of this is the height of the financial crisis and why it was a good time to do this merger. If you can give your answer wrapped up in that.

Clive Adamson: We thought at the time that it was a good strategic fit. We did think that Britannia would be safer in a larger group but it was—

Mr Newmark: Could it have survived alone at that time or not?

Clive Adamson: It is hard to speculate whether it could or could not, but at the time of the merger we thought it was an ongoing going concern firm, absolutely correct.

Q1364 Mr Newmark: Who came to that conclusion internally? Did you or did a group of you within your group decide that?

Clive Adamson: It was under my watch and I take responsibility for that. It was concerned by our ExCo three times. It was considered by the tripartite in late 2008/early 2009. As I said, even if it was in our view a good strategic fit, it was completely dependent upon whether it would be financially robust. We subjected the merged entity to the same capital framework that we used in October 2008 where we looked at the recapitalisation of the major banks. I can amplify it if it would be helpful. 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%.

Mr Newmark: Effectively, you had your own model for stress testing what would happen post-merger. Is that right?

Clive Adamson: Correct.

Mr Newmark: Do you think that model, with the benefit of hindsight, was a good model?

Clive Adamson: If I can give you the numbers that might be helpful, because I think that does indicate what we did. 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% and the stress tier 1 capital position could be between 6% and 7%. It was tight but it did meet our framework at the time. Now, if you look at the—

Q1365 Mr Newmark: Again, sorry, I just want to understand this quickly. The thinking of the stress testing; we are in a financial crisis at this time so we are not quite sure where the bottom ends. You say that your stress testing model was fit for purpose at that time?

Clive Adamson: We believed it was and, just 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%. In other words the stresses did materialise. Now, that was not a forecast by us at the time but it did meet our capital framework at the time. For the benefit of this Committee, what is unusual about the Co-op Bank is indeed the stresses did materialise. Not only did the impairments materialise, but they also had PPI provisions that were more than forecast. The difficulty for the Co-op is that while, at 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.

What has transpired with the Co-op is that, as a mutual, it is much more difficult to raise additional core tier 1 capital to restore its position to the capital framework that now applies quite correctly on the PRA.

Q1366 Chair: Sorry, just to clarify, when you say “transpired” everybody knew that a mutual would always have that problem. It is not some problem that subsequently transpired. It was just a mis-judgment, was it not?

Clive Adamson: No, it wasn’t. If I can correct that; the judgment we made at the time with the capital framework that we used for mutuals and banks was if they could meet our capital stress framework that was acceptable. In effect it meant that firms could go down to a minimum core tier 1 capital position of 4% and survive. What has happened is that over time capital standards have been raised.

Q1367 Mr Newmark: That is answering a different question. He is saying you should have been aware all along that the Co-op, given its mutual status, could not access the markets in the same way as ordinary banks. I think that is point the Chairman is making. You have not answered his question.

Anyway, I have a different question. You talk about the tripartite discussions and so on and I am curious as to what discussions the FSA held with the Treasury and the Bank of England about the Britannia merger.

Clive Adamson: Those discussions were at the tripartite meetings. I wasn’t in attendance at those, but
they were discussed and the tripartite did give its agreement to the merger in January 2009.

Q1368 Mr Newmark: Were you aware of any differences between the Bank of England and the Treasury in their encouragement of the Britannia merger itself?

Clive Adamson: No.

Mr Newmark: You were not aware of any difference or you were not aware, period?

Clive Adamson: I don’t believe there was a difference. I think the bank may have had a tougher approach to capital at the time but, as far as I am aware, as a result of the tripartite discussions, the tripartite as a whole did agree to the merger.

Q1369 Mr Newmark: One final question: were you aware of any separate independent discussions between the Treasury itself, separate from the Bank of England, with the Co-op on this particular merger? Were there independent meetings between Treasury Ministers and members of the Co-op on discussing this, independent of being in a formal tripartite meeting?

Clive Adamson: I am not aware of them directly. Indirectly, as I am sure you are aware, there was a Private Members’ Bill that was introduced to Parliament in January 2009 by Sir John Butterfill and the purpose of that was to—

Mr Newmark: No, that is a separate question. My question is, were there discussions between any Ministers in the Government at that time and members of the Co-op regarding this particular merger?

Clive Adamson: Not that I am aware of.

Chair: There were no discussions with you?

Clive Adamson: No.

Chair: Or with anybody that you are aware of in the then FSA?

Clive Adamson: No, other than normal discussions on a tripartite.

Q1370 John Mann: Just recapping the facts. The Co-op has been going for 100 years, meandering along. It suddenly does something it has never done before. It merges and takes over the Britannia, which has a dodgy loan book in terms of its traditional model. The two organisations are coming together and the Co-op has a unique structure, even for mutual, because of the Co-op group. You approve a chairman who has a criminal record on two occasions—I make no moral judgment at all—for what I think is reasonable to describe as risk-taking behaviour. This does not concern you?

Clive Adamson: There was a disclosure by him of a spent criminal conviction from 1981 in relation to gross indecency. We were aware of that. I am not sure what the other one was you referred to. That is the only criminal conviction that we were aware of.

John Mann: You were not aware of any conviction in relation to drink driving?

Clive Adamson: No. To be clear, we didn’t consider that spent criminal conviction to be relevant to his capacity to undertake the role.

John Mann: But you were not aware of a second criminal conviction for drink driving in 1990?

Clive Adamson: I was not.

Q1371 John Mann: I may have mis-heard, did you say the Co-op put forward five candidates to be chairman?

Clive Adamson: No, they considered five candidates. They put forward one candidate, which was Mr Flowers.

John Mann: Did you or any of your staff have any discussions over which one of the five they were putting forward?

Clive Adamson: No, we were informed that—

John Mann: That was entirely their decision?

Clive Adamson: Entirely theirs, quite correctly, because we do not think it is our role to vet lists of candidates.

Q1372 John Mann: Have you ever turned anybody down for a position in a bank?

Clive Adamson: As I said earlier, what happens in practice is that a candidate or a firm never put themselves in a position where they are turned down. They withdraw from the process if we express concerns. As I said earlier, the process has considerably changed as one in 10 withdrew—this is across financial services—

John Mann: Let’s go back to the period of time we are talking about for the approval of the Reverend Flowers. How many people withdrew then?

Clive Adamson: That would be in the period where one in 10 withdrew during the process.

John Mann: One in 10 withdrew. One in 10 you regarded as unsuitable?

Clive Adamson: Not necessarily unsuitable, but we expressed concerns about them and so, rather than they or the firm putting their candidate through the next stage of the process, they withdrew.

Q1373 John Mann: One in 10 are not getting through the process and yet here we have a financial institution that has done something that it has never done in its history before; at the height of the financial crisis, with somebody with some question marks and no relevant experience—I just don’t quite get here—in an hour and a half you approve.

Clive Adamson: There were no question marks. The only event is that a candidate or a firm never put themselves in a position where they are turned down.

John Mann: They put forward one candidate, which was Mr Flowers.

Clive Adamson: No, they considered five candidates.

Chair: There were no discussions with you?

Clive Adamson: I was not.

Q1374 John Mann: I can only conclude one of two things. One is that the individuals making the assessment are not up to the job or the culture in the regulator is such that it overrides concerns because it sees all the financial contagion and the situation with the Britannia, and that is the overriding pressure that is there, “We have to get this show on the road. The merger has been approved, or is getting approved. Therefore, let’s push it on”. Is that the culture that was there?

Clive Adamson: No, not at all. Bearing in mind I was put into the job in April 2008 to raise standards and I believe standards were raised considerably during my tenure of MRGD. The meeting I had with Mr Flowers,
I think, was robust. There was certainly no culture where we were just putting things through.

Q1375 John Mann: Has the FSA come under any political pressure between 2008 and 2013 from Government Ministers in relation to the Co-op Bank and anything relating to the Co-op Bank?
Clive Adamson: I am not aware of any political pressure. There was certainly none put on me personally.

John Mann: I wasn’t asking on you personally, I was asking on the FSA.
Clive Adamson: I am not aware of that. I think there was, to be fair, an atmosphere of political support for the Co-op but that is different from any interference in my decision making.

Clive Adamson: Only that there was support for the Co-op movement.


Clive Adamson: I am not trying to infer anything untoward here. I am just saying that the connection of the Co-op movement to Co-op sponsored MPs, there was support for it but I think that is very different from any political inference in our decision making. I can categorically say there was no influence on our decision making.

Q1376 John Mann: Culture is rather critical to what has been going wrong in banking in some people’s view, including mine. Culture in the regulator could also be said to be something that has gone very wrong. I still do not get, even after the almost hour and a half of this hearing, how this particular one slipped through the net because it looks fairly obvious to me that this is going to be a difficult merger to take forward. It is going to need a strong hand at the tiller and yet you have put someone in who is very weak but who the Co-op clearly wants as opposed to other people. Something is not quite right in all of that and your organisation does not seem to want to carry any responsibility for this. I want to know, what is wrong in the regulator that has led to you making such elementary errors in this case.

Clive Adamson: If I can take you back to my earlier comments, I stand by the decision that I was involved with at the time. I think it was the correct decision at the time. Yes, improvements were necessary in our process, which we completely agree with. Those improvements were being made over the years subsequent to 2008–09.

Q1377 John Mann: How can you possibly say it was the correct decision at the time? What is your barometer for making that extraordinary statement? You only had an hour and a half interview. You didn’t have all the information in front of you, clearly. What is your barometer for saying that is a correct decision at the time? What is going wrong with the regulator here?
Clive Adamson: I do not think that there was anything untoward about that decision. I have explained why the decision was made and what we were looking for at the time. The individual did not run the bank. He was a non-executive chairman. We did ask for and agree with him that additional support from the deputy chairman was needed. The events that have emerged around the individual were not known to us and, as I said earlier, I am as disappointed as anybody that nobody saw fit, from all the people who seem to know something about the individual, to tell us what happened.

Q1378 Chair: I regret to have to persist with this line of questioning but you have told us, if I can summarise, that he was the correct person at the time because, although he didn’t satisfy one of the normal criteria for a top job, which is that they know something about it, he did satisfy the other, which is that he had the ability to run a board. Correct?
Clive Adamson: That is what I considered at the time, yes.

Chair: I know it is a crude summary but do you want to challenge it?
Clive Adamson: No, that is correct. Everything we saw thereafter.

Chair: Why are people who can do both so rare? Could you not try to find someone?
Clive Adamson: It is a very good question. They are rare, they are hard to find. If I can give you—

Chair: The other banks have them.
Clive Adamson: They do have them but, as I talk to boards and chief executives of firms, these individuals are very hard to find. It is not easy to find the requisite combination of board experience and financial experience.

Q1379 Chair: You have said that this was the correct decision at the time. Do you agree with Andrew Bailey’s contention in an interview recently where he said that Mr Flowers would not get through now?
Clive Adamson: 1 do.

Chair: What has changed?
Clive Adamson: What has changed? I think at least two things have changed. The first is that, as both regulators have toughened their process—

Chair: It is the process?
Clive Adamson: Process and judgment.

Chair: The judgment is made on the basis of information collected by the process. What information would you have collected that you did not collect at that time? You said earlier this decision was made on the basis of the available information.

Clive Adamson: The information is, as I say, essentially the same as it was three years ago.

Chair: Then how would this decision be different?
Clive Adamson: Because today both regulators would insist upon financial services experience at the chairman level.

Chair: It is the judgment that you do need somebody who knows how to run a bank at the top of a bank?
Clive Adamson: It is now both regulators’ judgments that we would require somebody with financial services experience to be in the chairman position.

Q1380 Chair: One further issue you raised in the last set of exchanges that we have just had. You said
that you were aware of what you described as a “spent conviction for gross indecency”. By “spent”, do you mean something that you were obliged to disregard?
Mr Mudie: No. We regarded it, but it was from 1981 and we did not think that the nature of conviction was directly relevant to his ability to perform his role.
Chair: You would not make a habit of appointing people with convictions for gross indecency to the top of major financial institutions, though, would you?
Mr Mudie: No, we wouldn’t. I think we have to be very careful—
Chair: It was relevant, was it not?
Mr Mudie: I interrupted you, sorry. Go on.
Mr Mudie: Were you satisfied with the final due diligence performed by the Co-op Bank and its advisers?
Mr Mudie: Yes. I do. To be clear, we think the responsibility for any due diligence that has been carried out should be done by the firms. It is not our responsibility.
Clive Adamson: Moving away from the chairman’s appointment but taking the same attitude to due diligence, do you think that you were sufficiently adequate in your due diligence of this merger?
Mr Mudie: All right. The FSA had accepted, in that period, in their report on RBS that, because of the lack of responsibility for agreeing and so on the AMRO acquisition, that led to certain errors and one of the errors was a lack of real due diligence, but you are saying you are very happy with the due diligence. You are content that you carried out the job adequately?
Mr Mudie: Yes. You would not be changing that approach now?
Chair: You are content that you carried out the job adequately?
Mr Mudie: No, I am speaking about the overall—
Mr Mudie: Three things arose from that. One of them particularly was that they left to the senior management and the firms involved to do the due diligence. You would still accept that as being acceptable?
Mr Mudie: You are saying you are very happy with the due diligence. Of the errors was a lack of real due diligence, but you are saying you are very happy with the due diligence. You are content that you carried out the job adequately?
Chair: No, so in what respect was it not ignored?
Mr Mudie: No. We regarded it, but it was from 1981 and we did not think that the nature of conviction was directly relevant to his ability to perform his role.
Chair: Then set it aside.
Clive Adamson: Doing everything else, I would, yes.
Chair: That sounds like ignored to me but perhaps there is a distinction there.
Mr Mudie: Yes. I do. To be clear, we think the responsibility for any due diligence that has been carried out should be done by the firms. It is not our responsibility.
Mr Mudie: By us or by the firms?
Mr Mudie: By yourselves, by the FSA.
Clive Adamson: Yes, we went well beyond what was required by our process. To be clear, at that point this was a merger between two mutuals. It was not subject to our FSMA change of control process. The actual formal process required for that merger was very light, legally, partly because of the Butterfly legislation that was passed. Technically, all that was required was agreement by the Co-op Bank board and a vote of the Britannia members. Our role technically was quite limited in that. I decided we should go well beyond what was legally required and treat it as close to a change of control as we could. That is why we did the analysis we did.
Clive Adamson: That is why we did the analysis we did. 
Chair: I agree. I agree with the point about time too, but do you think that this was something you should ignore?
Mr Mudie: I believe so, yes. Clearly this will be—
Chair: That sounds like ignored to me but perhaps there is a distinction there.
Mr Mudie: I interrupted you, sorry. Go on.
Chair: No, we didn’t.
Mr Mudie: By yourselves at the time because we conducted our own analysis but, yes, we were satisfied.
Mr Mudie: I am not sure I understand that. I am simply asking, were you satisfied with the final due diligence performed by the Co-op Bank and its advisers? Were you satisfied?
Chair: It is not a direct question we asked ourselves at the time because we conducted our own analysis but, yes, we were satisfied.
Clive Adamson: Certainly at the time that was normal.
Q1385 Mr Mudie: Implicit in that answer is that you are accepting that the standards set at that time were lower than you would now accept?

Clive Adamson: As I said, we—

Mr Mudie: No, I am not trying to be funny. Are you accepting that the standards that applied at the time of the Co-op/Britannia merger were lower than you would accept now?

Clive Adamson: They probably were lower, but I would say again that we conducted our own assessment.

Mr Mudie: You conducted your own?

Clive Adamson: Our own analysis.

Mr Mudie: What does that mean? When you say “analysis”, analysis of what?

Clive Adamson: As I said earlier, the critical question for us was whether the combined entity would meet our capital standards. We were satisfied that it did.

Q1386 Mr Mudie: As time is short, KPMG told this Committee that the Co-op performed its own due diligence on Britannia’s commercial real estate book. Were you made aware of this?

Clive Adamson: I don’t believe so, no.

Mr Mudie: Was this arrangement normal practice?

Clive Adamson: I think that would be up to the individual boards whether it was.

Q1387 Mr Mudie: I am moving away from these questions but I am just at a loss to understand. In the market that was current at that time and the worry about real estate and property, you weren’t told by the Co-op that they had done their own due diligence on this. They had passed it out to their advisers and you had not thought to ask who did it.

Clive Adamson: The critical question for us was two-fold. First, did it meet our capital standards, which it did. Secondly, KPMG, separate from whatever due diligence they did or did not do, were obliged to sign off on what is called the “fair value adjustments at the time of merger” and we were satisfied with that.

Q1388 Mr Mudie: I am not an expert, but when they signed it off they would sign it off on the basis that the Co-op had done it. KPMG would not accept responsibility for doing it, I presume. You must have been aware at some stage, even if it is looking at the final signing of documents, that this was done by the Co-op themselves. Did that not raise any questions in your mind?

Clive Adamson: No, it didn’t.

Mr Mudie: No. You find that acceptable?

Clive Adamson: Yes.

Mr Mudie: I am a party to the merger. I am taking over this firm and I say they are all right to the regulator and you say, “Oh, that’s good”. That is a layman attitude of how you are approaching regulation. Is that acceptable to you?

Clive Adamson: I think, given where we were at the time and the work that we did and the limited reliance we placed on external advisers, we were satisfied, yes.

Mr Mudie: I am not asking whether you were satisfied, I am asking you now, sitting here, are you telling this Committee, the British public and the Co-op bondholders who have lost a lot of money that you were content as a regulator when the Co-op said, “Oh, it’s okay”; “Oh well, fine”?

Clive Adamson: Yes.

Q1389 Mr Mudie: I have had this view since this started. In terms of the Lloyds merger, Project Verde and this Britannia one, what on earth were the regulators doing? Now you are telling me my worst fears are confirmed, that you as the regulator took the word of the Co-op who were taking over this firm without questionining the real sensitivity at that time that had to hit you in the face.

Clive Adamson: If I may, it absolutely did and that is why the stress analysis that we did at the time has proved to be pretty close to what happened.

Q1390 Chair: Is there any aspect of this huge road accident, as it might be summarised in the phrase of the Co-op, which would have been worse had it not been for the regulator?

Clive Adamson: Yes, I think there are aspects that we underestimated.

Chair: No, I am talking about things you picked up and managed to stop.

Clive Adamson: Yes, there are a number we managed to change during the course of the time from 2009–10. The capital position of the firm did improve between the time of the merger and April 2011 by about 1 percentage point. The board was reduced from 22 to 14 over that period. Yes, there were some things that we did improve over that period.

Q1391 Chair: Capital improvements were taking place right across the sector and were going to happen anyway, were they not?

Clive Adamson: They were different in different firms. The capital—

Chair: This was a global initiative. This was not something that was Co-op specific.

Clive Adamson: I think it was Co-op specific because we did point clearly out to the firm in May 2010, where we sent a risk assessment letter to the board, the risks that we saw around capital business model liquidity and so on. We very clearly expressed those and we did act upon them.

Q1392 Chair: You would argue that you brought something to the piece that improved matters but you would also, would you not, concede you did not bring enough in retrospect?

Clive Adamson: I believe we did do our job effectively at the time. Clearly, the review that has been announced by the Chancellor will look in detail at whether there was regulatory failure, but I believe at the time we did our job effectively. Things could have been better and I completely accept things could have been better, but did we do the job expected of us at the time? I believe we did.
Q1393 Andrea Leadsom: It does seem quite astonishing that we have heard witness after witness come along and tell us why none of it is their fault and you are just another one. You are the regulator. You are somebody who is absolutely paid to defend the British taxpayer, the bondholders and those investors in the Co-op who subsequently lost a fortune, many of them very unable to do so. Does it strike you as odd that there is a complete lack of accountability for this entire problem?
Clive Adamson: I would say that accountability rests with executive management of the board. I accept complete responsibility for decisions that were made under my watch and I accept responsibility for doing the best for bondholders that we could do given the events that have occurred.

Q1394 Andrea Leadsom: You have been very clear that you feel you did a good job with regards to what was expected of you at the time. Are you therefore saying that at the time FSA senior executives were not required to think outside the box; they were merely required to tick the box?
Clive Adamson: No, I am not saying that at all.
Andrea Leadsom: That seems to be what you are saying because in effect you are saying it was perfectly normal to have a non-banker at the helm of a bank in those days and it was perfectly normal to not bother to challenge any of the due diligence that was done in house, let alone done by external advisers. All those things were perfectly normal and it never occurred to you, bearing in mind we were in the middle of the biggest financial crisis ever, to think that you might possibly challenge some of those assumptions. You just went along with what was normal.
Clive Adamson: No. As I hope I have explained, we did challenge all the assumptions and, as some of the other people who have been before you said, the challenge we provided to the merger was very rigorous. In relation to Mr Flowers, I think I have answered that question.

Q1395 Andrea Leadsom: In retrospect, was the due diligence work on Britannia flawed?
Clive Adamson: I can’t answer that on behalf of the firm. I can answer it on behalf of the analysis we did, which did suggest that under a stress the core tier 1 capital position would fall to about 4.3%.
Andrea Leadsom: It was flawed in retrospect or it wasn’t?
Clive Adamson: No, I think what has happened is that the stress events for this have crystallised. It is not flawed.
Andrea Leadsom: Was the analysis flawed or not? The due diligence work on Britannia, was it flawed or not in hindsight? Was it accurate at the time or was it not?
Clive Adamson: I can’t speak on behalf of the firm’s due diligence. I can speak on behalf of the work we did and I do not believe that was flawed.

Q1396 Andrea Leadsom: In the FSA’s own report into the failure of RBS, the FSA admitted that it had not offered sufficient challenge to the ABN AMRO due diligence. Only 18 months later a deal is completed with Britannia. Do you see any similarities there? Do you anticipate that there will be accusations that perhaps the FSA should have challenged the due diligence that was done on the Britannia?
Clive Adamson: I can see that. What happened at the time of the RBS and ABN acquisition was very different to this merger we are talking about.
Andrea Leadsom: It is very different in terms of the organisation but is it very different in terms of the process? Is it not the case that—
Clive Adamson: It is completely different.
Andrea Leadsom:—18 months earlier, in the middle of a financial crisis, there is a very clear example of due diligence that has gone wrong? Would you not think, as any normal person might, “Well, that didn’t go very well so let’s do a bit more due diligence, a bit more challenge in this instance”? 
Clive Adamson: I think what was completely different was that the level of assessment the FSA did for the RBS/ABN acquisition was extremely limited. The level of assessment we did for this merger was much more substantial.
Andrea Leadsom: In what sense?
Clive Adamson: In the sense, as I hope I have explained, that we subjected this merger to the same test that we applied to the bank recapitalisation exercise in the autumn of 2008; namely this H64 test I mentioned earlier.

Q1397 Andrea Leadsom: You are saying your own due diligence was much better—
Clive Adamson: Our own analysis, correct.
Andrea Leadsom:—than the due diligence on the ABN AMRO, but you did not think to challenge the due diligence done by either KPMG or by the Co-op itself?
Clive Adamson: No, because we didn’t take that into account in our analysis.
Andrea Leadsom: Okay, but just for clarity; in future, faced with a similar situation, would you look at the KPMG and the Co-op due diligence?
Clive Adamson: We would, but that would not preclude us from doing our own analysis.
Andrea Leadsom: No. I accept obviously you need to do your own analysis, but what I am trying to get at is, were you to see the Co-op Bank do its own due diligence, would you then look at that in the future or not? Do you still think it is not relevant?
Clive Adamson: Yes, we would and it would be a factor we take into account. Again, I do not want to speak completely for the PRA—that would be Mr Bailey—but we would take into account our own analysis of the situation.

Q1398 Andrea Leadsom: Of course you would. It is standard practice to revalue a firm’s assets on acquiring them. Co-op Bank’s fair value adjustments to the acquired Britannia loan book amounted to a downward revision of £867 million, as reported in its 2009 financial statements. Who calculated that figure?
Clive Adamson: I believe that would have been calculated by the firm and subject to the accountant’s review.
Andrea Leadsom: Did the FSA scrutinise those adjustments at all?
Clive Adamson: No.
Andrea Leadsom: In hindsight, were those adjustments prudent enough?
Clive Adamson: In terms of what has happened—
Chair: Just to be clear on this point. You are saying that, unlike the RBS case where basically the FSA put their hands up and did not quite say that they were asleep at the wheel but they certainly said that they were not as alert as they would like to have been, that was not the case with respect to any aspect of the supervision of the Co-op. Is that correct?
Clive Adamson: I think it was very different. I am certainly not saying it was perfect. I am saying that we substantially improved what we did between the time of the RBS acquisition and the time of the Co-op.
Chair: Yes, we have that point aboard. You talked about judgment earlier. It is a question of judgment, isn’t it, Mr Adamson?
Clive Adamson: Yes.
Chair: Was it basically okay, fit for purpose, what you were trying to do at the time or was it not?
Clive Adamson: I believe it was.
Chair: You are still arguing that it was it?
Clive Adamson: I believe it was.
Chair: Unlike the FSA’s with the advantage of hindsight response on the RBS case where they said what they were trying to do was inadequate.
Clive Adamson: I think at the time of the RBS/ABN acquisition it was completely inadequate. The level of assessment was not carried out at all. The level of work we did was, in my judgment, adequate at the time.

Q1400 Andrea Leadsom: It is a question of accountability, isn’t it? You have made a very good and consistent fist of saying it is not your fault, but you clearly did get it terribly wrong in hindsight, there can be no doubt about that, as did lots of other people. It is, of course, the regulator that the taxpayer and the bondholder look to to protect their interests and you failed to do that. I ask you again: not to personalise it to you, but is it right that all of those people in the regulator who, by omission or by failure to think outside the box, failed to protect the taxpayer and the bondholder should still be in work in the FCA?
Clive Adamson: I can perhaps correct you, if I may. We were not completely wrong. I believe our assessment was correct at the time and I have given you the numbers to evidence that. We went well beyond what was needed at the time as part of our attempts to improve prudential supervision during that period. I strongly believe that I did the right thing at the time, but I do feel complete responsibility for the decisions I made.

Q1401 Mr Mudie: The FSA admitted in their report on RBS that, at that time, they had a policy on due diligence that was inadequate in hindsight. Andrew Bailey said in 2011 they have changed all that and they were much stronger now, but you are saying to us that you stand by that inadequate level of due diligence or the FSA was wrong to say it was inadequate; you thought it was adequate?
Clive Adamson: What I am saying is that, whatever due diligence was done or not done by Co-op, we did our own assessment, which proved to turn out to be more accurate.

Q1403 Stewart Hosie: Mr Adamson, just on this Co-op/Britannia merger, to summarise where we are. You approved a merger between these two mutuals in the middle of a financial crisis, before we knew where it was going to end up, based on an assessment that would leave core tier 1 capital at just above 4%, when many of the assets that would lead to subsequent impairment were already in the bank, when the fair value required a write down of £800 million at the time. This is a merger between two mutual institutions who could not raise money in the market when a non-mutual financial institution could. Do you ever wake up in the middle of the night and wonder why you let this happen?
Clive Adamson: I look at a lot of things and wonder how we made decisions. In this particular decision, I think it was the correct decision at the time and I stand by it. I think we did do a reasonable job at the time, which was a lot better than the job we did at the time of RBS.

Q1404 Stewart Hosie: What was the job then? What was the role at the time of the merger and, in particular, what discussions and relationship did you have with Co-op and Britannia in the early stages between 2008 and the final merger in 2009? What was the FSA’s role?
Clive Adamson: The formal role was quite limited. As I explained earlier, this was a merger between two mutuals. That is not subject to our FSMA formal change of control regime. Technically, it only required the agreement of the Co-op Bank board and a vote of Britannia members. Our scrutiny of the documents was deliberately set by legislation to be quite limited. That was somewhat changed—
Stewart Hosie: Can I just stop you there? The final merger was almost two years after the run on Northern Rock—
Clive Adamson: Correct.
Stewart Hosie:—a small mortgage bank, an ex-mutual building society, which had systemic consequences. You are telling me that, two years after that, the role of the FSA at that point was still incredibly limited in the way you have described?
Clive Adamson: No, let me correct that if I may. Our formal technical role was very limited. I decided to go well beyond our formal technical role and subject it to a more intensive degree of assessment.

Q1405 Stewart Hosie: You concluded it was all right to allow the merger because core tier 1 capital would remain just above 4%.
Clive Adamson: It was tight. It was not just myself. I was the director responsible. It was considered by our ExCo and by the tripartite authorities on numerous occasions. We decided there certainly were not sufficient grounds where it fell below the line to object to the merger.
Stewart Hosie: Could you have blocked or vetoed the merger? Did you have the ability to do that given what you have just said?
Clive Adamson: If we had objected then I am sure the merger would not have occurred, yes.

Q1406 Chair: Just to be clear, whatever the legal or technical position is in the Act, in practice—
Clive Adamson: In practice.
Chair:—you are saying what everybody has acknowledged for years, that when the regulator raises an eyebrow that is the end of the deal?
Clive Adamson: Yes.
Chair: Correct?
Clive Adamson: Correct.
Chair: Right. This was a big issue with respect to a couple of other deals that took place.
Clive Adamson: Yes. I am absolutely convinced that if we had said that the merger was unsafe it would not have proceeded.
Chair: You were not going to be told by your lawyers you would be sued?
Clive Adamson: No. Well, they may have tried it but that would not have worked.

Q1407 Stewart Hosie: Neville Richardson has told us at the beginning the FSA was sceptical about this merger, but ultimately gave its regulatory approval. What caused the FSA to change its mind?
Clive Adamson: We did not change our mind. What we did was—
Stewart Hosie: Neville Richardson was wrong?
Clive Adamson: No, we challenged the merger. If he used the word “sceptical” he used that. I would use the words, “We challenged the merger”.

Q1408 Stewart Hosie: What convinced you that, “Heavens, we are not dreadfully keen that this is a good idea” to, “Yes, it’s a good idea”. What got you into that position?
Clive Adamson: We felt that the strategic fit was potentially a good fit. We did think that a larger mutual, if—and I emphasise the word “if”—it was financially sound, would be good for the marketplace, but it had to be financially sound. Although it was tight, it did meet our criteria.

Q1409 Stewart Hosie: I suppose this is the bit we are all struggling to come to terms with. Within a couple of years of that, many of these assets, which had all been subject to due diligence, which had been written down to some extent at the time, began to become badly impaired to the point there was a massive hole in the Co-op Bank book and the rest is history. What was it that the FSA were not looking at at the time that they should have been looking at to identify the real flaws in this new bank?
Clive Adamson: I am not sure there was anything that we should have been looking at. Again, without wishing to avoid responsibility at all, prudential supervision moved in April 2011 to the Prudential Business Unit and the PRA. The actual impairments came through in the accounts of 2012 and the first half of 2013. Until that point, it was not evident, I believe, that the assets were impaired.
Stewart Hosie: Does that show a weakness in the analysis you do?
Clive Adamson: I believe it did not show a weakness in the analysis we did in 2009 because our stress analysis indicated that the core tier 1 position could fall under stress to 4.3%.

Q1410 Stewart Hosie: Right. In 2009, two years after the run on the Rock, no one in the FSA was concerned about over-reliance on lending to property and all of the other reasons that we finally had the big crash, even though all of these things were evident in the books of Britannia, Co-op and the merged bank?
Clive Adamson: No, that is incorrect. We were concerned and we maintained our concern. In our ARROW letter in May 2010, which we did after the merger, we were very clear about the continuing risk that the merged group faced. We did comment clearly about the risk to the business model in an environment of low interest rates. We did comment upon threats to the capital position if the economic conditions continued. We commented upon the liquidity position. We commented upon the size of the board and we commented upon their conduct performance.

Q1411 Stewart Hosie: Just one final question.
Chair: And a quick reply.
Stewart Hosie: A very quick reply as well. At what point did the FSA indicate informally to Co-op and Britannia they would allow this merger to proceed in advance of giving formal approval?
Clive Adamson: There was no formal approval because this was not a formal change of control. I believe we told them in January 2009 that we and the tripartite were content to not object to it.
Stewart Hosie: Less than five months after this discussion had begun, you had come to a conclusion, notwithstanding everything going on around, that it was probably going to be all right?
Clive Adamson: Correct. We revisited that analysis on two subsequent occasions before the actual merger in August 2009 and we remained content.
Q1412 Jesse Norman: Mr Adamson, who sat on the panel evaluating Paul Flowers with you?  
Clive Adamson: There were two individuals. One was a senior adviser at the time and another was a member of the supervision team.  
Jesse Norman: What were their names?  
Clive Adamson: The name of the member of the supervisory team was Reece Phillips and the name of the senior adviser was Graeme Hardie.  
Jesse Norman: Right, thanks. Am I right in thinking that Mr Hardie then became a director of the Co-op Bank?  
Clive Adamson: Correct.

Q1413 Jesse Norman: Would it be fair to say that the following occurred? You collectively reached a judgment that Mr Flowers was an acceptable candidate to be chairman of the bank. That is to say, you failed to detect his unsuitability. You let him through and Mr Hardie, who was one of the people evaluating Mr Flowers, then goes to work as a non-executive director of that institution. That is a question. I am wondering if you are going to say “yes” or “no” to that.  
Clive Adamson: That is factually correct.

Q1414 Jesse Norman: That is factually correct, thank you. The question I want to ask you here is: do you approve of this revolving door in this case?  
Clive Adamson: I think it is quite acceptable, particularly as Mr Hardie’s role was as a senior adviser. He was not a member of the executive. I believe he stepped down from his role before he was appointed as a non-executive director of the Co-op.

Q1415 Jesse Norman: You do not detect any possibility of a conflict of interest there, that somehow a person who has been in judgment on Mr Flowers might then be taken on to this institution almost certainly at the behest of Mr Flowers?  
Clive Adamson: There is always a risk of a conflict of interest as people move from the regulator to the regulated. We are very careful about managing those conflicts, but I think it is healthy for people to move between regulated firms and the regulator and the other—  
Jesse Norman: You were aware of this move? You approved tacitly within the FSA the move of Mr Hardie to the Co-op Bank?  
Clive Adamson: I believe he would have been approved by us to take up that position.  
Jesse Norman: You knew about that and, indeed, you were institutionally comfortable with it?  
Clive Adamson: Yes, we are.  
Jesse Norman: Okay, thank you. Were you aware of any prior closeness between Mr Hardie and Mr Flowers?  
Clive Adamson: No.

Q1416 Jesse Norman: Were you aware of any Labour sympathies on behalf of Mr Hardie?  
Clive Adamson: No.  
Jesse Norman: Do you think he is in a position where he should be allowed to retain his job, given the fact that this judgment has spectacularly failed and there has been this evident conflict of interest?  
Clive Adamson: As I said, there are potential conflicts of interest. I think in Mr Hardie’s case he is an individual of integrity and he—  
Jesse Norman: You have made that substantive judgment about Mr Hardie?  
Clive Adamson: Yes. I have known him for a while, I believe he is a man of integrity and I believe he will add strength to the Co-op Bank board.

Q1417 Jesse Norman: It seems to me the problem is this. Either you saw that Flowers was financially incompetent or you did not.  
Clive Adamson: We did.  
Jesse Norman: Which was it? You saw that he was financially incompetent?  
Clive Adamson: As I said earlier, we agreed with him and he agreed himself that he did not have sufficient banking experience.

Q1418 Jesse Norman: Good, okay. The way you attempt to handle this is by putting in place safeguards, notably Mr Baker-Bates and Mr Davies on the board as the financially competent people. You say, “This man is incompetent but the good news is we have some financially competent people on the board alongside him”, except it turns out that on the one substantive issue where their financial competence is clearly called into play and on which they disagree, in a context in which boards very rarely are allowed to maintain disagreements, in which unanimity is generally required for a decision to be taken, they did not agree. This did not raise any alarm bells because you did not know about it. In other words, the system that you created to guard against the incompetence of Mr Flowers spectacularly failed as well.  
Clive Adamson: I do not quite agree with that. As I said earlier, the issues that Mr Baker-Bates raised were precisely the issues that we wanted satisfaction about before we would consider the merger.  
Jesse Norman: I am sorry, could you repeat that?  
Clive Adamson: The issues that Mr Baker-Bates raised about the capacity of the firm to take on something else were precisely the issues that were raised with the firm that both regulators would need to be satisfied about to consider that merger.

Q1419 Jesse Norman: Right, but it did not show that the system that you had used, which was to hedge Mr Flowers around with people who knew what they were talking about, was not working. After all, it took a very long time for the deal to fall through after Mr Baker-Bates had had that conversation with you guys. I want to come back to this a third time or it may even be a fourth time. I understand it may be personally impossible for you to say that you got it wrong but, since Adair Turner and Andrew Bailey have both said that the FSA was far too lax in the period before 2008–2009, it seems to me that you ought to be in a position to say, “We institutionally got it wrong with the Reverend Flowers.” Can you say that?  
Clive Adamson: Again, I stand by the decision I made at the time.
Jesse Norman: I am not asking about your decision. I am saying, “We institutionally got it wrong. We, the FSA, got it wrong.”

Clive Adamson: Would we now approve an individual—

Jesse Norman: No, I am asking the question: did you get it wrong? Did the FSA get it wrong? We know what the issue is. We have had it perfectly clear. We have gone through the whole thing. Adair Turner has talked about raising of standards. We know that you would not have done it the same way now. The question is: did you get it wrong? Did the FSA get it wrong?

Clive Adamson: With the benefit of hindsight, yes, I think we did get it wrong.

Jesse Norman: Okay, that is helpful.

Clive Adamson: But that is different from—

Jesse Norman: Do you feel sorry about it? Do you think colleagues should feel sorry about it?

Chair: Could you finish that sentence: it is different from?

Clive Adamson: It is different from saying I have taken responsibility for the decision I made at the time. I think it was the right decision at the time.

Q1420 Jesse Norman: It is the almost precise logical equivalent of saying, “The operation was a great success but the patient died.” You said in an earlier answer that the FSA’s principle is to separate board management from overall leadership of an institution when looking at a chair of a bank. That was the standard you applied to the Reverend Flowers. You thought he would be a good manager of an unruly board, a split board as between the Britannia members and the Co-op members. You are nodding to this. I am hoping you are thinking I am saying a correct, accurate assessment of what you said earlier.

Clive Adamson: I think what I said was that the role of a non-executive chairman is not to run the bank. That is the role of the executive management.

Jesse Norman: Right, so you agree. Do you think it is to give overall leadership to the institution as well?

Clive Adamson: He should give some overall leadership, but the primary leadership of the institution should be given by the executive management.

Q1421 Jesse Norman: Fine, we are not disagreeing. It is a well-known fact in all institutions of this kind that the link between the chair and the CFO is absolutely vital because that is the constraint on a CEO who is operating out of control.

Clive Adamson: Yes.

Jesse Norman: Now, the link between the chair and the CFO can only be a good one if the chair is able to talk about the state of the financial situation in the institution with the CFO. Correct? The CFO has to be able to say, “I have all these concerns. Look at the numbers. What do you think?” The chairman goes, “Okay. great. Yes, let us go through it.” Am I right about that?

Clive Adamson: Generally right. I think that is something that we did discuss in 2010.

Jesse Norman: It turns out then, if that is true, that, contrary to your claim, financial experience in the chair is not optional. It is vital because the chair has to be able to have the capacity to engage intelligently, to quiz, to assess, to support the CFO in making substantive judgments about the balance sheet as part of an understanding of whether the chief executive and other members of the executive team are doing their jobs. Is that right?

Clive Adamson: As I said, I think in an ideal world the chairman should have both financial experience and wider leadership skills.

Q1422 Jesse Norman: The doctrine that you can separate board management from overall leadership or from running the bank in that sense that I have described is hopelessly wrong and sounds like it has been corrected. A final question, if I may. Mr Chairman.

Chair: It will have to be the final question.

Jesse Norman: It will be. The Co-op had loan impairments in 2012 of £970 million on the banking side. Were you aware of that when you handed over responsibility for the bank to Andrew Bailey in April 2011?

Clive Adamson: The major impairments came through in 2012–13. There were some impairments in 2010 and 2011, but they were roughly in line with those in 2009.

Q1423 Jesse Norman: Right. Why, when the rest of the sector has already blown up a couple of years earlier, was the FSA so slow to pick up on this escalating disaster of loan impairments within the Co-op based on its own performance and also on the merger with Britannia?


Jesse Norman: That is my point: why didn’t you pick up on the fact that they were about to break, that that loan book was getting much worse that much more quickly?

Clive Adamson: It was not getting worse in 2011.

Jesse Norman: Your position then is that it only got worse in 2012, which was when it was formally recognised?

Clive Adamson: What appeared to be the case was that the actual impairments only started to be realised in 2012–13 of any size.

Jesse Norman: You are dodging the question by saying that. I am asking why you didn’t pick up on what the true position was, not on what the apparent position of impairments was.

Clive Adamson: We pointed out in May 2010 to the firm that we would be concerned about the high-risk lending in the book and the impact on capital if that situation got worse. We were very clear to the firm in 2010.

Q1424 Mr Love: Can I refer the Committee to my designation in the House as a Labour and Co-operative Member of Parliament? Mr Adamson, can I come back to the issue of the governance structure of the Co-operative Bank? You mentioned the unusual nature of it. When you were supervising the Co-operative Bank did you have any concerns that you
expressed about the governance structure of the Co-operative Bank?

Clive Adamson: Our primary concern was the size and composition of the board of the Co-op Bank. We did express that concern, yes.

Q1425 Mr Love: When Mr Marks came and gave evidence to us said that around a third of the membership of the Co-op Bank board were representatives of the Co-operative Group and the other two-thirds were made up of executives and what he called professional non-executive directors. Is that a balance that you would not consider to be unusual? After all, the representatives of the Co-operative Group are there to protect the shareholding. The others are there to enhance the role of the bank. Was there anything unusual with that structure?

Clive Adamson: It is not completely unusual. I think our concern was both the size of the board and the relative experience levels on the board, and both of those concerns we did make.

Q1426 Mr Love: Let me come on to experience because when the Reverend Flowers was asked about this matter he said that six or seven non-executives had banking experience. Were you well aware of that? The rumour appears to have gotten out that the only person with banking experience was Rodney Baker-Bates. Were you aware of the experience of the board of the Co-operative Bank?

Clive Adamson: Yes, we were. I believe by 2011 when the board had been reduced from 22 to 14, which we agreed with, six members of the board had some degree of financial services experience.

Q1427 Mr Love: I asked the staff here to provide me with the information about the board in 2011 and I was rather surprised to discover that Rodney Baker-Bates and David Davies were prior members of the board of the bank when they were made into deputy chairmen. We had rather gained the impression that they came on to the board at that time, but they did not, did they?

Clive Adamson: No.

Q1428 Mr Love: As well as Rodney Baker-Bates and David Davies with significant experience in banking or insurance, Anne Gunther, Peter Harvey, Paul Hewitt, Merlyn Lowther and Bob Newton all had significant banking and/or insurance experience. That does not include the two executives, Martyn Wates and Barry Tootell. Would you not say that that bank board had very significant insurance and banking experience?

Clive Adamson: In 2009, at the time of the merger, we believed the board was both too big and the proportion of individuals with financial sector experience was not sufficient. By 2011 that ratio had improved; so by then half the members had some degree of financial services experience.

Mr Love: In your view or in the view of the FSA or the FCA, whichever you were acting on behalf of, was that sufficient to reassure you that the board had the technical competence to carry out its functions?

Clive Adamson: I think at the time of the merger in 2009, to be clear—Mr Love: No, I am talking about 2011.

Clive Adamson: In 2011 we thought the mix was better, but still was not perfect in terms of the degree of experience on the board.

Q1429 Mr Love: Much has been made about the mutual status of the organisations that make up the Co-operative Group but, of course, the Co-op Bank is and always has been a plc.

Clive Adamson: Correct.

Mr Love: In the view of the regulator, did that give the bank sufficient independence from the Co-operative Group to satisfy you that decisions were taken by the bank board on behalf of the bank board?

Clive Adamson: With the degree of cross-membership between the group board and the bank board, notwithstanding that, as you correctly say, the bank was a plc in its own right, there are question marks over the degree of influence on the bank by the group.

Q1430 Mr Love: Even though the bank has its own board, its own executive and its own chief executive officer, you were concerned that there was undue influence on the part of the Co-op Group?

Clive Adamson: At the time we were not concerned.

Mr Love: I am separating it out now. I am talking 2011.

Clive Adamson: Yes. In 2011, we were not concerned. As events have unfolded subsequently, I think there is a question to be asked about the degree of influence by the group on the bank board.

Q1431 Mr Love: Looking at the board for 2011, as I understand there were five nominated board members to the bank from the Co-operative Group out of a board of 14.

Clive Adamson: Correct.

Mr Love: I come back to the question I was asking earlier on about getting the balance right in the Co-operative Bank. Do you think that was an undue weighting towards the Co-operative Group in terms of balance on the board?

Clive Adamson: It is not necessarily undue. The question is what happened in the boardroom about how that influence was or was not exercised.

Mr Love: Could you elaborate that and explain to the Committee why you were concerned in relation to that?

Clive Adamson: To be clear, in 2011 we did not have that concern. We did think the board was better balanced than it was before. It did have more financial services experience on the board, so we were more content with it. The point I am making is that, as events have unfolded, the degree of influence by the group on the bank board is a question that needs to be asked and I am sure that will be looked at as part of the overall review of what has happened.

Q1432 Mr Love: A final question, not in relation to the merger because that took place significantly before the bank board of 2011, but in terms of how the merger proceeded and the difficulties they were having and the Verde deal. Most of the decisions
Q1433 Chair: One other colleague wants to come in and I will let him in in just a second. That is Mark Garnier. Can I take you back to the exchange we had about the approved persons regime at the beginning of this session where you said you agreed with the recommendations of the Banking Commission that the APR was a busted flush?

Clive Adamson: Yes.

Chair: What we said was, as the primary framework for regulators to engage with individual bankers, the APR is a confused and complex mess. It fails to perform any of its varied roles to the necessary standard. You do agree with that?

Clive Adamson: Yes. To be clear, I think one of the aspects pointed out by the commission is that it was viewed as a gateway and, after the approval, the actual supervision of individuals was very limited. I absolutely agree with that.

Chair: Therefore, you presumably support what is now in statute as the solution, which is the senior managers regime and a new certification system?

Clive Adamson: Yes, completely.

Chair: Two completely new regimes.

Clive Adamson: Yes.

Chair: And that the APR should be scrapped?

Clive Adamson: Yes, I do. Yes. We believe the new senior person’s regime will be very important in helping to raise standards.

Clive Adamson: And some investment firms.

Chair: That was a mistake in the drafting of the Bill, which the commission has identified because the Bill even at a late stage did not have an accurate definition of a bank in it.

Clive Adamson: Yes.

Chair: In fact, it had a wildly inaccurate definition that would have excluded investment banks.

Clive Adamson: That is right. For those investment firms prudentially supervised by the PRA, the new regime will apply to those as well. Correct.

Chair: I am just asking the question: if the APR is unfit for purpose for banks, why do we think it will carry on being fit for purpose for other financial institutions?

Clive Adamson: As I said earlier, we have been improving as best we can the operation of the approved person’s regime for other firms.

Chair: But it is a dead duck process. We all agreed it was useless and, as you have just said, you agree with that conclusion. Don’t you think it is time that the FCA started to consult, after discussion with the PRA, on what to do about other financial institutions?

Clive Adamson: We would have preferred the new regime to apply to all financial services firms.

Chair: Would you?

Clive Adamson: We would have preferred it.

Chair: That is an extremely helpful remark, which will be noted well beyond this room. In fact, it is crucial to the long-term regulatory structure for the financial services industry in this country.

Q1435 Mark Garnier: Can I just come back on a couple of points that you were talking about a little bit earlier? The first is you keep maintaining that, despite his lack of financial knowledge, the Reverend Flowers had extensive governance experience, which made him a good candidate to be chairman of the Co-operative Bank. Can you share with us what governance experience you felt was appropriate and where he got it from?

Clive Adamson: To be clear, I think what I said was that his experience would be helpful in his role as non-executive chair and I did feel he had the expertise to play that role.

Mark Garnier: You are going to share with us what that expertise was, I hope.

Clive Adamson: As is well documented, he had limited experience in terms of a governance role in major firms, if any. What I was trying to get across to the Committee was that my judgment was that he was an individual who could play that role and provide robust challenge to the board and the chief executive.

Mark Garnier: That was based on an hour and a half conversation?

Clive Adamson: Correct.

Mark Garnier: Really?

Clive Adamson: Yes.

Mark Garnier: In an hour and a half conversation, you assessed that a 65 year-old man was capable of being the non-executive chairman of a medium-sized financial institution?

Clive Adamson: To be clear, that is not uncommon. The SIF interviews we have for chief executives or chairs of any firm are roughly an hour and a half in length.

Mark Garnier: You must have gone through his curriculum vitae to have a look?

Clive Adamson: I did.

Mark Garnier: What stood out in his CV that made you think that he was an ideal candidate to be the chairman of the Co-operative Bank?

Clive Adamson: I do not think he was an ideal candidate. We were asked to judge the candidate put forward: did we think he was confident to perform the role?

Mark Garnier: Based on an hour and a half conversation only?

Clive Adamson: Yes.

Q1436 Mark Garnier: You are seriously saying to all those bondholders who have lost money, these nickel and dime savers who put their money into these bonds, that based on an hour and a half’s conversation you think that this individual was the right person to be the chairman of this bank that went bust?
Clive Adamson: It has not gone bust, if I can correct that.

Mark Garnier: Well, sorry, it has been bailed out and bondholders have lost money.

Clive Adamson: Remember, the taxpayer has not contributed.

Mark Garnier: Sorry, it has still been bailed out. It has been bailed out by hedge funds. It has had to be rescued. There has been a rescue package. The fact that it has not been bailed out by taxpayers is completely irrelevant. Where the money comes from is irrelevant. The fact is it has been bailed out. I just want to be absolutely clear. You did no other research on this individual to see if there was anything you could—

Clive Adamson: That is correct.

Mark Garnier: Wow. I am absolutely stunned, absolutely stunned. You also—

Clive Adamson: To be clear, that is no different from the approach we would do today where we roughly spend an hour and a half. Admittedly, now it is both the FCA and the PRA would conduct a detailed interview for that period.

Q1437 Mark Garnier: I am pretty much speechless. There was something else that you did say on two occasions.

Chair: Nonetheless, Mark will come out with a further question.

Mark Garnier: No, I certainly will do as I gather my thoughts on this amazing revelation that it merely takes an hour and a half’s chitchat with the regulators in order to be approved as the chairman of a bank.

Clive Adamson: I would not agree it is chitchat. From all my conversations with boards and senior executives today, virtually without exception they believe it is a tough process.

Mark Garnier: What are you talking about? When you are sitting down with him and you have done no research into his CV and his background, what do you talk about?

Clive Adamson: As I think I have explained to the Committee, the subjects we covered were the correct subjects.

Mark Garnier: You must have a basis on which you are going to ask those questions. You must have done a little bit of research. For example, he was the chair of the governors of Lidget Green Primary School. Did you ask him how that was relevant to him talking to the chief financial officer of the Co-operative Bank?

Chair: Or whether it was an unruly group of governors.

Mark Garnier: Yes, or a particularly tough congregation at one of his Sunday services. I am making some light comments, but this is a very serious point. How on earth can anybody conduct an interview with an individual about their suitability to be a chairman of a bank when you have not even read his CV?

Clive Adamson: No, I did read his CV.

Mark Garnier: What part of it—

Clive Adamson: The point I am making, if I may, is that the subjects—

Chair: Sorry, Mark, do just finish that question: what part of it.

Mark Garnier: What part of it stood out as illustrating that in his background there was something that directed you towards a certain set of questions that would reinforce an opinion you must have based on looking at his background?

Clive Adamson: Because the subjects we talked about is how he conducted himself in his previous roles.

Mark Garnier: As the chairman of Lidget Green Primary School, for example.

Clive Adamson: Or whatever his previous roles were, so what exactly his personal style was and how he would use that or not in his role on the board.

Q1438 Mark Garnier: You are talking about an unruly 22-person board and you are asking him in the space of an hour and a half based on—I do make light and poor Lidget Green Primary School probably will not thank me for mentioning it so many times, but he was part of the executive council of Bradford City Council. He was part of Rochdale Metropolitan District Council where he was vice-chair of social services. He did do other stuff, but what I am trying to get from this is how you make the link between his background and his skill to be able to deal with an unruly group of individuals based on more than just an hour and a half’s conversation. It simply does not stack up.

Clive Adamson: All I can say is that it is the subjects we did cover, which I think were relevant to his role on the board. We did cover—

Mark Garnier: Can you give us an example?

Clive Adamson: We covered how he would run the board, what his—

Mark Garnier: Can you give us a bit of a flavour to how that conversation went?

Chair: Well, we are going to see the notes, aren’t we? We are going to see the record of all this.

Mark Garnier: The transcript?

Chair: Yes. I think we had better see all the papers that were relevant to this appointment both in 2009 and then as chairman in 2010.

Clive Adamson: I am happy to do that.

Chair: Just one last question.

Q1439 Mark Garnier: Yes. It is quite an important one. You have mentioned on two occasions, first to Mr Ruffley and secondly to Mr Mann in their questioning, and I will quote exactly what you said, that you were “disappointed that associates, colleagues and those in public life did not come forward to share with the regulator what they knew about the Reverend Paul Flowers.” What did you mean by that?

Clive Adamson: All I mean is there have been various allegations about his role in previous areas where he has been involved and the point I make is at no time has anybody from any of those organisations or, indeed, people he has worked with in the Co-op ever come to us to indicate aspects of his behaviour that could be relevant to his role.

Q1440 Mark Garnier: Did you ever approach those organisations? Again, assuming you went through his CV, you would have seen his quite extensive contacts in the Methodist Church, the Lifeline charity, the
Labour Party, the Labour and Co-operative movement. Did you ever approach any of those organisations in order to find out?

Clive Adamson: No, we did not.

Mark Garnier: You did not get any references on him at all and you are expecting those organisations—

Clive Adamson: Can I be clear why? We believe, and it is still the case, that it is the role of the firm who are putting him forward to conduct their due diligence.

Chair: All right, but did you ask them whether they had done it?

Mark Garnier: Yes, quite. What checks did you do on the firm?

Chair: Did you ask them whether they had done it, as simple as that?

Clive Adamson: I cannot recall. I believe not.

Mark Garnier: You did not check on the background process that reinforces the decision you made to say that this bloke was okay to be the chairman. Are you suggesting—

Chair: This had better be the last question.

Mark Garnier: This is the last one.

Chair: We had the last question some minutes ago.

Mark Garnier: It is the same question with different wording. Chairman. The important point is this. Are you suggesting that there is a veil of deliberate silence over this individual’s background that has kept this information from you?

Clive Adamson: I think that is probably a step too far.

Chair: Describe the step that you would like us to be able to spot.

Clive Adamson: I personally believe that those people should inform us—and it should be true of anybody who has particular knowledge about somebody performing a senior role in financial services—if they do know something that they think is relevant to the performance of their role.

Chair: This is back to the whistle-blower problem and the fact that the culture of the FSA was so shot through that it had failed to inculcate or even examine the need to inculcate a whistle-blower culture in many of our financial institutions, another of the Banking Commission recommendations, Andy Love has a quick question he wants to ask and I also have a question.

Q1441 Mr Love: Just arising from that, the Reverend Flowers was chairman when they negotiated the reduction from 22 to 14 on the board, which was in accordance with your wishes.

Clive Adamson: It was.

Mr Love: What role did he play in that process?

Clive Adamson: What role did he play?

Mr Love: Yes, as a non-executive chairman.

Clive Adamson: I believe that he ensured that happened.

Q1442 Chair: I do have one remaining area I want to cover. It is again taking you back to some remarks you made earlier. When I asked you what value added the FSA had brought to the piece with respect to the regulation of the Co-op, you said that there were two areas you would like to cite. One was improvements to the board and the other was improvements to the capital position. There may be others and you may want to mention those in a moment, but I just want to probe a bit further those two.

On the first of those, your contribution appears to rest on the fact that you got the numbers down, 22 to 14, and that that had something to do with the appointment of Paul Flowers, who had been put in partly to perform that function. I hope I have this correct so far. Under sustained questioning, you have not told us anything in Paul Flowers’ background, which you were looking at at the time, that you can say was giving you confidence he could run a board, have you? You have not touched a single item. What area of his experience gave you confidence he could run this board?

Clive Adamson: As I have tried to indicate to the Committee, it was less the appointments he previously had. It was more how he conducted himself in interview with me.

Chair: There was nothing that he was bringing to the table prior to the beginning of that discussion whatsoever that you were taking into account in making that assessment?

Clive Adamson: That is correct.

Q1443 Chair: I have to say that in the whole history of interviews for jobs at almost any level, starting with trying to get a university place all the way up to being chairman of the board of a major public company, that is unprecedented. I cannot think of a single post where people look only at what they hear in the interview. If you can think of one, let me know.

On the second issue, you said that there had been improvements to the capital position and you said you had succeeded in raising the core tier capital ratio by around a per cent. Was that correct?

Clive Adamson: Correct.

Chair: The risk-weighted assets are around £16 billion, so what we are talking about here is that is equivalent to raising capital of about £160 million?

Clive Adamson: Approximately, yes.

Chair: What were the losses, roughly, of the Co-op in the end?

Clive Adamson: In 2011 it was still profitable.

Chair: I am talking about the subsequent losses.

Clive Adamson: The subsequent losses in terms of impairments are around about £960 million for 2012 and 2013, plus PPI provisions, plus the write-off of—

Chair: On the IT?

Clive Adamson: Correct.

Chair: They are about 300 each; in fact, one of them has risen to rather more, but we are up at 1.6, aren’t we?

Clive Adamson: Somewhat less than that. The extra PPI provisions were about £60 million and the IT write-offs were about £150 million.

Chair: I thought they were nearer 300, but you may be right. Okay, so we are talking about somewhere between £1 billion and £1.5 billion. This extra bit of capital is not taking us very far, is it?

Clive Adamson: No, it is not.

Chair: No. Therefore, the capital improvements were of pretty nugatory value in relation to the losses, weren’t they?

Clive Adamson: In terms of the losses to come, correct.
Q1444 Chair: Yes. Looking again at the two areas where you say the FSA made a difference, where we are better off with a regulator than without, we have not succeeded in identifying very much yet, have we? I said a moment ago if you have other areas—those were the two that sprang to mind when I asked you this question earlier—whether you want to put any more on the table.

Clive Adamson: If I may, I would also come back on that point. In terms of the areas we were concerned about at the time, there was an independent review conducted by a third party on their corporate credit risk process. There was a review that we commissioned in terms of their quality of advice. All of those activities were carried out during 2010 and 2011. We believe there was very active supervision carried out during that time.

Chair: This has been a very long and probably very arduous session for you and it is the first time you have appeared before a parliamentary committee as well. I want to express the gratitude of the Committee for you coming today and for doing your very best to answer some very difficult questions over a sustained period. This session has lasted rather longer than our sessions normally do and that reflects both an interest and a concern around this table for this subject. Thank you very much indeed.

Clive Adamson: Thank you.
Tuesday 21 January 2014

Members present:
Mr Andrew Tyrie (Chair)
Mark Garnier
Stewart Hosie
Andrea Leadsom
Mr Andrew Love
John Mann

Mr George Mudie
Mr Brooks Newmark
Jesse Norman
Mr David Ruffley
John Thurso

Examination of Witnesses

Witnesses: Lord Levene of Portsoken KBE, former Chairman, NBNK Investments, and Gary Hoffman, former Chief Executive Officer, NBNK Investments, gave evidence.

Q1445 Chair: Lord Levene and Gary Hoffman, thank you both very much for coming to give evidence to us this morning. Lord Levene, what have been the consequences for you personally arising from the failure to acquire Verde’s branches?

Lord Levene of Portsoken: Chairman, first of all, thank you for your welcome. We are both very pleased to have the opportunity to speak to your Committee this morning. For me personally, the NBNK project—if I can put it like that—was a proposal that was put to me some time ago. It was a proposal put together by some of the largest investing institutions in the country, long before I had anything to do with it. I think they had rightly concluded that pure retail banking in the UK was a good business, that to a large extent a number of the largest retail banks had lost their way and if there could be a retail bank again, which was just that, pure retail, this would be a good thing for them to invest in.

They invited Sir Brian Pitman, who I think was regarded as one of the best retail bankers of his time, to become the chairman of it and he agreed. Sadly, he died and so they approached me to take over. I thought this was a good idea. I still do, and it is a matter of great regret to me that this did not happen. For me personally, I got the usual flak; although I think perhaps when some people have seen what has happened subsequent to that they may have changed their view somewhat. I have other responsibilities that happened subsequent to that they may have changed their view somewhat. I have other responsibilities that I follow, and so personally for me it is a matter of carry on with life.

It is still a matter of regret to me that something that I think would have been a good idea, which was being supported by all political parties and, if we read the statements just at the end of last week by the leader of the Opposition, it seems to be déjà vu all over again, “Why don’t we create some challenger banks?” So I think it was a good idea, but life goes on and so you have to get on with it.

Q1446 Chair: You have made a number of very serious allegations or inferences of allegations in your evidence. Overall, do you think that the bidding process for the Verde branches was fair?

Lord Levene of Portsoken: No.

Q1447 Chair: Are you alleging bad faith on Lloyds’ part?

Lord Levene of Portsoken: Looking at the whole situation in the round, Chairman, and, of course, as time goes on things start to become clearer, I was told at one stage, quite late on in the process, that I should look at the references to financial services in the Coalition Agreement. One of those references said that it was one of the goals of the Coalition to promote the interests of mutuals. I think that there were two particular champions as Ministers in the Coalition, the Financial Services Secretary—

Q1448 Chair: Sorry, could you just tell us when it was that your attention was drawn to a section of the Coalition Agreement?

Lord Levene of Portsoken: I would say about halfway through the process, certainly before the decision had been taken.

Q1449 Chair: This is after the first bid or between the bids?

Lord Levene of Portsoken: From memory, it was after the first bid.

Chair: After the first bid, okay. Sorry, do carry on.

Lord Levene of Portsoken: Yes. Clearly the Business Secretary had said for a long time that he was a big supporter of mutuals. He told me that himself when I saw him, and I had not understood the full inference of that. I have subsequently learned that the Financial Services Secretary is thought to have been a very significant supporter of mutuals. With the benefit of hindsight—which of course one always likes to have—there seems to have been a view that, if the creation of a new challenger bank would be created by a mutual, this would be another tick in the box for the goals that had been set out. I have no difficulty with that, provided it was done by fair means rather than foul.

Your clerk has provided us with some of the later evidence that was put in by Lloyds Bank to say, “How would one know? How were NBNK so perceptive that the Co-op were going to fail in such a spectacular manner?” We were not so perceptive.

Q1450 Chair: We will come on to that in a moment. The question was whether you are alleging bad faith on Lloyds’ part and you have just suggested that foul means were in play. If foul means were in play, it sounds as if you are alleging bad faith. Is that correct?
Lord Levene of Portsoken: Well, “Foul means” is one terminology. What I would say is that, in our view, they chose to concentrate on all the positive aspects of the Co-op and none of the positive aspects of our bid.

Q1451 Chair: Okay, but can I come back to the question: are you alleging bad faith on Lloyds’ part?

Lord Levene of Portsoken: I believe that Lloyds were swayed by political considerations, which I—

Q1452 Chair: We will come on to that in a moment, but are you alleging bad faith?

Lord Levene of Portsoken: I would say that their assessment of our bid, to the extent that that was explained to their board—and we have no idea whether that was done—was not done fairly.

Q1453 Chair: Do you think that that unfairness constitutes bad faith?

Lord Levene of Portsoken: Yes.

Q1454 Chair: So you are alleging bad faith?

Lord Levene of Portsoken: Yes.

Q1455 Chair: Bearing in mind—and I have known you a little bit for a very long time, and you are one of the shrewdest and most thoughtful operators around—that that must have been one of the key questions that you would be asked today, why did you spend five goes before coming to the conclusion that you were alleging bad faith?

Lord Levene of Portsoken: Could I just ask Mr Hoffman to talk about the five goes, because I do not think that we had five goes. Do you want to just address that point?

Q1456 Chair: No. I just want to ask you, Lord Levene, why you did not say, “Yes, I am alleging bad faith”?

Lord Levene of Portsoken: Because at that stage we believed that we were bidding reasonably fairly, and the reason that there were five goes, which was—

Q1457 Chair: My question is about the evidence that you have given me this morning. I am trying to clarify why you have not come and just said, “I am alleging bad faith”.

Lord Levene of Portsoken: If you ask me do I think it was bad faith, yes I do.

Q1458 Chair: Before I leave that area, I would like to ask you whether, in the light of that, you are planning any legal action.

Lord Levene of Portsoken: No, Chairman.

Q1459 Chair: As far as we can tell, you made that clear in a conversation with Mervyn King on 5 July 2012, didn’t you?

Lord Levene of Portsoken: Yes.

Q1460 Chair: We have seen the minutes of that conversation. If you are alleging bad faith—which is a very serious allegation—why are you not contemplating legal redress?

Lord Levene of Portsoken: Because, as of today, neither I nor Mr Hoffman have any particular standing in this. We are no longer directors of the company. We are no longer shareholders. I think that if one looks at the bigger picture today—

Q1461 Chair: The shareholders have £25 million they might like to recoup, haven’t they?

Lord Levene of Portsoken: That is up to them, Chairman.

Q1462 Chair: Right at the beginning you pointed out that initially there was a reputational hit for you as well. There is a lot at stake, so why are you not suing?

Lord Levene of Portsoken: Because I would like to believe, Chairman, from what I have heard from people that I know in the City and from what I have read in the press, that the belief now is no longer—as we were very unfairly tarred with—that we were a bunch of incompetents who did not know what we were doing. Even in the last few days many senior people have said, “Now we understand what was happening. Now we can believe what you said”.

Q1463 Chair: It is the allegation of incompetence that has triggered the vigour of your response?

Lord Levene of Portsoken: In part, yes.

Q1464 Chair: But you are not going to seek redress, even though in your view it was action taken in bad faith. Did you take legal advice on whether you could take action?

Lord Levene of Portsoken: Only informally.

Q1465 Chair: Is that a “Yes” or a “No”? Either you go to seek legal advice or you do not on a matter of that gravity.

Lord Levene of Portsoken: One of the few remaining members of the board is a distinguished lawyer, and I talked to him about it. I decided—and I think Mr Hoffman decided—that life goes on at the end of the day. I believe that my reputation—

Q1466 Chair: Do you think you would win a case for bad faith?

Lord Levene of Portsoken: It would be a very complex case and it would cost a lot of money, and I am not sure that we would win too many friends from pursuing it.

Q1467 Chair: So the answer to that is, “We might win. We might lose. But it would cost a lot of money”, and you do not want to lose friends.

Lord Levene of Portsoken: Yes, that is a fair summation.

Q1468 Chair: We might come back to that in a moment. Just to be clear about the Coalition Agreement, you said that the Coalition Agreement was brought to your attention after the first bid.

Lord Levene of Portsoken: Yes.

Q1469 Chair: Were you not already aware of the Coalition Agreement?
Lord Levene of Portsoken: I was generally aware of it from memory. The Coalition Agreement is a very long document.

Q1470 Chair: But this is on page 1 of the Coalition Agreement. It is on page 9 technically, but the first eight pages are of foreword. It is in the middle of page 1 and page 1 starts with “Banking”. It is right at the top. I must ask you whether you were aware already of the commitment in the Coalition Agreement—
Lord Levene of Portsoken: To promote the interests of mutuals?
Chair: Yes.

Lord Levene of Portsoken: Only parenthetically and it was not at the front of my mind.

Q1471 Chair: When you say, “My attention was it was not at the front of my mind.” does sound a bit curious that you were not already aware of it.

Lord Levene of Portsoken: Let me put it into context. When it was suggested to us that there had been considerable political interest in this I said, “Why?” They said, “Well, perhaps you would like to have a look at the terms of the Coalition Agreement”, which I then did. When we were in the middle of making a bid for a large number of retail banks like this, we thought that we were dealing with a normal commercial situation. Perhaps we should have looked more at the Coalition Agreement, but certainly it was not the first thing that came to mind.

Q1472 Chair: Lord Levene, you have been in Government for years and years and years. You were right at the heart of the most difficult negotiations of the lot. That is with the Defence industry. You knew you were not in—as you have described it—a normal commercial situation. This is offloading a major holding of a part state-owned institution. You knew jolly well that politicians would be thinking about this decision and have an interest in the outcome. You will agree with that, surely.

Lord Levene of Portsoken: Of course, because before this was well under way I consulted widely with a number of politicians. If I recall rightly, I even came to see you because obviously, as Chairman of this Committee, you had an interest. We were given considerable encouragement by everybody we saw, from all political parties, to press ahead with this. If I recall rightly, at the time there was no suggestion that a mutual—in this case the Co-op—was going to be one of the bidders.

Q1473 Chair: Did you say a moment ago that you came to see me to ask whether you should go ahead with this bid?
Lord Levene of Portsoken: No, I did not ask whether we should go ahead with the bid.

Q1474 Chair: I do not remember any such conversation about that. I would like to clarify the point that you did make there, parenthetically.

Lord Levene of Portsoken: Let me make clear what I meant. I came to see you to say that we were interested in bidding for this and that I wanted to let you know, I did not ask you whether we should do it.

I just wanted to let you know, and you said words to the effect of, “Thank you for letting me know”.

Q1475 Chair: I think that that is accurate. Can I just come back to this Coalition Agreement before we move on? Knowing your extremely distinguished record in Whitehall over many years, I have to say that it strikes me as extraordinary that you were not aware of the terms of the Coalition Agreement before you set off on this path, and that you only discovered the import of it after your attention had been drawn to it in between the two bids.

Lord Levene of Portsoken: I think the import of it is correct, Chairman. Of course we knew the Coalition Agreement existed. That is a very lengthy document. We knew that it was the wish not only of the Coalition but, as far as I was aware, of all political parties to encourage the start of a new challenger bank, which is what we were doing. We certainly informed as many relevant politicians as we could talk to of our wish. They all thought this was a good idea and, as I said at the time, we did not focus on the particular issue of mutuals because the Co-op at that time certainly was not a bidder. They came in later on. Should we have looked further? Perhaps we should, but we had a lot of other things to look at. We believed and we had been told by the politicians involved—and you will have seen the correspondence—that they were keeping strictly out of this.

Q1476 Chair: But you feel perhaps that you should have looked further?
Lord Levene of Portsoken: Perhaps we should have done, but we believed—

Q1477 Chair: Would you go as far as saying that was incompetence or not?
Lord Levene of Portsoken: No. I think it was one issue and perhaps we should have paid more attention to it. We had a lot of other things to look at.

Chair: Yes, I understand that.
Gary Hoffman: If I could add, Chairman—
Chair: I would like to clarify one more point and then there will be an opportunity for you to come in, in just a moment.
Gary Hoffman: No problem.

Q1478 Chair: I want to clarify that the allegations you are making, in a nutshell, are: first, that there was political interference to public detriment and that you feel this constitutes bad faith.

Lord Levene of Portsoken: Yes.

Q1479 Chair: Secondly, that Lloyds moved the goalposts of the auction to help ensure the Co-op won and that that constitutes bad faith.

Lord Levene of Portsoken: I would say that constitutes unattractive commercial practice.

Q1480 Chair: Okay. Just to be clear, is this also part of the bad faith allegation or not?

Lord Levene of Portsoken: Yes.

Q1481 Chair: That also constitutes bad faith. There are numerous subsidiary elements to each of these.
Thirdly, Lloyds’ evidence to this Committee has—and these are the words you have used—“been at best disingenuous”.

Lord Levene of Portsoken: That is a very good description, Chairman.

Q1482 Chair: We will come on to all three of those in more detail in questions from other colleagues. Mr Hoffman, before I pass the questioning on to Jesse Norman, I realise that you have not been given an opportunity to have a go. So do respond or add to any of the thoughts or exchanges.

Gary Hoffman: Chairman, the only thing I was going to add is that, of course, we were aware of the political backdrop. In some ways we were encouraged in this process because of the political backdrop, because that was about creating challenger banks, creating something different, creating something that was purely retail-focused, and that is what we were about. Notwithstanding the Coalition Agreement’s mention of mutuals, the overriding point was that we needed new challenger banks, and there was Vickers, the Banking Commission on Parliamentary Standards, as well, and we were encouraged by some of the conclusions there. Therefore, we entered into this process believing, and with assurances, that the process would treat the different bidders on the merits well, and we were encouraged by some of the perspectives.

Lord Levene of Portsoken: It did.

Q1483 Chair: On that specific point, Lord Levene, if I can come back to you for one point of clarification? When you said, “Why isn’t this happening?” presumably that coincided with the point at which your attention was drawn to the Coalition Agreement?

Lord Levene of Portsoken: It did.

Q1484 Chair: Is that correct? That is the point at which—

Gary Hoffman: That is what I am trying to add.

Q1485 Chair: Who was it who drew your attention to the Coalition Agreement?

Lord Levene of Portsoken: I actually do not remember, Chairman. But once somebody mentioned this to me—and I actually cannot remember who it was—then it was like the penny dropped and we suddenly started to realise where this was coming from.

Q1486 Chair: This is a set of thought processes that—as you said a moment ago—perhaps you should have had earlier but which, nonetheless, you feel is short of incompetence?

Lord Levene of Portsoken: Yes. We were looking much more at the commercial and financial issues that were involved. Should we have spent more time on this? Perhaps, but we did not.

Q1487 Jesse Norman: Lord Levene, I want to clear up a couple of points of fact arising from the Chairman’s questions. First of all, have you sustained or have your investors sustained any financial loss from this failed bid?

Lord Levene of Portsoken: Have I sustained? Yes.

Q1488 Jesse Norman: How much?

Lord Levene of Portsoken: I invested £100,000. I received back something like £40,000, so I lost £60,000.

Q1489 Jesse Norman: You lost £60,000?

Lord Levene of Portsoken: Yes.

Q1490 Jesse Norman: How much have your investors lost as a result of the failed bid?

Lord Levene of Portsoken: If they have realised their investment—

Q1491 Jesse Norman: No, how much have they lost so far from the bid having failed as a result of the process that you say is the result of bad faith?

Lord Levene of Portsoken: If they have not realised their investment they have not actually lost anything yet.

Q1492 Jesse Norman: Sorry, it is a paper loss, yes. Lord Levene of Portsoken: A paper loss of 60%.

Jesse Norman: Of 60%?

Lord Levene of Portsoken: Yes.

Q1493 Jesse Norman: On the investment of £50 million?

Lord Levene of Portsoken: Correct.

Gary Hoffman: That is right. The amount that was spent was just under £30 million.

Q1494 Jesse Norman: The amount that is in play is about £30 million?

Lord Levene of Portsoken: Yes.

Q1495 Jesse Norman: You said you do not intend to seek legal redress yourself on this matter. Have you had any indication from any of the investors whether they may seek legal redress?

Lord Levene of Portsoken: I have heard tell that some of them may be waiting to see what happens as a result of this hearing, Mr Norman, to see whether they will do so or not, but I have nothing definite about that.

Q1496 Jesse Norman: Thank you. Potentially there is a lawsuit for £30 million on the table and consequential costs?

Lord Levene of Portsoken: Yes.

Q1497 Jesse Norman: I am grateful for that, thank you. I want to focus on the details of the bid for the moment. Lloyds has told us that the final bid from the Co-op for the Verde branches was superior to the one that your NBNK consortium offered, both financially and in terms of its execution risk. What I want to ask is, whether or not you agree with that assessment, and we know that you do not agree with it, was that not a reasonable conclusion for it to reach?

Lord Levene of Portsoken: If I may, I am going to ask Mr Hoffman to answer that in detail because he
was more involved with the numbers. But from my understanding of it, and from what I have seen now—and, again, with the benefit of hindsight—I do not think anybody would come to that conclusion. But may I ask—

Q1498 Jesse Norman: Just to be clear, you do not think anyone could come to the conclusion that it was reasonable for Lloyds to take the Co-op bid over your bid?

Lord Levene of Portsoken: We did not come to that conclusion. If you say “anyone”, anyone can take any—

Q1499 Jesse Norman: But it was a reasonable conclusion. They were not committing an egregious mistake.

Lord Levene of Portsoken: For what it is worth, my view is that it was not a reasonable conclusion.

Q1500 Jesse Norman: Okay. Thank you. Mr Hoffman?

Gary Hoffman: I think it is important to say that when Lloyds communicated the decision to us, on 27 June 2012—and, as an aside, I had met with them at 7 am that morning because late the night before they had requested me to come down to talk about a number of issues, so I went to speak to Antonio Lorenzo and Toby Rougier—they were very clear, during that meeting on the day on which the decision was made, that the key determinant was not price. They understood where we were on price. I said, “Is there anything more we need to do on price?” They said, “No, we understand where you are. We understand your price adjustment mechanisms”. In communication of the decision, that is after the event of the decision, they said to me at 4.55 pm that day that it was not about price; it was about a number of factors, principally about execution risk, and that is what they have said to me, Lord Levene and others since that date.

In terms of the specific numbers, clearly I am not privy and should not be privy to all the detail of the Co-op. However, from what I have seen publicly given, theirs was a £350 million offer upfront with a further £400 million over 15 years, dependent upon performance of the business. Our offer was a range of £630 million to £730 million and an additional £120 million invested upfront to get to completion. Our monies were going to be paid—let us use the £730 million number—upon signing of the sale and purchase agreement, that is well in advance of completion, whereas the Co-op monies would be paid at completion. Hence, I conclude from those figures that our offer was financially superior.

Q1501 Jesse Norman: But it was not unreasonable for them to prefer the other offer. You have said they preferred it on execution grounds, but you are not suggesting that it was unreasonable for them to reject it on financial grounds. You think yours was better.

Gary Hoffman: I think it perfectly reasonable to say, “Price is important but not the only thing”. They may be there or thereabouts both on price. I happen to think ours was superior, but I have not seen all the detail of the Co-op bid. You should of course take into account other factors, such as: how this fits with state aid rules—I could talk about that—that is what is the risk of execution for our customers and for employees, and what is the risk of execution for funding? I think it is perfectly acceptable to take all those things into account and make a decision either in favour of the Co-op or NBNK or neither. It is difficult to be objective when you are one of the bidders but, having been around financial services for a long time, it was crystal clear to me that the execution risk for the Co-op was extremely high. I said at the time I thought it would unravel over a short period of time, which is what it did.

Q1502 Jesse Norman: Just to be clear, it was not unreasonable for them to choose the other bid on financial terms and it was not unreasonable for them to choose the other bid on execution terms, although in fact the judgment turned out to be flawed, as we have seen by the performance of the Co-op subsequently. That is what you are telling us?

Gary Hoffman: It is perfectly within their rights and they can change the process. I can talk about the process more, but they can change the process at any time according to the letter of the process and they can make a decision based on what they regard as the criteria.

Q1503 Jesse Norman: Of course, you as a challenger institution, following what you believe is a Government remit to increase competition by providing new entrants into the market, have all the benefits of being the new entrant and hopefully—as you hoped for at the time—the support of that. Of course, they are an existing clearing bank and, therefore, the purchase of branches might be seen to be mitigated, in terms of execution risk, by giving it to an existing player even if it did not meet the remit of increasing competition by bringing in a new entrant. Is that right?

Gary Hoffman: It is possible you can conclude that. But 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.

Q1504 Jesse Norman: How widely known were those issues in the market at the time?

Gary Hoffman: Very widely known. Clearly I am not going to talk about lots of informal conversations I had with senior bankers, but 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.

Q1505 Jesse Norman: Thank you for that. Lord Levene, you have said you think that it was unreasonable for Lloyds to prefer the Co-op bid. Could you explain why?
Lord Levene of Portsoken: Mr Norman, as I said earlier, everyone can be very wise with the benefit of hindsight, but we were making it very clear that we believed that the Co-op could not perform. They did not believe us. I think if you look at what has happened with the Co-op overall since then—even yesterday—the number of problems that they faced were unfathomable. How would they do this? There is one particular point that they made in their evidence that I would like to bring to your attention. They said that we did not have committed funds. In effect, that is not true. When I started my evidence today, I explained how the genesis of this programme was when some of the largest institutions in the United Kingdom decided—and I think quite rightly—that retail banking was a good sector in which they should invest. They decided to commit, certainly to us, up to £2 billion to pay for the acquisition, which is roughly what they then thought it was going to be worth, of those 632 branches of Lloyds Bank. They immediately wrote us out a cheque for £50 million just to get us going.

Throughout the evidence that we have seen that has been submitted to your Committee, Lloyds seem to be saying that we had no committed funds; we did not have the money there. It was absurd. They knew who our shareholders were. In fact, Mr Hoffman can tell you that he offered to take these very large institutions into Lloyds to say to them, “Look, we commit to make this money available. You do not need signed letters from us. You know who we are”. Jesse Norman: The equivalent of the old “highly confident” letter.

Lord Levene of Portsoken: Yes. You know when you have people of the nature of the backers that were backing us you do not need—

Q1506 Jesse Norman: Let me ask you a question about that. JP Morgan was acting as the financial adviser to Lloyds Banking Group. If you think that their assessment was unreasonable, JP Morgan must have been wrong in giving that advice. Is that right?

Lord Levene of Portsoken: Mr Norman, you are experienced in this as well. You will always have advisers and the advisers of Team A will say, “Black”, and the advisers of Team B will say, “White”. Are they all always right? No, I am sure they are not.

Q1507 Jesse Norman: Why would JP want to say that black was white, from your point of view? What would be the point, from JP, of having a well-respected international institutional come out in favour? They do not have any skin in the game, do they?

Lord Levene of Portsoken: Because they were acting on behalf of their client.

Q1508 Jesse Norman: Their client is instructing them to come out in favour of the Co-op, on your way of thinking of it?

Gary Hoffman: If I can just add here that, of course, in any acquisition process like this a bidder will be asked to increase the confidence of the funding during the process. In the early part of the process we gave comfort letters. We gave highly confident letters later in the process. It would not be usual at any stage in the process, until we get to a sale and purchase agreement, to provide committed funding and that would be true of NBNK. It would be true of the Co-op. It would certainly be true of an IPO where, of course, you would not get that committed funding until right towards the end of the process.

As Lord Levene says, we offered several times for there to be joint meetings between Lloyds and our investors to show what their commitment was, and our investors were very happy to have those meetings.

Q1509 Jesse Norman: They turned you down?

Gary Hoffman: Lloyds said they did not need those meetings because they understood the quality of our investors. I think the other thing to say is that—

Jesse Norman: So quality spoke for itself. They did not need to meet your investors to know that they were highly reputable institutions that would—

Gary Hoffman: Of course. They were mainly blue chip investors. They were not hedge funds there to make a quick buck. These were long-only blue chip institutional investors. Of course the other important thing to say on this is that funders will only provide underwritten funds when they have, in effect, prospectus-quality information. Lloyds was not able to provide that information to anyone, including themselves, in order for that committed funding to be provided because they were working to provide that prospectus-quality information in line with an IPO timetable, not in line with our timetable. That delayed us significantly—and, understandably, we did not moan—in the ability to provide the increase in confidence on funding.

Jesse Norman: The Chairman has an interjection and then I want to go on.

Q1510 Chair: Just to be clear, it was Lloyds’ fault that a higher level of confidence on funding was not provided? It was Lloyds fault that they did not—

Gary Hoffman: I would not have used those words. They asked for comfort letters. We gave them. They asked for a repeat of those letters at each stage of the process. We gave them. Towards the end of the final bid, on 11 June 2012, they gave us some additional financial information. We asked them if they would like further letters and whether they would like to meet. They said, “We do not need anything else”.

Q1511 Chair: I heard that in previous evidence. I am asking you to summarise where the blame lies—if there is blame to be had or to be allocated—for the fact that there was not a higher level of confidence in this bid written out in a document at the time the decision was taken.

Gary Hoffman: What I am saying is that no party—whether it be the Co-op, NBNK or a prospective IPO—could provide that level of committed underwritten funding at that stage. It was Lloyds that turned down meetings with our investors where they would have stated their clear intent.

Q1512 Jesse Norman: Mr Hoffman, I do not understand that. Am I not right in saying that Lloyds
wrote to you requesting more details around your funding plans?

Gary Hoffman: Yes.

Q1513 Jesse Norman: They would not have done that if they were comfortable with the quality of the funding that you were showing them.

Gary Hoffman: No, I do not think that is true. I think that is a normal thing to happen in these processes and we updated them each time they asked us for that. Clearly, I do not know what they were asking the Co-op. I think that the Co-op would have had more difficulty providing the sort of letters that we had because they had different—

Q1514 Jesse Norman: But the letters you had were all on an uncommitted basis. They had exactly this language. “This letter does 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”. Is that right?

Gary Hoffman: Yes. What I am saying is that—

Q1515 Jesse Norman: They are explicitly disavowing any commitment in those letters.

Gary Hoffman: Mr Norman, all I am trying to say is that is normal in this type of process and Lloyds understood that. They would not have expected to receive any letter without that legal caveat in the back.

Q1516 Chair: Are you attaching any blame to Lloyds’ conduct with respect to this issue?

Gary Hoffman: I think they should have met with our investors. If they had concerns about whether our investors were committed at this stage of the process that we were at, then I think they should have met with our investors as offered several times.

Q1517 Jesse Norman: The thrust of your point is, how could they be grumbling about execution risk if they were not even prepared to meet with your investors, whom you had offered to, and who were some of the biggest institutions in the country?

Gary Hoffman: Yes, exactly.

Q1518 Jesse Norman: The final point, just to come back to Lord Levene because you did not follow through. You said to us that it was unreasonable for Lloyds to prefer the Co-op Bank bid. You have acknowledged that they were so advised by JP Morgan and you have said that JP Morgan was instructed by their clients to give that advice. They were acting at the behest of their clients. Is that right?

Lord Levene of Portsoken: No. I did not say they were instructed by their clients to tell them that the bid was good. Of course, they were instructed by their clients to give them their advice, which is what they did.

Q1519 Jesse Norman: So JP Morgan were acting and exercising their judgment independently, in response to a request from their clients for their best advice?

Lord Levene of Portsoken: I would imagine so, yes.

Q1520 Jesse Norman: You are not suggesting that they were catering to a pre-understood idea in Lloyds that they wanted the Co-op?

Lord Levene of Portsoken: No.

Gary Hoffman: JP Morgan would have been advising on the financial aspects rather than the other execution aspects; even though, of course, they always stray into those, so they would ask me quite a lot about technology. Let us not forget that JP Morgan would know the Co-op well, having advised them on the Britannia acquisition.

Q1521 Chair: On the JP Morgan aspect of this, you are suggesting they sang the song that their clients told them to and that they were prepared to subordinate their independent professional judgment to that?

Gary Hoffman: Those are not my words, Chairman.

Q1522 Chair: No. That is the impression I got back when I heard the exchange that took place a moment ago about JP Morgan from you.

Gary Hoffman: No, I was saying that JP Morgan would have provided advice on the financial aspects of it. I have no idea what that financial advice said, so I cannot comment on that.

Q1523 Chair: Is it your view that JP Morgan acted professionally and as they should in every respect, as far as you know?

Lord Levene of Portsoken: I do not have enough information about their advice to be able to say that, Chairman.

Q1524 Chair: You said a moment ago that you had lost money.

Lord Levene of Portsoken: Yes.

Chair: £60,000 I think you said.

Lord Levene of Portsoken: Yes.

Q1525 Chair: How much were you paid in total as directors’ emoluments?

Lord Levene of Portsoken: I think I was paid about £300,000 a year.

Chair: So the total was about £600,000?

Lord Levene of Portsoken: Yes.

Q1526 Chair: Mr Hoffman, how much were you paid? You were in a full executive role. You were in a non-executive role for £600,000.

Gary Hoffman: Yes, my salary was £750,000 a year.

Chair: That is about £1.8 million.

Gary Hoffman: I cannot remember how long—I am sure your calculation is right.

Chair: I do have the figures in front of me.

Gary Hoffman: I am sure your calculation is right.

Q1527 Chair: Yes. Lord Levene, you were down £60,000 but you were up £600,000. That would have been a more accurate reply to the question.

Lord Levene of Portsoken: Not entirely, Chairman, because, of course, there is tax to be paid on that as well.
Q1528 Chair: You were down £60,000 gross and up £600,000 gross would have been a fully accurate reply.

Lord Levene of Portsoken: Chairman, I think a fully accurate reply is that I might say there was an opportunity cost because if I had not been doing that I might have been doing another job. Could I make one other point?

Gary Hoffman: Yes.

Q1529 Chair: I just want to clarify on the money with Mr Hoffman. You were paid just under £1.8 million, but in addition to that there was a commencement fee, wasn’t there?

Gary Hoffman: Yes. Clearly I was leaving another role in order to do this and there were monies due from that role and that was part of me joining. It was—

Q1530 Chair: I have from the accounts that the commencement fee was another £1.8 million, so we are talking about £3.6 million here.

Gary Hoffman: Yes. I am not passing any comment on whether those were the right sums of money for this type of work. I am passing a comment on the allusion that was made earlier, that either or both of you might have lost money.

Gary Hoffman: Your numbers are clearly factually correct. Lord Levene has told you why he got involved. I got involved in order to create something different in UK retail banking. My great shame and regret is the fact that we were not given that opportunity.

Q1531 Chair: I am not trying to clarify these numbers. You said a moment ago that the total amount at risk was about £30 million. I make it about £25 million on the basis of what is in the public domain. In any case, we are talking roughly about £20 million. Could we revert on that? I do not have those numbers.

Gary Hoffman: Yes.

Q1532 Chair: No, I have that point. I am just trying to clarify these numbers. You said a moment ago that the total amount at risk was about £30 million. I make it about £25 million on the basis of what is in the public domain. In any case, we are talking roughly about £20 million. I have from the accounts that the commencement fee, was another £1.8 million, so we are talking about £3.6 million here.

Gary Hoffman: Yes. Clearly I was leaving another role in order to do this and there were monies due from that role and that was part of me joining. It was—

Q1533 Chair: I am not passing any comment on whether those were the right sums of money for this type of work. I am passing a comment on the allusion that was made earlier, that either or both of you might have lost money.

Gary Hoffman: Your numbers are clearly factually correct. Lord Levene has told you why he got involved. I got involved in order to create something different in UK retail banking. My great shame and regret is the fact that we were not given that opportunity.

Q1534 Mr Love: Can I refer the Committee to my designation as a Labour and Co-operative MP? Can I come back to this issue of your investors and the commitments they gave? Is it unreasonable for Lloyds Bank to interpret the following comment in the letter, “This letter does 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”. Is it unreasonable for them to interpret it that way?

Gary Hoffman: The only way in which that paragraph could and should be interpreted is in a transaction process such as this. That would be exactly the paragraph that anyone would put in at this stage, and Lloyds and their advisers would expect that.

Q1535 Mr Love: That is not what Lloyds have said to us. The letter then goes on to say, “The letter may not be used without our prior written consent save that a copy may be provided to Lloyds Banking Group who may place no reliance on it.” How would you interpret that? Would it be unreasonable for Lloyds Bank to interpret that as not being committing any funds to this proposal?

Gary Hoffman: No, it would be unreasonable for them to do that. This is, unfortunately—and advisers and legal advisers play a role in these processes—exactly what you would expect to be put in such letters at this stage of the process. That is why we wanted to ensure there was more flavour around the legal caveats are always put into these letters. It was because of the compliance departments in those investment organisations that we wanted to provide more flavour to LBG. LBG would have understood exactly why those letters say that. It would be extraordinary for them to say anything else.

Q1536 Mr Love: That is not what they are saying in their memorandums to us and when they gave evidence. They also raised the backdrop to this, being that public equity markets were effectively closed at that particular time and, therefore, it was a very difficult investment climate. Do you take that into
account in recognising the reasonableness of the way in which Lloyds responded to your offer?

Gary Hoffman: Clearly, as Lord Levene has already said, our blue chip investors had already provided £50 million without any financial information being provided. Therefore, it would be wrong to say that equity markets were completely closed for this type of potential investment because they had already provided £50 million in order to fund the transaction and they had provided comfort letters. Clearly, the investment proposition has to be sufficiently compelling for them to then put the money in in due course, but—even during that very difficult period—transactions were being done if the investment proposition was right.

Q1537 Mr Love: But if I can put the opposite case, very many good investment prospects were not being done because of the climate. You were asking Lloyds to take a very large risk at that particular time, plus the letters that they received—now, it may well have been that they could have met with your investors—they suggest that the information from you was quite clear and their interpretation is entirely different from yours.

Gary Hoffman: Mr Love, they understand how these processes work extremely well and they would not have expected any different from those letters. Indeed, they said that to us at the time. The other thing I would say is let us not forget the context here. This is a forced sale. This is not a choice for Lloyds to sell something in the markets. It was a forced sale into the markets, which was mandated by the European Commission and a legally binding agreement. I assume, between the Treasury lawyers and the European Commission to sell this asset in the market by November 2013 and, if that did not happen by that time, then it should be sold at no minimum price. This is not a normal type of equity transaction where the seller has a choice, which it does. The timing of the transaction needs to be taken into account in what we are saying here. If those equity markets are difficult—and indeed they were—then that would be true for us, for an IPO, and presumably for the Co-op in raising their funding, too. We happened to have a number of very strong, very large, very long-only, not in it to make a quick buck, institutional investors that were prepared to back us and to provide letters, with the normal caveats in a transaction process, and they said they were happy to show their commitment.

Q1538 Mr Love: I would like to come back because, of course, there was the IPO as a backdrop and there was still competitive tension with the Co-op Bank at that particular time. Let me ask you, Lord Levene, did it not send alarm signals when Lloyds clearly did not wish to meet your investors? Did that not send a signal to NBHK that perhaps your bid was not being viewed in quite the positive light that you had expected?

Lord Levene of Portsoken: No, Mr Love, it sent a completely different signal. The chairman of Lloyds Banking Group is a very experienced investment banker, more so than a commercial banker. He will have understood the import of those letters better than anybody and would have known that this was totally standard practice.

For the benefit of you and the Committee, perhaps I can just tell you who some of those investors were: Aviva, Invesco, Foreign & Colonial and Baillie Gifford. As Mr Hoffman said, these are not fly-by-night operators. This was not my idea to start NBHK. This was their idea. They had put up money. They had stood behind us throughout. At no time throughout the process did any of those investors come to us and say, “Hey, look, it looks like Lloyds do not treat you seriously. Do we still want to go ahead with this?” Quite the opposite; they were astonished as well. We were very surprised at what happened and we do not believe that, looking at this, any experienced investment banker would have regarded the caveats that were put in the letters by those investors as being anything other than entirely standard procedure.

Q1539 Mr Love: It is clearly coming across, in the evidence that both of you are giving, that the terms of the forced sale that the European Union was imposing upon Lloyds led you to believe that the very competitiveness of your bid may not need to be as good as it would be in normal circumstances. I am rather hacking at it at the moment, but the point I am trying to make is that, between your first bid in 2011 and the second bid in 2012, there was not a significant improvement. In fact, some would say you lowered your bid. Was that against the backdrop of the forced sale?

Gary Hoffman: No, not at all. We were crystal clear that there were a number of competitive bidders and, therefore, we needed to be on the mark, on our game, with a competitive bid in financial terms. Of course, we knew in a forced sale, in an environment where the Banking Commission and politicians wanted a challenger bank, that there were other factors to be taken into account and, frankly, we thought we ticked all the boxes on those.

The only reason for the reduction between December 2011 and our final bid on 27 June 2012 was the fact that on 12 June, I think it was—or it might have been 11 June—2012, 18 months into the process Lloyds gave us updated information that showed a reduction in profits of several hundred million pounds for the Verde transaction. That is the only reason our bid was reduced, because their projections had reduced by several hundred million pounds. For example, up until that point, they were assuming base rates would be in the high 300 basis points by the end of 2014; clearly it was never going to happen.

Q1540 Mr Love: Could I come to execution risk?

Lord Levene, is the characterisation of NBHK as having no bank, no treasury, no clients and no infrastructure, a fair characterisation?

Lord Levene of Portsoken: No, I do not think it is a fair characterisation. We were set up as a new venture. Of course we did not have any branches. Of course we did not have any clients. We were encouraged to start a new venture, which is what we did. By its very definition, a new venture does not have clients. But what we did have—as I have been at pains to explain—was basic investors who were there from the
outset, who were ready to do this because they believed that the creation of a new challenger retail bank was a very good investment. To be fair to them, I think they also felt this was a good thing to do for the greater society where clearly a number of people have been failed by retail banks. We did not.

I understand entirely your question, which I think is a fair one: were we trying to see if we could squeeze the last penny out of it because there was so very little competition? That was not where we were, and I will tell you why. We had set this up precisely to buy these banks. There was no other motive there. When it was coming to what was now clearly the crunch, our interest was to put in the best possible bid that we could, and that is what we did. We certainly did not say, "Let’s see if we can shave a few pounds off this". That was not the way we operated, otherwise we would have failed.

Q1541 Mr Love: Let me ask you a final question. In the circumstances, just looking at NBNK, was it reasonable for Lloyds Bank to consider execution risk so considerable in relation to NBNK as to discount it from the bidding process?

Lord Levene of Portsoken: All I can say is that I do not agree with them. I understand what they did. I think they are wrong. I understand why they said that, but I just think they were wrong.

Gary Hoffman: I would add that if they had concluded that having no branch infrastructure, no legacy systems infrastructure and no banking licence was a non-starter in this process, then they should have said that at the beginning of the process. They did not say that because they did not believe that to be true, nor did the FSA. Clearly, we had many sessions with Lloyds on all of those issues where we believed we satisfied them on all of those issues and, indeed, they said that we had satisfied them on most. Let me give an example on IT.

Q1542 Chair: I do not think we need the example, unless it is absolutely essential, on grounds of time. Why do we not just accept that point?

Gary Hoffman: I will just make the one sentence. In Lloyds’ evidence they say that we did not have a platform. All I would say is that we were introducing a partner that runs platforms for hundreds of millions of customers; probably better to do it without the legacy platform, a clean platform doing different simple things for customers.

Q1543 Chair: We are already at 11.10 am and we have lots of colleagues who want to come in. On the basis of what I am seeing so far, we might take a very brief interval at 11.30 am to give everybody a breather for five minutes or so, and then we will resume at 11.35 am or thereabouts and run until lunchtime. Just following up Andy Love’s questioning on execution risk, let us set aside execution risk for one moment and go back to the JP Morgan assessment that you were cross-examined on earlier. You were sent the supplementary evidence that has been put to us, which we are publishing today, the short supplementary evidence last week. You have seen that, haven’t you?

Lord Levene of Portsoken: Yes.

Q1544 Chair: I will ask Lord Levene these questions. Lord Levene, you say that the December 2011 rejection of the first bid showed that the deck was stacked against you. That is correct, is it not?

Lord Levene of Portsoken: Yes.

Q1545 Chair: You had your nose ahead as far as the financial assessment is concerned, setting aside the execution risk. Is this correct?

Lord Levene of Portsoken: Yes.

Chair: I have it completely correct? I have not missed any key point out?

Lord Levene of Portsoken: Yes.

Gary Hoffman: I think that that JP Morgan note concludes that as at December 2011.

Chair: That is correct and that was this supplementary evidence shows.

Gary Hoffman: Yes.

Q1546 Chair: With respect to the second bid, they concluded that the Co-op bid was ahead on financial grounds alone but—in evidence to us a moment ago—you were saying that was because they were just— peddling whatever line their clients wanted.

Lord Levene of Portsoken: No, Chairman. Mr Hoffman can give you more evidence on this, and I think I pointed this out in a note previously. They had done their sums incorrectly and, in fact, if you had done the sums properly, you would find that our bid was higher and not lower.

Q1547 Chair: You are saying that, with respect to this issue, just the financial aspect of the analysis, JP Morgan was incompetent?

Lord Levene of Portsoken: No, I am saying that when Lloyds—and I do not know who told them to say this—said that the other bid was higher—that is right, isn’t it?

Gary Hoffman: I just go back to the very perceptive—

Chair: No, hang on, I just want to clarify. Are you saying that they were incompetent with respect to this?

Lord Levene of Portsoken: All I am saying is that they said that our bid was lower and we believe they miscalculated it.

Q1548 Chair: They miscalculated it. Was that a piece of incompetence? What led to this miscalculation?

Lord Levene of Portsoken: I cannot tell you that, Chairman. I do not know why they got the calculation wrong.

Chair: Just a momentary rush of blood to the head.

Lord Levene of Portsoken: I do not think so.

Q1549 Chair: I am just trying to get to why it is that JP Morgan came out with a view based on a calculation that you yourself said was erroneously put together.

Lord Levene of Portsoken: Perhaps we are not privy to everything they saw on the Co-op and, as I said before—
Chair: There may be further undisclosed information?

Lord Levene of Portsoken: There may be. In very simple terms, for me it would be difficult to conclude that a £350 million upfront payment from the Co-op followed by £400 million dependent on business performance over 15 years compared with £730 million upfront would be a better deal. There must be other things in there that made that because JP Morgan is full of clever people that would not normally get that type of calculation wrong.

Q1550 Chair: There is more that we should be asking of JP Morgan in evidence to explain this gap?

Gary Hoffman: I think I would go back to—

Chair: Although you are not passing judgment at the point that you are saying JP Morgan are incompetent, you are saying that there is information, not yet in the public domain, which is required in order to explain why such a group of clever people—as you described it—took such an extraordinary decision. Do I have that right?

Gary Hoffman: I would agree with that if the decision was made principally on price. We were told—

Q1551 Chair: This may be the further piece of information.

Gary Hoffman: Yes, but we were told it was not.

Q1552 Chair: I am trying to summarise what you appear to be saying to us, because there is a great deal of inference and I am trying to translate it into evidence. Perhaps you could summarise that point for us. Lord Levene, am I right in thinking—in the absence of that further piece of information, that further explanation that may be of a non-financial nature—that JP Morgan’s judgment with respect to this would be incompetent?

Lord Levene of Portsoken: Chair, I am not passing any judgment on JP Morgan. I am only commenting on what Lloyds Bank said to you in the evidence that we have seen, where they said that they believed that our bid was lower. We believe they are wrong. We do not understand why they were wrong. If they had advice from JP Morgan that we are not privy to, then we cannot comment on that.

Q1553 Chair: In December 2011, when you concluded that the deck was stacked against you, you must have sat around the table and thought, “We are up against deep, dark forces here. What on earth are they?” Did you?

Lord Levene of Portsoken: Yes.

Q1554 Chair: In which case, why did you sally forth with another bid?

Lord Levene of Portsoken: Because we believed that we would be treated fairly, certainly by—

Q1555 Chair: Even though you felt there were deep, dark forces at work?

Gary Hoffman: I think much more—

Chair: I am just asking Lord Levene, but by all means come in in a minute.

Lord Levene of Portsoken: Whenever we inquired about this, either formally or informally, we were told, “Do not worry. This is a commercial decision and that is the only basis”—

Q1556 Chair: But you already had the evidence that the deck was stacked against you, Lord Levene, staring you in the face, and you decided to go ahead and—as I put it—sally forth with a second bid. Why did you do that? Why did you put your shareholders’ money at risk?

Gary Hoffman: Can I come in here with a comment?

Chair: In a moment. I just want Lord Levene to comment, since he was leading this project.

Lord Levene of Portsoken: Because we were being given signals from those involved that this was very fair, and if we believed there were dark forces at risk, we should not believe them, and this was—

Q1557 Chair: Hang on, just to clarify what you are saying there, each piece of your evidence has a high degree of inference in it and I think it is important that we draw it out. What you are saying here is, yes, you considered that the deck was stacked against you; yes, you considered that there were dark forces at work, but that you sought reassurance before going ahead, before sallying forth with that second bid. Have I summarised your position correctly?

Lord Levene of Portsoken: Yes, and I think—

Q1558 Chair: Okay, I just wanted to clarify that. If that is the case, I would be grateful if you could tell us from whom you sought that assurance and what evidence you can provide of it, of the exchanges, of your concern that there were these dark forces at work and wanting reassurance before going ahead with the second bid.

Lord Levene of Portsoken: Certainly. I asked the Chairman of Lloyds Bank if there were any outside influences and he assured me there were not. I asked the—

Q1559 Chair: But you pointed to the stacked deck, did you not, at that point and said, “But come on, old chap. It is obvious that there is something amiss here. There are these deep, dark forces at work”?

Lord Levene of Portsoken: He assured me that I was wrong. He made—

Q1560 Chair: You believed him?

Lord Levene of Portsoken: I listened to what he said. We also made inquiries—

Q1561 Chair: But if you disbelieved him, if you were not believing him, you would have been mad to go ahead with the second bid, wouldn’t you?

Lord Levene of Portsoken: I mean, short of categorising everybody we spoke to as lying to us, which I was not and did not—

Q1562 Chair: But you are now. You are now saying this was in bad faith, are you not?

Lord Levene of Portsoken: Chairman, if you look at the history of this, which we set out here, this has taken place over a long period and it is like doing a
Chair: But a pretty big piece fell into place in December 2011, did it not, something that led you to conclude that the deck was stacked against you? That was your evidence to us.

**Lord Levene of Portsoken**: This is what we had been led to believe and I thought it was quite possible. But when we made inquiries of the Chairman of Lloyds Bank and in the Treasury, I was told I was wrong. It was only, Chairman—and you will have seen this—when I was called in directly for a one on one meeting with the Governor of the Bank of England, who told me that our fears were well-founded. That is when I finally realised that we had not been told the truth.

**Chair**: Mr Hoffman, you want to comment.

**Gary Hoffman**: Chairman, one more point, yes. Of course we believed that we had not had a fair hearing at that point in December 2011. The other people we consulted were our investors because clearly we were spending their money, so it was important to get their view. The announcement from Lloyds was that they would reach heads of terms with the Co-op by the end of March. That is what their 17 December—I think it was, or perhaps 14 December—announcement said. We were of the clear view that the Co-op would not meet that date, indeed would not be able to get anywhere near heads of terms by that date and hence, if they were going to miss that date, we should stay in the game. That is what we believed, that the Co-op would not deliver on what they said they would deliver in December through to March. That is why, during March and April, when that became clear that they were not going to meet that, we reacted.

Chair: Unless you want to chip in, Andrea?

**Andrea Leadsom**: Yes, just on that. Was it the decision of your investors that you should continue or was it your executive decision that you should continue?

**Gary Hoffman**: It was our recommendation to our investors, but, given that they had started this venture in the first place, clearly we always consulted with them very closely and we would not want to go ahead without their full support. But our recommendation was based on the fact that we thought the Co-op deal would fall apart.

**Stewart Hosie**: Lord Levene, you note that, over the Verde bidding process, Lloyds made repeated changes to the process and the package on offer. How many times was the package changed significantly and what were the most significant changes that were made?

**Lord Levene of Portsoken**: Perhaps I can ask Mr Hoffman to answer that, because he is more in the detail.

**Gary Hoffman**: Five, substantially. The initial package was a large package of £70 billion of assets and I think £40 billion of liabilities, with a funding gap therefore of £30 billion. That would have been very difficult for any bidder to close, although we did have some discussions about the way in which that could be done. It was changed when we did the second round bid in September, and it is important to make the point that every single date we were asked to meet, we met. I do not think that is true of any others bidders. After September and before December, the package was reduced substantially in order to remove that funding gap to make it more of a balanced book.

Then after December, when Lloyds had tried to reach heads of terms through to the end of March, had failed to reach heads of terms with the Co-op and had allowed us back into the process in April, there were then further changes made to the package, including taking out some price-promised mortgages, which would have been difficult to manage in this, and the IP portfolio, for example. In the end, what we were bidding for was about a £22 billion balance book of assets and liabilities, so you can see a change from something over here to something quite changed.

**Stewart Hosie**: But presumably you would agree that Lloyds were entitled to change the terms of this offer and the timetable of the auction process at any time during that period.

**Gary Hoffman**: Yes.

**Stewart Hosie**: There was nothing untoward necessarily in the nature of the changes?

**Gary Hoffman**: I think that they would say that the reason they were doing it was to protect their shareholders and to make sure they had more people in it. It was clear to me that—I am not saying they were not doing that—what they were also doing was making this a more attractive package to the Co-op.

**Stewart Hosie**: We will come back to that, but they will maintain that this flexibility that they were putting in was to protect the shareholders, to protect shareholder value.

**Gary Hoffman**: Of course.

**Stewart Hosie**: Again, that is not an unreasonable thing. Explain to me then, why were these changes being made more attractive to the Co-op?

**Gary Hoffman**: First of all, let us remember that we were the only ones to bid on a second round bid in September 2011 and Lloyds could have progressed with that bid. If they had stuck to the letter of their process, they could have said, “Right, we have the bid. We have an IPO in the background. No one else has been able to bid. We will go forward with the person that has bid, if that is acceptable in terms of finances”. My guess is it was, but instead they chose to repackage it to enable the Co-op back into the process.

**Stewart Hosie**: Lord Levene, is that what you meant by suggesting that Lloyds moved the goalposts in order to induce a bid from Co-op Bank?

**Lord Levene of Portsoken**: That was one of the elements of it, yes.

**Gary Hoffman**: To be crystal clear, of course their advisers would undoubtedly have been saying, “You
want more than one horse in the race alongside the IPO to keep commercial traction”.

Q1572 Stewart Hosie: Then can you explain a specific change—either to the package or the bidding timeline—that specifically benefited Co-op at any time in this process?

Gary Hoffman: The fact that the Co-op did not meet any date that was given to them in the process, and they were given more time each time, suggests to me absolutely the process was changed in order to accommodate the Co-op.

Lord Levene of Portsoken: Mr Hosie, can I just underline there that the Chairman mentioned that I have spent a lot of my career effectively working on your side of the table, working with Government, and in particularly large transactions—as the Chairman said—with the Ministry of Defence. When you have a large bid like this and you have a closing date, then that is it. That is the closing date. In my experience, it is very unusual to say, “Right, you have to submit your bid by noon on 24 May. That is it”, come 24 May or whatever the date was, we go and say, “How have we done?” and they said, “You are the only bidder”. I said, “Fine, then we have won”. “Oh no, we are going to start bidding again.” I found that very unattractive and I thought that was very wrong. Legally, are they able to do that in a commercial transaction? Yes, Morally, I think it is very wrong.

Q1573 Stewart Hosie: Of course, what Lloyds have said is that, in addition to your bid, they had other letters of interest.

Lord Levene of Portsoken: But they did not amount to anything.

Q1574 Stewart Hosie: Given that is what they are telling us and we have no reason to doubt that, and this is a complex, big transaction, hundreds of branches, the creation of a challenger bank, it is not unreasonable—and also forced in part by the European Commission—surely to allow as much time as possible to get as many bids in as possible rather than simply working to a date?

Gary Hoffman: I absolutely agree with that. In terms of other letters of interest, that would not be true after September 2011. Clearly I am not privy to the fact, but, in terms of the process that I knew of, there was Sun Capital, us and Co-op. After September it was just us and the Co-op, and I doubt there was other interest after that.

Q1575 Stewart Hosie: I want to just probe further on this moving of the goalposts in order to benefit the Co-op. The Co-op was named the preferred bidder in December 2011, it was granted exclusivity, but NBNK was readmitted to the process in April. Is that not an argument to suggest that the goalposts were being changed to facilitate NBNK at that point?

Lord Levene of Portsoken: Mr Hosie, 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, which is what they did, and they were not able to reach any kind of deal with the Co-op. Had they been able to, they certainly would not have come back to us.

Gary Hoffman: My interpretation is that they were having considerable difficulties getting comprehensive executable plans from the Co-op, so they allowed us back into the process. I think that is an understandable thing to do.

Q1576 Stewart Hosie: Have you any evidence of that?

Gary Hoffman: Have I any evidence of that?

Stewart Hosie: Other than the absence of a firm bid, have you any evidence to suggest that is the case?

Gary Hoffman: Apart from the fact they did not put a bid in, apart from the fact that they did not meet the date they had set for the heads of terms, apart from the fact that a number of people that had worked for me in NBNK were working in Co-op and said there was no way that they were going to meet their plans, no.

Q1577 Stewart Hosie: If that was known to you, presumably that was known to Lloyds as well, and presumably also to Government and the other backers of the bid.

Gary Hoffman: My complete mystery in all of this, and the reason for the frustration, is I think it was pretty obvious to nearly everyone involved in this, and observers and advisers, and yet they progressed. That is what I do not understand.

Q1578 Stewart Hosie: Let me just ask a final question then. There is a lot of supposition, there is a lot of reading between the lines and there is a lot of nuance. Why was NBNK’s bid rejected in favour of Co-op?

Lord Levene of Portsoken: May I venture my own view, which is that there was considerable pressure on Lloyds to accept a bid from the mutual. That is what I believe.

Chair: We are going to come on to that latter on, but I can assure you there will be a good deal of examination on that question. I think we should take a five-minute interval, because we have been going 90 minutes. We will resume, because I think there is half a dozen more colleagues, or certainly five more colleagues, to come in. We will resume at 11.35 am. Sitting suspended.

On resuming—

Chair: We shall recommence and I will hand over the questions to Andrea Leadsom.

Q1579 Andrea Leadsom: Thank you, Chairman. Good morning still. I want to talk to you about the missing risks document. Lord Levene, you have said in the evidence to the Committee that it is inconceivable that the Treasury Committee could accept that, having been required by NBNK’s board to submit this document to Sir Win, you would then fail to do.

Lord Levene of Portsoken: Correct.

Q1580 Andrea Leadsom: How could that possibly have happened? How can it be that you handed over the risk document that NBNK thought highlighted the
Lord Levene of Portsoken: As I think you have seen, I was instructed at a board meeting to take this document to the Chairman of Lloyds. Both Mr Hoffman and I attended that meeting 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.

Q1581 Andrea Leadsom: That was on 27 January 2012?
Lord Levene of Portsoken: Correct, in his office. I can remember very clearly doing so.

Q1582 Andrea Leadsom: That document was about NBNK’s perspective on what the risks were of the Co-op bid?
Lord Levene of Portsoken: You have a copy of the document.

Andrea Leadsom: Yes. Just to be clear that it is that document?

Lord Levene of Portsoken: Yes, it was that document. People have said, “With the benefit of hindsight, that was a pretty perceptive document”. That document was not produced with the benefit of hindsight, that document was produced, together with our advisers, of what we believed to be the case at the time. Unfortunately, we were proved only too right, because if anybody looked today—

Q1583 Andrea Leadsom: Yes, we will come on to that. But on this point about the fact that there is a dispute over whether Lloyds ever received it, is Sir Win lying, do you think, that he did not receive that document?
Lord Levene of Portsoken: I gave the document to Sir Win like that. Mr Hoffman can confirm.

Q1584 Andrea Leadsom: So he is lying—that he never received it?
Lord Levene of Portsoken: Perhaps he had a senior moment.

Q1585 Andrea Leadsom: Okay, so a senior moment or lying?
Lord Levene of Portsoken: Perhaps it dropped down the side of a sofa, but if he says I did not give it to him, that is untrue.

Q1586 Andrea Leadsom: Did you give it to him and tell him what was in it or did you just hand him a piece of paper that he could have put down and—
Lord Levene of Portsoken: We were talking about our bid and I said, “We have been considering our bid, and we have had prepared for us a detailed assessment of the strengths and weaknesses of the other bid”, which you would expect us to do. He and I were certainly good friends at the time. I said, “Win, I really think you should read this, 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”.

Q1587 Andrea Leadsom: Bearing in mind all the circumstances and the conditions under which you handed it to him and so on, is it conceivable that he might have handed it to an aide and just not thought any more of it?
Lord Levene of Portsoken: Anything is conceivable. I gave him the document. Now, people have said, or may have said, “Why wasn’t it emailed?” I think if you read that document and you consider the circumstances of the time I gave it to him, it was a very, very sensitive piece of paper and we took the deliberate decision not to email it because, as I am sure members of your Committee know, emailing bits of paper can be quite risky. I said, “I will not take that risk. I will give it to him in person”. I gave it to him in person and he took it. What he—

Q1588 Andrea Leadsom: Can anyone back up the decision that you took to only hand it over in person? Is that minuted anywhere, that a decision was taken not to email it?
Lord Levene of Portsoken: Yes, Mr Hoffman can, and other members of our board who were at the meeting.

Gary Hoffman: Yes. I think there is important context in the background here. Clearly we were a rival bidder, so it is always difficult for a rival bidder to be commenting on someone else because it can be seen as sour grapes. We were not about that. We were trying to do an objective assessment of what we thought, given what our objectives were. You will see at the top of that piece of paper it says, “To the board of Lloyds Bank” and I think Sir Win questions the provenance of it because of that.

I will get to your specific question. We discussed whether we should send it to the Lloyds board electronically. We thought for three reasons we should not: first, because we were a rival bidder; secondly, because we thought that would undermine Sir Win’s position as Chairman. If he was Chairman he would be annoyed if we did that, and we did not want to annoy him; and thirdly, that we thought it would be best if we talked it through with him and that Lord Levene left it with him. That was the reason that it was done.

Q1589 Andrea Leadsom: Is that decision minuted anywhere?
Gary Hoffman: Yes, it is.

Q1590 Andrea Leadsom: So we could see in the minutes where you had decided?
Gary Hoffman: Yes.

Lord Levene of Portsoken: You have had a copy of the board minute. If I could draw your attention to another document, which I think—

Gary Hoffman: I think it is minuted in the board meeting of 26 January, the day before, that Lord Levene should hand it to him.

Q1591 Andrea Leadsom: That would be helpful to see.

Lord Levene of Portsoken: I thought that had been circulated to the Committee.

Could I just draw your attention to another document that concerns this directly that I circulated, which is a
file note of a conversation that took place on—I will just try to check the date—26 June 2013, when I had a phone call from the Times telling me that the Lloyds’ press office were developing a story that this whole document was a fabrication by me. Fortunately for them, before that went to press, they decided to pull that story. I was very angry. I telephoned another director on the board, Norman Blackwell, who by coincidence is the Chairman designate of Lloyds, and I said, “If you dare state that, I will throw the book at you”. That to me says a great deal about Lloyds’ thinking on this, because that document clearly did exist. I was not lying, Mr Hoffman was not lying, our board was not making this up and the only defence was to say that I had fabricated the whole thing. That to me says a great deal about it. Although they may pooh-pooh it and say, “Well, anybody could have said that” they were obviously worried that they had been given this advice and had ignored it, or he had been given it and certainly had not shown it to his board.

Q1592 Andrea Leadsom: Thank you. In fact, the Treasury Clerk’s team have just shown me the extract of the minutes of your board meeting that says, “The board considered a tabled paper entitled, ‘Key risks to the Co-op and Verde transaction’ and agreed that subject to a final review for sensitivity, it would be appropriate for the paper to be left with LBG’s chairman at the forthcoming meeting”. It does not explain that it was not being electronically sent, but it does clearly show the intent.

Lord Levene of Portsoken: It said “left with” because we deliberately decided not to send it electronically for the reasons I say.

Q1593 Andrea Leadsom: Mr Hoffman, can you confirm that you saw Lord Levene hand the document to Sir Win?

Gary Hoffman: Yes. We talked about a number of topics in that paper and then it was handed over just as we were leaving.

Q1594 Andrea Leadsom: Who else was at that meeting?

Lord Levene of Portsoken: Nobody. The three of us.

Q1595 Andrea Leadsom: Just the three of you, okay. You were scheduled to meet António Horta-Osório the following week. Did that meeting take place and did you discuss the document with him then?

Gary Hoffman: I cannot recall a meeting the week after. To be fair, I saw Lloyds lots of times during this process. The number of times we saw them between January and March was very few and far between, because Co-op were in exclusive talks, so I do not recall a meeting after that.

Q1596 Andrea Leadsom: For the record, can you confirm why did you decide to write that memo and what the purpose was of writing it? To help your bid?

Lord Levene of Portsoken: The memo was written to our board to inform them on our internal adviser’s assessment of the Co-op bid, which, as you read that memo today, you may say it was pretty perceptive, which it was. We were asked earlier why we carried on with this bid; because we thought that we had the best bid.

Q1597 Andrea Leadsom: Sorry, I understand that you are claiming that it is prescient in hindsight, but at the time, was the purpose of writing it to encourage your own shareholders that you were still in with a chance? Was it to improve your bidding possibilities?

Lord Levene of Portsoken: It was to our board. In a large transaction like this, obviously as it moves ahead, you get reports on what is happening. This was a report on what we believed to be the status of the Co-op in their bid. We saw it. It was seen by our board and, as you will have noted from the extract from the minutes, it was agreed by the board that I should hand a copy of that to the Chairman of Lloyds Bank, which I did.

Gary Hoffman: There were two reasons. First, yes, we had to convince ourselves that it was right to continue to keep NBNK open, spend some money—less money than we were spending—pending perhaps the Co-op bid falling apart, so we had to convince ourselves there was a strong argument for us to do that, otherwise it would have been a waste of our investors’ money. We thought that the Lloyds’ board should be informed what we thought about it. I suppose secondly, and probably less easy to believe from your perspective as to why we were doing some of this, as someone who had been involved in financial services for a long time, I truly believed that a challenger bank that was very different was needed. I could not see that that was going to happen, given all that was happening with the Co-op.

Q1598 Andrea Leadsom: Again, thank you to the clerks, they have pointed out in that same board minute that, “Meetings have been arranged with the LBG Chairman on 27 January and the Chief Executive during the week commencing 6 February, so that the company can hear in more detail what aspects of its bid LBG had liked or disliked and to enable the company, NBNK, to express its concerns about the Co-op’s ability to complete the transaction”. That would have been the week of 6 February that you are meeting with António Horta-Osório. Can you tell us, did you raise the memo with him at that meeting? Did you give it to him?

Gary Hoffman: I cannot remember what I did at that meeting.

Q1599 Andrea Leadsom: Okay, but it would have been normal, would it not—

Gary Hoffman: Absolutely. There were a number of conversations I was having at the time, whether it be with LBG, indeed with their advisers, indeed with the FSA and of the stakeholders where I would have highlighted what was in that paper, including with the group Chief Executive of the Co-op.

Q1600 Andrea Leadsom: Are you saying that that memo was shown to different stakeholders, including regulators and other advisers? You have said on the one hand that you felt this was exceedingly
confidential, so that you were not going to email it, but now you are saying you cannot remember who you talked to about it, because you were talking to lots of people about it.

Gary Hoffman: What I am saying is that we did not hand that paper to other people, but the contents in it, what we thought, we would have explained to other people.

Q1601 Andrea Leadsom: Within a week, surely you would have talked to António Horta-Osório about the contents of that paper—

Gary Hoffman: Yes.

Andrea Leadsom:—which Sir Win says that António Horta-Osório completely denies you ever having raised it with him. Is he lying?

Gary Hoffman: On many occasions I discussed with Antonio Lorenzo, who my main conversations were with, rather than António Horta-Osório, who remember was absent for three months during this critical period. My main conversations were with Antonio Lorenzo and with Toby Rougier, the Head of Corporate Development. I am sure they would be fully aware of mine and the board’s opinions on what the Co-op’s weaknesses were through various conversations.

Q1602 Andrea Leadsom: In Sir Win’s letter to the Chairman, he says, “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, Antonio” who I presume he means Horta-Osório, “or our advisers”.

Gary Hoffman: I think there may be a semantic piece here and we need to be careful. Whether he is saying, “I do not remember you referring specifically to that paper yet again”—

Q1603 Andrea Leadsom: No, this has surely become much more important than that. This is much more important, isn’t it? This is effectively Lloyds Banking Group saying that you have not raised with them—

Gary Hoffman: Concerns about the Co-op.

Andrea Leadsom:—some very real concerns about the Co-op bid.

Gary Hoffman: That is nonsense.

Q1604 Andrea Leadsom: They are lying then? In your opinion, they must be lying, must they not?

Lord Levene of Portsoken: It is untrue.

Gary Hoffman: It is inconceivable that they would not know we had serious concerns about whether the Co-op would be able to execute. We said it many times to them, to their advisers and the FSA. It would be inconceivable that they would not think we had raised that.

Q1605 Andrea Leadsom: Finally on that point, then I just want to move on very quickly to something else: what turns on this letter, other than your reputations? Is it significant in this issue?

Gary Hoffman: I do not care about my reputation at all in this, so nothing turns so far as my reputation is concerned. What turns on this is the fact that there could have been a challenger bank set up by now and a deal done and it was not, because people were not cognisant of the execution issues associated with the Co-op. That is what turns on it.

Lord Levene of Portsoken: For me, it is slightly different. This is personal, insofar as I have stated to this Committee—I have put it in writing—that I handed this piece of paper to the Chairman of Lloyds Bank on 27 January in his office. I stand by that and I know that Mr—

Chair: I think we have that firmly on board.

Andrea Leadsom: Yes.

Lord Levene of Portsoken: Okay. If you want to know what turns on it for me, it is me being accused of lying and I will not accept that.

Q1606 Andrea Leadsom: Yes, I understand. Just one point on the letter, of course the risks memo does not identify the one thing that sort of took the Co-op bid down, which was the £1.5 billion black hole in the balance sheet. In that sense, while it may have highlighted a lot of the risks of the Co-op bid, it did not highlight the one thing that—

Lord Levene of Portsoken: It was not just that.

Gary Hoffman: It did not specifically say, “The commercial loan book on the Britannia” and all of those other things that created the so-called black hole of £1.5 billion. It did not say that, but what it certainly said was that, for all sorts of reasons in the Co-op group, including its structure, including issues elsewhere in the group, including problems with its IT systems, where it might have to write off money—

Chair: I think we have that.

Gary Hoffman: Sorry, Chairman, I am addressing the particular point. It explicitly says, “We think that the Co-op will struggle to raise the finance for this”.

Q1607 Andrea Leadsom: Mr Hoffman, one final question. After the decision was taken to go exclusively with Co-op, but before NBNK came back into the bidding process, did you go and have discussions with the Co-op Bank about becoming their new Chief Executive?

Gary Hoffman: I was invited to have a discussion with the Co-op to see whether I would be interested in that position via some head-hunters. I said I would only be prepared to go and have that discussion on the basis that the principal reason for me going would be to explain to the Chief Executive, Peter Marks, that I did not think they were capable of executing on the deal. That is the discussion I principally had with him. Yes, we had some tentative discussions about whether I could become the Chief Executive of the Co-op Bank. I said it would be inappropriate for me to have any discussion like that when I do not think this game is over.

It was also a strange conversation in some ways, in that I remember when Mr Marks gave evidence here, he said he did not have clear control and oversight of the bank, but was a non-executive director of it and an approved person. In that meeting, he made it crystal clear to me that he was the driving force behind the Verde deal and that the Co-op Bank Chief Executive reported to him and was accountable to him. He also said, given the background as to why I
went to see him, in effect, “Please, Sonny Jim, do not come and tell me how to run a bank”.

Q1608 Andrea Leadsom: Did you take it any further? Did they offer you a job? Did they want to see you again?

Gary Hoffman: No. They did say, “We would like to set up meetings with the Chairman, Mr Flowers”. I said—and I think they agreed, by the way—that it would be inappropriate for me to have any further discussions, despite the fact that the Co-op was in exclusive talks; if the game was not over, it would be inappropriate for me to have those meetings.

Q1609 Andrea Leadsom: Had the game been over, would you have considered it favourably?

Gary Hoffman: No.

Q1610 Chair: Just to be clear, if we ask him, Mr Marks will confirm, will he, that you had a conversation on the basis that they would not get the deal?

Gary Hoffman: Sorry?

Chair: That your conversation with him about your future there was wholly on the basis of them not getting Verde. That is the point you made earlier.

Gary Hoffman: No. I mis-spoke, if that is what you heard. What I said was the only reason I would have a conversation was to explain what I thought about their bid and that they were incapable of executing on it. It was not that I would consider the role of Co-op if they won the bid. I did not say that.

Q1611 Chair: Just to be clear, we are agreed you feel this document that went missing was very sensitive and very important, but are you asking us to accept today that, although you had numerous follow-up meetings with Lloyds, you cannot explicitly recall a conversation about that document with any of the participants?

Lord Levene of Portsoken: I did not have numerous follow-up meetings with the bank.

Q1612 Chair: No, but you did, Mr Hoffman.

Gary Hoffman: Yes.

Q1613 Chair: Just to be clear, that is what you are asking us to accept, isn’t it, that you had these numerous meeting with Mr Lorenzo—

Gary Hoffman: Mr Rougier.

Chair: —and other parties, very senior parties. You had just handed over a very sensitive and very important document, so sensitive that it could not be emailed, but you did not raise that document at all at any time in any of those subsequent meetings, the contents or the substance of it.

Gary Hoffman: I raised the contents.

Chair: But not the fact of that document?

Gary Hoffman: I did not.

Q1614 Chair: That is your evidence?

Gary Hoffman: Yes, absolutely.

Q1615 Mr Ruffley: Lord Levene, on the question of bad faith, where earlier today you have alleged bad faith, I just want to explore the legal position because it seems to me that we have heard that £30 million has probably been lost by various parties. In most of the commercial experience I have had, if a deal goes bad and one of the parties collectively is down £30 million, they go to law, they seek damages. We have had legal advice to the effect that there could be three courses of action in law. One would be insofar as the tender process is a contractual arrangement; it could be for breach of contract because, as you know, in British law there is an implied term that parties act in good faith, that the process is fair. You are suggesting it was not fair. So, first point, there could be a common law action for breach of contract; secondly, under the law of equity there could be restitution because from your evidence you were misled, you were not treated fairly, there was a misrepresentation, you incurred costs and you could get restitution of the costs incurred; thirdly, perhaps more difficult, there is action for deceit, for fraud.

That is just the general advice this Committee has received and it seems to me that, if £30 million is what we are talking about, you would have taken fairly serious legal advice as to whether or not to launch legal proceedings and I wonder why that is not the case.

Lord Levene of Portsoken: First, we are not talking about one party losing £30 million.

Mr Ruffley: No, I said collectively.

Lord Levene of Portsoken: Yes. Collectively, it is with a number of very large investors, £30 million to you and to me is a considerable sum of money. For them individually, if they had £2 million or £3 million each in multi-billion pound fund, it is not a huge amount of money, and they are not out of it yet. Another element you have to consider is that a lot of those investors were also investors in Lloyds Bank.

Not because of this, but in fact because the world has moved on, their investment in Lloyds Bank will now be worth a lot more than it was before and I would imagine that they are looking at this and saying, “Yes, this was not good, but in the fullness of things, do we have time to bother with something like this, which for our institution is £2 million or £3 million? It is too much trouble”.

I think that is what happened.

Q1616 Mr Ruffley: I think that is helpful, because the mystery has been that, because there seems to be an allegation of bad faith and injustice and impropriety, you have explained why there might not be legal proceedings.

You just said in your last answer words to the effect, “They are not out of it yet”. I just want to probe very quickly; on 10 December last, there was a report on “Sky News” that some remaining shareholders in NBNK—no names were mentioned—are considering legal action. I appreciate you are not one of their number, but is there anything either you or Gary Hoffman could do to illuminate that point? Are there letters before action being served?

Lord Levene of Portsoken: I was told this, and it was the usual sort of rumours, stories, whatever you want to call them, that go around the City. It may still be there, it may happen, it may not happen. I am not part of it. I was also told that they may be waiting to see
what happens as a result of the inquiry from this Committee, but I do not have anything specific to say on that.

Q1617 Chair: Just to clarify one point you made there in response to David Ruffley, Lord Levene, you seem to be suggesting that these sums, £2 million or £3 million, are very small beer for the investors.

Lord Levene of Portsoken: For those investors.

Q1618 Chair: That does not in any way set aside their fiduciary duty to look after their clients’ money, does it?

Lord Levene of Portsoken: No, but they may say that they have not sold their shares; they have not lost the money yet. They might get it back. They may say, “Look, by not making a fuss we will do better, because if we do make a fuss—” I mean, there is always the case if any action were taken against Lloyds Bank, it might slow down the flotation that inevitably is going to happen. I do not know; I am not speaking for them. These are just suppositions.

Q1619 Chair: But you consulted them and they were not keen, or you did not consult them?

Lord Levene of Portsoken: No, I have not consulted them, because I have no standing in the matter anymore.

Q1620 Chair: You have not even taken formal advice on it, even though you think there was bad faith?

Lord Levene of Portsoken: I have spoken to one or two people and the advice is equivocal. I spent two and a half years on this process and it went nowhere. I think—

Chair: You have already made those points earlier. I do not want to take up more time on them.

Q1621 John Mann: Just before I start my questions, is the concept of yourself, Lord Levene, and a challenger bank dead for all time?

Lord Levene of Portsoken: I would never say anything is dead for all time, but I believe that it was a very good idea. Just at the weekend when Mr Mark Hoban had had many, many telephone conversations to see what Treasury could do to assist the process. We know from the Reverend Flowers that the regulator, Andrew Bailey, had told the Co-op that the regulator was under no doubt at all that there was considerable political support for this deal from members of the Government and he wanted to make Reverend Flowers aware that that was the case. Throughout, we are very clear from the evidence that Government has had its hands all over this. Lord Levene, your attention was drawn to this possibility in the summer of 2011, so that would have been July or August 2011. Was that the first time you were aware?

Lord Levene of Portsoken: There had been inferences for some time.

Q1622 John Mann: For some time? What does “some time” mean?

Lord Levene of Portsoken: I would imagine a few months. Mr Mann, in transactions like this, rumour abounds, stories abound, and you learn after a while that you hear them, you believe some; you do not believe others. I had no basis to complain in detail to Government Ministers until I had something absolutely specific from a source that I am sure this Committee would regard as unimpeachable, which was when I was called to go to see the Governor of the Bank of England, when he told me this quite specifically.

Chair: We are going to come on to that shortly.

Q1624 John Mann: Yes. I am interested in the earlier period, because you have said that your attention was drawn. It cannot have been many months earlier.

Lord Levene of Portsoken: We had discussions with officials; I spoke to the Permanent Secretary for the Treasury; I spoke to other officials in the Treasury and was assured that this was being treated very fairly.

Q1625 John Mann: But we are talking about the period up to September 2011. You tell us your attention had been drawn to the Coalition Agreement. Is that the first time that you had an indication that there was a political viewpoint in Government on what should happen?

Lord Levene of Portsoken: On that specific point of mutuals?

John Mann: Yes.

Lord Levene of Portsoken: Yes.

Q1626 John Mann: But that is what this is about, so that was the first time. That must have come as quite a bombshell to you?

Lord Levene of Portsoken: No, I regarded it as one more piece in the jigsaw of what was happening. I knew a lot of these officials. I knew the Ministers involved and whenever I spoke to them formally or informally, they said, “That is not a problem”. Of course it was always there. Of course in any transaction like this there are pros and cons of all sorts of things. At the end of the day, one would hope that in a transaction of this kind, and particularly with a very large public interest involved, that the financial considerations would be paramount.
Q1627 John Mann: But which Ministers did you speak to?
Lord Levene of Portsoken: I certainly spoke to Mark Hoban and I certainly spoke to the Permanent Secretary to the Treasury, and they assured me that this was being treated fairly. They did not deny that there was a clause obviously in the Coalition Agreement about favouring mutuals, but perhaps naively—and I like to think normally I am not naive—I thought that this, because it was a high-profile transaction, would be treated very fairly on its own merits.

Q1628 John Mann: When was the first time you raised that concern, either with the Permanent Secretary or Mark Hoban?
Lord Levene of Portsoken: I cannot tell you precisely. I cannot tell you precisely.

Q1629 John Mann: But approximately. You have given us a detailed timescale, so approximately.
Lord Levene of Portsoken: Some time after it had been raised with us, and as time went on, after it had been—

Q1630 John Mann: So it was raised with you in July or August 2011 and then you raise it, because it will have come as a bombshell, it is a big issue—
Lord Levene of Portsoken: I would not say it is a bombshell. It is another piece of the jigsaw.

Q1631 John Mann: Someone has told you to look at the Coalition Agreement.
Lord Levene of Portsoken: Correct.
John Mann: If you are about to embark on the creation of a challenger bank potentially—
Lord Levene of Portsoken: We were not about to embark, we were halfway through the process.

Q1632 John Mann: The process has begun, you are in the game. Someone has dropped this huge bit of information, the implication of which is there is the possibility of an undue bias. We find now from the Co-op and from Lloyds that they say that that is the case. They admit it. Both the Co-op and Lloyds have told us that, so that is the case. You find out. You presumably raise it immediately?
Gary Hoffman: No, I do not think we did. If I could come in on this, in some ways you make a better case for the bias than we have, because you are able to recount a number of things that have been given in evidence here that we have seen, and of course we were not privy to those things at the time. Clearly raised with Lord Levene was the Coalition Agreement, and we were fully aware of the political—

Q1633 John Mann: Raised by who?
Gary Hoffman: I think we talked about it at the board and with advisers.
John Mann: At the board and with advisers?
Gary Hoffman: Yes.
John Mann: In the summer of 2011?
Gary Hoffman: That is right. On the other hand—

Q1634 John Mann: But who raised it with you?
Gary Hoffman: I think it was one of our advisers, but I cannot be sure. Now, the more important point—can I just carry on?

Q1635 John Mann: Sorry, no, this is important. You think that one of your advisers raised this, and it is important enough to discuss it at the board?
Gary Hoffman: Yes. But let me round it out because this is important, that, notwithstanding that political backdrop—which is important—we were being given assurances that this bid would be treated on its merits, so it was only until after September, when we were the only ones to put in a bid on time. But then the package was changed and then only in December, when Co-op were given exclusivity, despite the fact that we thought our bid was more compelling and much further advanced than theirs was, that we thought this was something that should be a real concern to us.

Q1636 John Mann: So in July to September? We are not clear yet, Chair, on the timescales—
Chair: I am not sure about that, but anyway, you can have another go, John.

John Mann: No, we are not, and it is important that we do. July to September you are raising these concerns and getting assurances from the Permanent Secretary, Mr Mark Hoban—anyone else in Government at a senior level?
Lord Levene of Portsoken: I also raised it with a number of politicians, and I think, if I may, the Chairman may remember that I raised it with him.

Q1637 Chair: You did not give me any intimation that there was anything untoward at any stage.
Lord Levene of Portsoken: No, no, but I had mentioned it.

Q1638 Chair: What was it that you raised with me?
Lord Levene of Portsoken: I mentioned to you that we had heard that there might be some political impetus behind this. More specifically, I raised it with the Chairman of the Public Accounts Committee, wrote to the Chairman of the Public Accounts Committee. She wrote to the Comptroller and Auditor General who wrote back afterwards and said that he did not think it was a matter in which he could become involved.
I hope you will forgive me for saying, Mr Mann, the sensitivity here is quite significant. If I believe—and I have been around in Government circles for some time—there is something that is not quite right that is taking part within the Government, it would be quite normal that I would go and raise this with a member of the Opposition. I am not sure if he was Shadow Chancellor at the time, probably not, but Ed Balls, whom I knew well, of course I then find—as Mr Love explained as well this morning—he is a Labour and Co-op MP. There has been further commentary on that. The same applies to the Chairman of the Public Accounts Committee, so I did not feel that I was able to find too many people who wanted to dig into this, so we had to sit there and wait to see what happened. It was only—and forgive me, Chairman, I know you said I have mentioned it a bit too early—when the
rumour and scuttlebutt was going around it crystallised in my being summoned by the Governor of the Bank of England to tell me this quite specifically.

Q1639 John Mann: No, that is not what Mr Hoffman has just told us. Mr Hoffman has just told us that in September and then in December this is seen by yourselves as being—
Lord Levene of Portsoken: Yes.

Q1640 John Mann: Lord Levene, you are not very convincing at the moment. You are trying to jump to—and no doubt we will come to it—an important issue with the Governor of the Bank of England, but that is the following summer.
Lord Levene of Portsoken: Yes, it is an ongoing process.

Q1641 John Mann: No, you have been in the heart of Government as a political operator. You know your way around.
Lord Levene of Portsoken: Yes.
John Mann: I put it to you that you have a discussion at your board, which we have now found out for the first time that there could be a Government impetus behind the opposing bid, for whatever reason, and the Government favours that. We have had that then confirmed both by Lloyds and the Co-op; that was clearly the message that they received. I put it to you that you then go around and you do talk to lots of people to ensure that that does not happen. I am trying to clarify who you spoke to, not in July 2012 but at the key time in 2011. Did you speak to the Chancellor? Did you speak to 10 Downing Street?
Lord Levene of Portsoken: You have to understand that when these issues were raised at the time they were rumour. I do not like running on rumour. You must not forget, we had two other politicians on our board and we talked to them about it and this was clearly—

Q1642 Chair: Just to tell the Committee who they were; I know who they were, but just for the public record.
Lord Levene of Portsoken: Lord Forsyth and Lord McFall. We took advice from them as well. It was clearly becoming a very, very difficult issue and so we hoped that we could believe in fairness at the end of the day, despite the rumour.

Q1643 Chair: Just to be clear, “It was becoming a serious problem”. When was that, because John Mann is particularly concerned about the chronology, so let us just be clear what date that was.
Lord Levene of Portsoken: It was a problem after we had lost the bid. All this happened afterwards.

Q1644 Chair: So this is after December 2011 and before—
Lord Levene of Portsoken: Clearly, we could have dropped the whole thing at that time and said, “We are out of it” and we did finally do that. But this is a very, very sensitive issue. I have been schooled in doing these things according to the book and we were trying to do them according to the book and some people may say we were fobbed off. Other people may say we had explanations given to us that we should adhere to. That is why I say—and I am sorry to keep harking back to this—it was only when I had final indisputable advice as to what had happened that we raised this further, by which time, as far as our bid was concerned, it was too late.
Chair: We are going to come on to that in a moment. John has one final question and then we must move on.

Q1645 John Mann: One final question. Obviously Mr Hoban has been sacked since, so there is no need to be the fall guy and resign from Government, but is it your view that there has been impropriety in Government in relation to the public interest with this case?
Lord Levene of Portsoken: What has happened, as your Committee has been clear to point out, is that it was stated quite clearly in the Coalition Agreement that the Coalition would do what they could to favour the interests of mutuals. I cannot say to what extent, in the particular case of the sale of the Lloyds’ branches, the political impetus in doing that overrode what would have been a better commercial decision.

Q1646 Chair: But just to be clear, are you saying that there was impropriety or not? We asked this question of numerous people in various ways. I have a list of half a dozen of them in front of me who have been involved in this deal in various ways and they have all given us one clear answer. We would like your clear answer. Was there impropriety?
Lord Levene of Portsoken: I believe that the people who took this decision could provide justification for so doing. One man’s view of that as to whether it is improper and another one as to whether it is politically expedient, you have to take their own view.

Q1647 Chair: So you are not alleging impropriety?
Lord Levene of Portsoken: I think it was—
Chair: You can say “Yes” or “No” to some of these questions. That is always an option.
Lord Levene of Portsoken: I think it was very unfair.

Q1648 Chair: Unfair on you or unfair to ask you to decide whether it was or not?
Lord Levene of Portsoken: No, I think it was unfair. I think it was certainly unfair on the shareholders.
Chair: I see. You are making a different point.
Gary Hoffman: The great tragedy out of all of this of course is, if there were political influence—which Mr Mann says the evidence suggests there was—then that has been to the detriment ultimately of the mutual sector and not to the championing of it. That is a great tragedy. The other great tragedy is we do not have a challenger bank.

Q1649 Chair: But to be clear, you are saying “if there was”. This came from all sides. You have cited the Labour Chairman of the PAC, the Shadow Chancellor, as well as meetings with Conservative politicians and also with senior officials. Everyone is in on this.
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I am going to move on now. I think we have—

John Mann: No, you have thrown in something that was not said.

Chair: Order, John. Order.

John Mann: No, you have thrown in something that was not said and I want to clarify it.

Chair: Order. Thank you, John.

John Mann: No, you are out of order. You are totally out order. You have been named in this. You are out of order in your questioning and you are out of order in your chairing of it. Issues have been raised here and they should be properly heard. You are out of order yourself.

Chair: David Ruffley.

John Mann: You are running away from this.

Chair: If you have further points that you want to raise later on, John, in a calm manner, we will consider returning to them. Pass me a note on what they are.

We have four more colleagues who want to get in. That is my main problem, John.

Q1650 Mr Ruffley: You have said, Lord Levene—now and also in your written evidence, and I am quoting—that you, “Received a number of messages indicating there had been significant political involvement leading up to the original decision on ‘Verde’. I want to explore what that political involvement entailed and who the individuals were who were getting politically involved, which politicians, because you have used in your testimony a few minutes ago the words, “It was at the level of rumour”. I wrote it down. No doubt there is a lot of well-informed rumour. You are a very sophisticated businessman and a very sophisticated political operator, so you are hearing this rumour. What I want to try to understand is who was applying this political pressure and what form did that political pressure take, because so far I am certainly not clear—and I do not think colleagues are clear—about the answer to those two questions, who and what?

Lord Levene of Portsoken: As you say, I can only guess as an informed observer here. But as it was the expressed preference of the Coalition to promote the interests of mutuals, and as the Financial Secretary was particularly responsible for this area and he has made no secret of the fact that he is a great believer in mutuals, I would imagine that it is quite likely. I do not know whether it is true or not, but you have heard Reverend Flowers say he had something like 30 conversations—I believe that is the case—with the Financial Secretary. One forms their own conclusion.

Q1651 Mr Ruffley: So the answer to the first question, “Who?” you have indicated that you do not know.

Lord Levene of Portsoken: I do not know.

Q1652 Mr Ruffley: But we are talking a Treasury Minister. We are not talking about senior mandarins. In all probability, we are talking about an elected—

Lord Levene of Portsoken: I am saying it seems likely that it could have been a Treasury Minister, yes.

Q1653 Mr Ruffley: The second question is if one accepts that it was an elected politician—let us just assume that—I wonder what you thought the method of exercising political influence or pressure was because, again, we have to be specific. Just to say “political pressure” does not cut the mustard for me. Does it involve this politician ringing up the Chairman and/or Chief Executive of Lloyds? Is it getting involved in moving goalposts? “Political pressure” to me is a meaningless description. What is the activity that you think took place that was improper?

Lord Levene of Portsoken: Mr Ruffley, if 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”. But I asked the Chairman of Lloyds Bank if that had been the case and he said, “Absolutely totally untrue, none whatsoever”.

Q1654 Mr Ruffley: He has given that testimony to this Committee.

Lord Levene of Portsoken: There you are. He said the same thing.

Q1655 Mr Ruffley: But if that be the case, does that get us anywhere? I am a former solicitor of the Supreme Court and I have a rusty legal brain, but I would say there is not much hard evidence here on the testimony we have received, and you are not able to demonstrate any hard evidence as to who did the influencing or, secondly, what that influencing was. Therefore, it seems to me that while no doubt your informed briefings from important people—and we will hear more about this in a minute—were to be taken seriously, I do not dispute that if one is a black-letter lawyer, one thinks this is a bit thin. What would you say to that observation?

Lord Levene of Portsoken: I would say you are absolutely right, and Mr Mann asked why we did not pursue further. Because we were getting nowhere. We were hitting a brick wall. We had no hard evidence until I was told quite specifically about this political influence by someone whose word I would say in this Committee is unquestionable. That is where we get to. Mr Ruffley: I think we are going to get that in the next question from my colleague, George Mudie, so I think that point will be taken.

Gary Hoffman: On that point, Mr Ruffley, I absolutely concur with Lord Levene. It is very difficult for us, because we were not the ones being influenced. We were the ones—if there was some influence—that were disadvantaged, but we did not have the conversations, if there were any, of influence.

Q1656 Mr Ruffley: Just a final observation. You are looking at the moving of the goalposts. You are looking at the way they calculated the valuations, and you are seeking a logical explanation as why these things were going on, and there is no other—

Gary Hoffman: Yes. There is no logical explanation why the Co-op would be chosen, given what people knew about the Co-op.
Mr Ruffley: Understood, fine.
Gary Hoffman: That is all I can say.
Mr Ruffley: I think this is going to be continued by my colleague, Mr Mudie.
Chair: Sorry, I was just going to bring John back with a quick rejoinder, because he has a particular concern that he is very concerned about, so let us hear what it is.

Q1657 John Mann: I merely wish to clarify—on the Chairman’s summation—whether or not in this period in 2011 you discussed your concerns with Mr Balls.
Lord Levene of Portsoken: No, and I do not think I suggested that I had. I said I thought about it and decided not to.

Q1658 Chair: What was your reference to all these other characters that you made then, to the Shadow Chancellor and to the Chairman of the PAC and me, for example?
Lord Levene of Portsoken: Why did I—
Chair: What involvement did we have in this political—
Lord Levene of Portsoken: Because I knew, Chairman, that you had an interest in this area. As a former accounting officer and Permanent Secretary, I had quite a lot to do with the Public Accounts Committee and I believed there was a public interest in the huge investment in Lloyds Bank. But I am afraid that nobody wanted to pursue it. I addressed it to the Comptroller and Auditor General. He did not want to pursue it either, so we—

Q1659 Chair: This was in? This is Amyas Morse we are talking about now?
Lord Levene of Portsoken: Yes, Amyas Morse, absolutely.

Q1660 Chair: You spoke to Amyas Morse about it when?
Lord Levene of Portsoken: I wrote to him. I also had correspondence on this with another member of the Public Accounts Committee, Austin Mitchell. I only chose him because I knew him well personally. He had, as you will probably know, quite forthright views on things like this.
Chair: I think we have clarified that.

Q1661 Mr Mudie: Just to confirm, you said until you spoke to the Governor of the Bank of England you had no hard evidence?
Lord Levene of Portsoken: Yes.

Q1662 Mr Mudie: As we are sitting now, do you have any hard evidence?
Lord Levene of Portsoken: None that I have not told you about. All of this was
Mr Mudie: You answered the question—
Lord Levene of Portsoken: Okay, the answer is no.

Q1663 Mr Mudie: No, good. If your fears have any substance, it is as a result of the meeting with the Governor of the Bank of England?
Lord Levene of Portsoken: Correct.

Q1664 Mr Mudie: Right. He invited you in?
Lord Levene of Portsoken: Yes.

Q1665 Mr Mudie: He invited you; he did not summon you? He gave you what some people in the banking industry would enjoy, a private meeting with the Governor of the Bank of England?
Lord Levene of Portsoken: Yes.

Q1666 Mr Mudie: So he did not summon?
Lord Levene of Portsoken: He called my office and said could I please go round to see him and I said, “Yes, with pleasure”.

Q1667 Mr Mudie: You fixed your diary a couple of weeks later and went to see him?
Lord Levene of Portsoken: No, I think it was a lot quicker than that.
Mr Mudie: No, it was not. It was the 28th and he telephoned your office on the 12th.
Lord Levene of Portsoken: That was probably the first appointment we could get.

Q1668 Mr Mudie: That was two weeks, yes. Was there just the two of you in the room?
Lord Levene of Portsoken: Yes. He probably had a private secretary there.

Q1669 Mr Mudie: Did someone take notes?
Lord Levene of Portsoken: I cannot recall.

Q1670 Mr Mudie: Was the person sitting in the room, the third person, taking notes?
Lord Levene of Portsoken: I do not remember.

Q1671 Mr Mudie: That is a good start. Your indication is the Governor said you were not going to win it?
Lord Levene of Portsoken: Yes.

Q1672 Mr Mudie: You naturally said, “Why?”
Lord Levene of Portsoken: Correct.

Q1673 Mr Mudie: What did he say?
Lord Levene of Portsoken: He said, “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”.

Q1674 Mr Mudie: That is a fairly serious thing to say and to put into the public arena.
Lord Levene of Portsoken: Yes.

Q1675 Mr Mudie: Was the meeting held on a private basis? Was that your understanding? Was it a confidential chat to you, too?
Lord Levene of Portsoken: It was a confidential meeting, yes. If I may, I would add this. I have been around long enough to know that, if I am invited to a private meeting with the Governor of the Bank of England, who tells me something as sensitive as this, I do not reveal it. It was only as this inquiry progressed and after the Governor had retired that I called him and I said, “Look, I am going to be—and, indeed, is the case today—called by the Treasury Select Committee to give evidence on this. I said that
I was given some information by a senior figure. Can I tell them what happened?” and he said, “Yes”.

Q1676 Mr Mudie: You will be suggesting that, if we ask Lord King, he will confirm that he told you there was political involvement and the decision was taken on that basis?

Lord Levene of Portsoken: Yes.

Q1677 Mr Mudie: Where did Lord King get the information from?

Lord Levene of Portsoken: As the Governor of the Bank of England at that time, the owner of the various regulators, I should think it was the sort of information he got every day.

Q1678 Mr Mudie: So the regulators knew this?

Lord Levene of Portsoken: I am not saying that. I am saying that it had just happened then. Whether the regulator knew that or not I do not know, but the Governor of the Bank of England is a very important figure and usually keeps his ear to the ground and knows what is going on.

Q1679 Mr Mudie: Yes. He said, and this is what you told in evidence, that he could not intervene?

Lord Levene of Portsoken: Yes.

Q1680 Mr Mudie: Did you give him any explanation why he could not intervene?

Lord Levene of Portsoken: Yes, because he said it was a political decision.

Q1681 Mr Mudie: He is the Governor of the Bank of England and there is a line that you do not cross. Whether the Chancellor wants something or not, there are statutory powers for the Bank of England and the Governor of the Bank of England. He could intervene. We have asked Bailey this and he saw no reason to intervene.

Lord Levene of Portsoken: Well, that is his view.

Q1682 Mr Mudie: Did you just accept that the Governor of the Bank of England was washing his hands?

Lord Levene of Portsoken: I am not going to question the Governor of the Bank of England called me to tell me what he thought and I accepted what he said.

Q1683 Mr Mudie: Right. One of the things he told you was to meet the politicians, which you duly did. He did not tell me to meet the politicians. I said, “What can I do?”

Mr Mudie: You said?

Lord Levene of Portsoken: I said, “What can I do?” and he said, “You can only discuss this with the politicians”.

Q1684 Mr Mudie: Yes, he told you the only way you could go was the politicians, you should meet them?

Lord Levene of Portsoken: Correct.

Q1685 Mr Mudie: You met them?

Lord Levene of Portsoken: Yes.

Q1686 Mr Mudie: You met Mark Hoban and you met George Osborne. George Osborne came into the meeting later but came into the meeting?

Lord Levene of Portsoken: Correct, yes.

Q1687 Mr Mudie: Did you raise this specific claim by the Governor of the Bank of England with them face to face?

Lord Levene of Portsoken: I am not sure whether I told him that it came from the Governor, but I think there was no doubt at that time why I was talking to them. I told them that I had been told at the highest level, because I had not yet got clearance from the Governor to mention his name, that this was a political decision. Mr Hoban denied it and said he had had no contact with the bidders at all.

Mr Mudie: He told them he had no contact with?

Lord Levene of Portsoken: The bidders.

Q1688 Mr Mudie: No, that is not the same thing. The Bank of England Governor is suggesting that the Government have made it absolutely clear they want this bid to succeed and that he could not intervene. Do you agree with that?

Lord Levene of Portsoken: That is what he told me.

Q1689 Mr Mudie: Are you genuinely telling us that when you went to see the Chancellor you did not say, “The Governor told me”? You would be outraged at this time; I would be. There is a lot of money at stake, a lot of prestige, and just the general injustice of it if this was happening.

Lord Levene of Portsoken: No, I did not because I regarded that as a piece of information I had been given in confidence, and I respected that confidence until I was released from that confidence.

Q1690 Mr Mudie: You were released when?

Lord Levene of Portsoken: Very recently.

Mr Mudie: Three weeks?

Lord Levene of Portsoken: I think in the New Year, at the beginning of January, because, as you may know, the Governor went to New York.

Q1691 Mr Mudie: Why, in your view, would the Governor volunteer this information to you, which was very, very sensitive information and very dangerous information to confirm?

Lord Levene of Portsoken: Because the Governor—and I know this Committee knows him well—is a very upright and proper person. He was coming to the end of his term. He had encouraged us from the very beginning to act as a challenger bank. He had seen all the work that we had done to try to bid for this. Remember, by this time the whole Co-op edifice had already collapsed. He had seen that whereas there had been the opportunity to have a challenger bank, which would have done what everybody wanted to see, that had fallen apart. I think that at the very last moment he had said to me, “Look, I cannot do anything about this. The only thing you can do is talk to the politicians”; I think that is why he told us.
Q1692 Mr Mudie: Do you accept that if the Governor was so worried about this unfairness or wrong he had the powers to stop it?

Lord Levene of Portsoken: You could only ask him that.

Mr Mudie: Sorry?

Lord Levene of Portsoken: I think you could only ask him that question.

Q1693 Mr Mudie: You are the one with the banking experience. You know the power of the Bank of England. You know the power of the regulators. You were speaking to the regulators all the way along. You were not speaking to them for fun. You were speaking because they were crucial to the agreement of the deal. If Lord King was so upset about it, why did you not ask him and why did he not take the appropriate action to intervene?

Lord Levene of Portsoken: I said to him, “Is there nothing you can do about this?” and he said, “Your only source of complaint now is to the politicians”. I was not going to question him why he made that statement.

Q1694 Chair: Again I want to be absolutely sure. I am sure John Mann will also want to be absolutely sure that we have all the facts absolutely straight here. First of all, was there one meeting or two?

Lord Levene of Portsoken: Two.

Q1695 Chair: Okay. Let us go to the first meeting. That was in May on the 28th?

Lord Levene of Portsoken: Are you talking about the meeting with the Governor?

Chair: With the Governor.

Lord Levene of Portsoken: Yes.

Q1696 Chair: That was on 28 May, so that is before the final decision of the second bid?

Lord Levene of Portsoken: No.

Chair: Which was in June?

Mr Mudie: Yes, it was, 28th.

Lord Levene of Portsoken: Yes, 28 May 2012, correct.

Q1697 Chair: Right, okay. Who called for that meeting?

Lord Levene of Portsoken: The Governor.

Q1698 Chair: Okay. You do not recall whether anybody else was in the room?

Lord Levene of Portsoken: I think it is quite possible—almost certain—there was a private secretary there.

Q1699 Chair: Did he say at that first meeting that a bid from NBNK would not be accepted?

Lord Levene of Portsoken: He said that the decision had been made to give the contract to the Co-op.

Chair: So he told you that it would not be accepted?

Lord Levene of Portsoken: Not that it would not be accepted. That it would not be the winning bid.

Chair: It would be refused. If not accepted it is refused. I do not know why you are challenging the language.

Lord Levene of Portsoken: Because “not be accepted” means that it is not an acceptable bid. It could be an acceptable bid without being the winning bid.

Q1700 Chair: He told you that the bid would lose?

Lord Levene of Portsoken: Correct.

Q1701 Chair: Just to clarify on the second meeting, this now took place at the beginning of July. Is this 5 July?

Mr Mudie: No, it was a day before the—

Chair: I think it was on 5 July but we will just see whether we are agreed on when this meeting was.

Mr Mudie: It was the day before the deal was announced.

Lord Levene of Portsoken: Yes, with Sir David Walker, that is right.

Q1702 Chair: There were more people present at that meeting, weren’t there? David Walker was there as well.

Lord Levene of Portsoken: Yes.

Q1703 Chair: At that meeting, did the Governor say that a bid would not be accepted because a political decision had already been made?

Lord Levene of Portsoken: I have to refer to the note. Yes, there is a minute, Chairman, which you may have, which is my minute.

Chair: I have seen it. I just want to put it on the record. We are clear that at that meeting he made this remark as well?

Lord Levene of Portsoken: Yes, it is the same thing.

Q1704 Chair: He made it in the first meeting and he repeated the remark that he had made in the first meeting in the second meeting?

Lord Levene of Portsoken: Yes.

Q1705 Chair: Did the Governor say that the bid had been altered to favour the Co-op?

Lord Levene of Portsoken: Mr Hoffman will correct me if I am wrong, but I think, Chairman, the decision had already been announced by 5 July.

Gary Hoffman: That is correct, yes, 27 June.

Lord Levene of Portsoken: The first meeting was before the event; the second meeting was after the event.

Q1706 Chair: Let us ask the question for both meetings, but it was in the second meeting I was referring that question to. Just on this first meeting, did the Governor say that the bid had been altered in some way to favour the Co-op?

Lord Levene of Portsoken: No, he did not say it was altered. He said the decision would be made in favour of the Co-op.

Q1707 Chair: Did he say that the bid in any way had been adjusted to disfavour you for the benefit of the Co-op?

Lord Levene of Portsoken: No.
Q1708 Chair: In the July meeting, did he make any reference of that type?
Lord Levene of Portsoken: No. The second meeting, the July meeting, was called at our request because I wanted to go with Sir David Walker to speak to the Governor. Effectively, he confirmed to us what was already the case. If you look in my minute, Chairman, you will see that one of the reasons I was doing this was because I was concerned that our shareholders might ask us what we had done about it.

Q1709 Chair: No, I understand that, but I am just trying to clarify a very straightforward factual point. Did the Governor say in 5 July meeting that the bid had been in any way adjusted to favour the Co-op at your expense?
Lord Levene of Portsoken: No.
Chair: He did not. Excellent. Thank you very much.

Q1710 Andrea Leadsom: Just a quick question. Lord Levene, is it your opinion that, if he considers a political intervention has been made, it is for the Governor of the Bank of England to stand by and allow that to take place where he is clearly accountable for the integrity of the British financial system? It seems to me utterly astonishing that he would have accepted and advised you to go and talk to the politicians. In his job as Governor of the Bank of England, with the systemic responsibility that he has just received that the best decision needs to be taken with all of the available information as opposed to a political decision, did it strike you as odd at the time? Did you say anything to him about, “Surely it is your job to ensure that it is free and fair”? We live in a free market economy, not in one where politicians decide who is going to own what, other than in extremis, which this was not. Did that strike you as odd? Does it strike you as odd now?

Lord Levene of Portsoken: Ms Leadsom, you know the then Governor as well as I do. I do not think it would have been very wise for me to go and tell the Governor of the Bank of England how to do his job.

Q1711 Andrea Leadsom: But why? Surely that is a copout.
Lord Levene of Portsoken: Well, that was my view.
Chair: That is your view. If I may, Andrea, I am going to bring in Mark Garnier because we have two more colleagues who want to come in and some of us—I think you, too, probably—would like some lunch.

Q1712 Mark Garnier: Lord Levene, I would like to test a bit more this accusation of political interference. I am very interested in your latest discussion about this conversation with the Governor of the Bank of England. You are suggesting in it that he told you that perhaps you might like to go and try and contact some politicians in order to discuss what was going on. Is it not possible that you could have misinterpreted what he was saying and, in fact, what he was suggesting was that there is, as yet, no political interference at all and that by you going and having a conversation with some politicians you could engender some political interference in your favour?

Lord Levene of Portsoken: No.
Q1713 Mark Garnier: You are absolutely convinced that that was not the case? You are utterly convinced that there was political interference working against you, that there was a conspiracy working against NBNIK?
Lord Levene of Portsoken: I was told by the Governor of the Bank of England that the decision was being made for political reasons.

Q1714 Mark Garnier: Just remind us what those political reasons are that you think.
Lord Levene of Portsoken: I can only surmise that they were because there was a wish to further the interests ofmutuals.

Q1715 Mark Garnier: You refer on a number of occasions to the Coalition Agreement, which I now have in front of me, which is a 35-page document of which the banking bit is not quite one side of A4. I will refer you to the particular bits you look at. It says here, “We want the banking system to serve business, not the other way round. We will bring forward detailed proposals to foster diversity in financial services, promote mutuals and create a more competitive banking industry”. Of course part of that is the mutuals, but a competitive banking industry, more people coming into the sector. I might also add there are two other paragraphs.

Lord Levene of Portsoken: Could I just interject there?
Mark Garnier: Please do.
Lord Levene of Portsoken: You answered the question that the Chairman posed to me: why didn’t I immediately say, “Aha, in the Coalition Agreement it says on the first page they are going to promote the interests of mutuals. Why on earth are you doing this?” I won’t say it was a throwaway remark but it was a small comment in a long document.

Q1716 Mark Garnier: You are absolutely right. It is a small comment in a long document and there are a number of bullet points. This is one of the bullet points. There are two other bullet points, which interestingly start with the same sentence. The first bullet point is, “We will reform the banking system to avoid a repeat of the financial crisis, to promote a competitive economy, to sustain the recovery and to protect and sustain jobs”. Later on, there is another bullet point that says, “We will reform the regulatory system to avoid a repeat of the financial crisis”. In your written evidence that you submitted to us, towards the end of it—bullet point 5 under the political interference question marks—you make this statement, “Respected journalists are thwarted in their Freedom of Information attempts to obtain papers and periodic articles appear that indicate there is a ‘smoking gun’ somewhere”. This is the important bit. “Frankly, given everything that has come to light about the Co-op, it is incredible to suggest that nobody in Lloyds Banking Group, in Government or in Regulation could have known about or predicted what was to happen”—or, if you do not mind me using slightly clearer English, “It is absolutely clear
to everybody that it was about to blow up”—“unless, of course, there was a collective will to push through the Co-op bid come what may”. Does it not strike you as being absolutely incredible that there will be political will to push through a bid from Co-op, come what may, which would result in this organisation blowing up? I think the important point is that, even if you are not privy to the inside information about what is going on within the Co-op in terms of its impaired loan book and all the rest of it, the reality is that you have a financial bank, a small bank, which is trying to increase its size tenfold in the space of three years, at a time of a highly stressed banking environment with dubious overall control in terms of the Co-op. It simply does not make sense that there would be the political will to put an institution at such colossal risk when two bullet points—using this agreement—refer to the fact they do not want to have a repeat of the financial crisis. Yet what you are suggesting is that the political will was to create a financial crisis.

Lord Levene of Portsoken: That is not what I am suggesting at all.

Mark Garnier: It is in your evidence.

Lord Levene of Portsoken: It is what I was told. With the benefit of hindsight and when history comes to look at this, they will say, “How can it be?” With everything that had happened—and with everything, of course, that it is good to know afterwards that happened about the Co-op, the situation it was in and the management and the way it happened—it is inconceivable. It is inconceivable. If you saw this and it had taken place in Latvia you would say, “How on earth could anybody have been so stupid?” This is the point. People have accused me, us, of being bad losers. You are a bad loser if you bid and someone else wins. Here, we were not bad losers. It was an appealing winner.

Q1719 Mark Garnier: Sure, assuming things go well and bearing in mind that, of course, we are still in a stressed banking market. Lord Levene of Portsoken: As with everything, one can always debate these things. What I think you cannot debate with the benefit of hindsight is that to go ahead with this for the Co-op along with everything else they have done was a terrible decision. Now, perhaps people should have known more at the time but—

Q1720 Mark Garnier: I want to challenge your assertion that there was political interference on this. Look, I do not think that anybody particularly disagrees with your overall point, but it is your direct challenge that there was political interference. Again, picking another bit of anecdotal evidence, you have made much of the investors in NBNK: Aviva, Foreign & Colonial, Bailey Gifford, Invesco, to name but a few of these absolutely blue chip, high quality investors. You also make a point: would you necessarily want to engage them, in terms of their relationship, with variance in the market and everything, in a legal battle, and that is absolutely right. Let us turn the telescope round a bit. If you are the Government sitting on two state-owned banks that at some point you want to privatise, the last thing you are going to want to do is to interfere in such a way that it is going to compromise your relationship with the market, who you are presumably at some point wanting to sell £40 billion worth of RBS to. It does not make sense.

Lord Levene of Portsoken: When the Government came into office they wanted to have two challenger banks. They were going to use the decisions of the EU to force Lloyds and RBS to sell off their branches to set out these two new challenger banks. What are we left with today, in January 2014? Nothing.

Mark Garnier: That is not strictly true.

Lord Levene of Portsoken: We have the wish that they are going to happen, but that is an awfully long time afterwards. The truth is that it did not happen. Perhaps now, happily, I hope, second time round, they will get it right. I think if you had said to anybody in Government then, “Look, you are going to hive off part of Lloyds, part of RBS, because they have been ordered to and I can tell you now that both of these bids are going to fail totally”, nobody would have believed you, but that is what happened.

Q1721 Mark Garnier: I am still struggling. Again, you have said on a number of occasions that the equity markets have been particularly troubled. Again, we all
agree that we are still in a period of stress for the banking industry and it is only gently coming off the high stress levels. It was always going to be difficult to try to push out two new challenger banks into this market irrespective of which way you wanted to do it. We have seen some of these other branches have not been sold off in other deals, which have also failed. You also assert that Lloyds Banking Group was using NBNK as a stalking horse for the IPO option. What is the difference between the IPO option and the NBNK deal? At the end of the day, there is no difference between the TSB—

Gary Hoffman: A couple of things to say on the comment. First of all, I do not think either of the deals to create the challenger bank has failed because of the equity markets. They have failed because of the inability to be able to execute particularly on systems. If you take the Santander Rainbow deal for RBS—which coincidentally was the Lloyds management now in Santander doing that deal—that failed as a result of execution issues and arguments about price adjustments, not about the markets. I think that is true of this, too.

Q1722 Mark Garnier: If the markets were good, they would have made it work. I think you would agree with that. Indeed, you are trying to make it work. You were trying to make your deal work and you are angry that it did not.

Gary Hoffman: The most difficult thing is execution, not raising the money, as long as you have the right price. I do not accept that the market stopped these things doing—

Mark Garnier: The market is part of it.

Gary Hoffman: Of course. The backdrop is not helpful, but execution is—

Mark Garnier: When you are assessing risk of any persuasion, you have to take into account—

Gary Hoffman: Agreed.

Lord Levene of Portsoken: If I may say so, the difference with our bid was we did not dream this up and say, “Let us go and find some investors”. This was the investors’ wish. They stood by us all the way through. When things got difficult they knew about all this. We said to them, “Are you still with us?” “Yes, absolutely”. Nobody can prove this with hindsight, but I can tell you now if the NBNK deal had gone ahead and been accepted, that bank would now be up and running. It would be in very good shape and we would have delivered what we said we were going to deliver. We had the investors behind us.

Gary Hoffman: The difference between us and an IPO—because you are right, there are some similar characteristics, but on the specific question raised—is, of course, on an IPO all the money is raised at the end, whereas we were saying that we would raise all the money at SPA and that would give, therefore, much more certainty. There is a much more important point as well. What is happening now is a bank is being created through an IPO, which has a Lloyds’ brand that they do not want. It has a lot of branches, most of which they do not want. It has Lloyds’ systems. It has Lloyds’ management. It has Lloyds’ products—

Mark Garnier: Which they do not want.

Gary Hoffman: It has Lloyds’ processes.

Mark Garnier: Which they do not want.

Gary Hoffman: The tie together of Lloyds and that IPO organisation will be for many years. They will be joined at the hip, and the commercial argument about how much Lloyds will charge that entity will be the pressure point for the investors for those transitional services agreements, which will not be transitional because they will remain there for about 10 years, I would say.

Q1723 Mark Garnier: I think that is a very, very important argument. I completely agree with you that the financing model is in reverse with you guys, because you have the money upfront rather than running the risk of it with the market. Nonetheless, whichever way you address this point, it still meets the target in the Coalition Agreement that you are diversifying the banking market and that is ultimately—

Gary Hoffman: Well, I do not think it does. I think it creates a mini Lloyds. It is like putting lipstick on a pig because all you are doing is putting a brand above it, same products, same systems, same processes, same people.

Q1724 Mark Garnier: Yours would have been different how?

Gary Hoffman: Absolutely it would have been very different; very new brand; very new systems without the problems of the legacy; introducing some new products that we had started to talk to Lloyds about; a very different attitude to service. There were lots of things that we—

Q1725 Mark Garnier: Have you looked at doing a block deal to buy TSB?

Gary Hoffman: No.

Q1726 Mark Garnier: Why not?

Gary Hoffman: Having tried this, we are not going to try that.

Mark Garnier: It is an easy one.

Q1727 John Thurso: I am tempted to say “Good evening”, but I am the last, you will be delighted to know. A couple of quick questions. First, regarding UKFI, did you have discussions with UKFI during the process?

Lord Levene of Portsoken: Oh, yes.

Q1728 John Thurso: Could you very quickly characterise those discussions for us?

Lord Levene of Portsoken: They were not interested to talk to us.

Q1729 John Thurso: Right, so they were non-discussions?

Lord Levene of Portsoken: They were non-discussions. I said I believed that their role was to safeguard the public interest in these financial institutions. I told them what was happening and they said they relied on the advice that they were given by Lloyds Bank. I said I thought they were supposed to be an independent assessor of what was going on.
They did not agree and we had quite an acrimonious discussion.

**Q1730 John Thurso:** Did you have any discussions with any other substantial shareholders of Lloyds?

**Lord Levene of Portsoken:** Only insofar as one or two of them were shareholders of ours as well.

**Q1731 John Thurso:** Those discussions you would characterise as?

**Lord Levene of Portsoken:** We were not talking to them as shareholders of Lloyds; we were talking to them as our shareholders.

**Q1732 John Thurso:** Your view of UKFI is as summed up in your conclusion, “The UKFI, as a watchdog for the public interest in state ownership of financial service industries, has failed in its duty”?

**Lord Levene of Portsoken:** Absolutely.

**Q1733 John Thurso:** Can I come to the FSA? What discussions did you have with the FSA during the course of the bid? I will skip over this. I am aware at the outset Adamson said you do not need a licence, you are all good people, and so on. That is not the point of the question. Did you have discussions going further on?

**Lord Levene of Portsoken:** I will let Mr Hoffman answer that because he had virtually all the discussions with them. What I would say is, as far as I could see and as far as I observed, the FSA behaved impeccably throughout.

**Gary Hoffman:** Yes, I think that is important to emphasise that the FSA were very even-handed.

Clearly, there were some hurdles that we had to get over as well as hurdles that the Co-op had to get over.

I think they were very different hurdles. We had exceedingly close and regular dialogue with the FSA about our business plan, about our capital liquidity plans, about our management structure, all of them things you would expect us to want to put in place in advance of a change of control. Of course, they were also intensely interested in our funding and what due diligence we had done.

By the time we got to the end of May 2012, in fact 29 May 2012, the FSA wrote to me to say that, of course, there were still some things to do but, to quote, “The process of engagement is satisfactory from our point of view at this stage in the process”. That is as good as it gets from the FSA during that type of transaction. We had done lots of work and planning and shared with them all of our plans for, as I say, capital liquidity, customer conduct, the fact that we would have no bonuses in the bank; all sorts of things that were appealing to the FSA we had been through.

I just do not know whether the FSA had been through a similar engagement. I doubt it.

**Q1734 John Thurso:** At any point during your discussions with the FSA, did you have the similar kind of discussions that were in the key risk document that you put forward to Lloyds? Did you share those concerns at all or discuss them with the FSA?

**Gary Hoffman:** Yes.

**Q1735 John Thurso:** What was the FSA’s reaction to what you said?

**Gary Hoffman:** “Thank you for sharing them with us.” It is difficult for the FSA. They were grateful for our views, and I suppose they were grateful for my personal views, given I have been around a long time and I had just completed a similar separation and restructuring of Northern Rock to what needed to be done at Lloyds in terms of separating systems. They understood that there are not many people that had done the execution that was similar to Verde, so I think they appreciated our views. They appreciated our views on the Co-op but, to be fair to them, they were even-handed and they were not going to comment on those views, they just received them.

**John Thurso:** Can I just check with the clerk this evidence has been published?

**Chair:** Yes, it has.

**Q1736 John Thurso:** I do not know if you had a chance to see the evidence because I think it is quite recently published. There is a letter from Andrew Bailey together with—slightly redacted for names—copies of the notes of the FSA’s meetings with the Co-op.

**Gary Hoffman:** I have not seen those.

**Q1737 John Thurso:** It is pretty damning stuff. It makes clear, to my mind at least, that whenever Project Mars I think they called it—

**Gary Hoffman:** Yes, they did.

**John Thurso:**—or Verde comes up as a heading there were very severe concerns as to the ability of the Co-op to fund it—I will not quote them but you can see it for yourself—going through to a point at which Andrew Bailey attended a strategy day that caused some concern. In my world they would call it “a hell of a bollocking” but he talked to them robustly I think is probably the right word.

**Gary Hoffman:** Yes, if you want my view on how these things work, having been involved in lots of conversations with the FSA over time, I think the FSA puts lots of conditions and hurdles against people doing things, sometimes believing that they will never get to meet those conditions or hurdles; therefore, it will ultimately fall apart. I think that is what has happened here. My personal view is they should be much clearer upfront and say no.

**Q1738 John Thurso:** Absolutely. When you get a chance to read this, for example, there is one dated 31st July 2011, “AB”—who I assume obviously is Andrew Bailey—“then set out his view that Britannia would have failed had it not been for the Co-op and Richardson had been lucky to survive, not least as CEO of the merged entity. He said that FSA continued to have issues with the effectiveness of the Group’s risk management and controls, and he was not persuaded that Richardson had ever grasped those issues. Consequently, AB was unconvinced that Richardson would ever fix them”. There are lots more about the internal problems within the Co-op.

**Gary Hoffman:** I think it just goes to emphasise the concerns we had were shared by lots of stakeholders.
Q1739 John Thurso: I think you would agree that that sort of concern would be shared between Andrew Bailey, the Governor and senior people; possibly even senior people at the Treasury might be aware of these concerns?

Gary Hoffman: Yes. I would also say as a matter of principle that the FSA would share them with Lloyds. Let me say why I would say that. In the interests of transparency, we were always clear throughout the process that anything that the FSA or Lloyds sent to us we were happy to be shared with the FSA and with Lloyds.

Q1740 John Thurso: To be absolutely fair and not to take things out of context, this was, of course, before the £1.5 billion black hole was discovered and the FSA were voicing extreme concern—

Gary Hoffman: Even then.

John Thurso:—as to the ability to raise the necessary funding and what that would do to tier 1 capital ratios and so forth.

Gary Hoffman: That was my point earlier on to Ms Leadsom in that although we did not explicitly in the risk paper refer to the 1.5 black hole because no one knew about it, we did point out that it would be extremely difficult, given their structure and given what was happening in the group that they would not be able to raise that money.

Q1741 John Thurso: I think we are broadly agreed that there was very considerable concern around and the probability is—it is almost a certainty—that the Bank of England would know of this. It is a pretty reasonable supposition that senior officials in the Treasury would know about this. Lord Levene, I come back to the central point that you have put before us in your memorandum, which is effectively that it was the pressure by the Government that caused the outcome that we now see. You have used a number of terms to describe this: from your meeting with the Governor that “for political reasons”—and I am quoting you, obviously—and earlier on a quote, “This is going to be a political decision”. I want to try to get to what supports that. It seems to me that a number of other words have been used. We have had interference, interest, support, but the core point that you are making to us is that the pressure was of a sufficient kind from people in Government as to amount to interference, such that it caused Lloyds to make a decision that it might not otherwise have made. Is that a fair summation of the charge sheet?

Lord Levene of Portsoken: I can only surmise that. I do not know that, but it seems a pretty reasonable supposition.

Gary Hoffman: We would just say, given all the evidence you have there, it would be strange because I would have thought Lloyds would have seen some of that at the time. As I say, people would share that correspondence and their concerns. How could you make that decision if there was not something else going on?

Q1742 John Thurso: That is a very interesting question and there may well be something else going on, but whether it is the particular something that you have put forward is what I am really—

Gary Hoffman: Yes, and we do not know.

Q1743 John Thurso: The reason I want to put this to you is, for example, what Reverend Flowers said when he was asked by Mr McFadden, “NBNK has alleged there was a Treasury favouritism or political favouritism towards the Co-op as being a preferred bidder in this deal. Is that what you felt?” Reverend Flowers says, “Not at all, sir. I am sure that the esteemed former chair of this Committee, who was a director of NBNK, and his colleagues believe that. Nonetheless, if you look at the rigour that is within the Vickers report in terms of the scale of a challenger bank that would be able to take on the others, and which would be encouraged in the Vickers report, we were looking at a challenger bank that would have somewhere between 6% and 7%”. He starts off by making it clear that is not his view. Earlier on, when we had the chairman of Lloyds before us, our Chairman began by asking, “Is it true, as has been alleged, that the decision to award Verde to Co-op was made on political rather than commercial grounds?” Of course you will say, “He would say that, wouldn’t he?” but Win Bischoff says, “No, it is not. What the board looked at was financial and the ability to execute”. You construct the argument for the political pressure, first, by being directed to the Coalition Agreement, which—as my colleague has pointed out—is one paragraph. Having had a very small part to play in that, the mutuals part of it to my understanding was building societies. I think there is at least room for interpretation as between whether it was Co-op or building societies or what. Even if that was something that is favoured, it is perfectly possible for Mark Hoban or Ed Balls or Vince Cable or whoever might be involved to say, “Gosh, that would be a great solution” without doing anything about it, but your allegation is they acted, one or all, to a point at which the outcome was changed. As a very experienced person in the corridors of power, Lord Levene, can I ask you whether that kind of conspiracy is credible?

Lord Levene of Portsoken: I can only comment on that from what I am told by politicians and, to my great relief, I have never been or pretended to be a politician. Politicians have said to me that Mark Hoban’s main raison d’être in life was to promote the interests of mutuals, and there is nothing wrong with that. All of a sudden he becomes the Minister who is responsible for this deal, in which he is looking at the interests of mutuals and he can suddenly see there is a great prize in store. Unfortunately—and I know Mark well, he is a nice guy—I think he got this wrong.

If I could also draw your attention to this famous document that the Chairman of Lloyds said he cannot recall ever getting, there is one sentence in it that I think sums up the whole thing. It says, “Co-op’s finances look to be overstretched, and it is unclear as to how they would raise more funds for Verde”. Perhaps if more people had thought about that we would not be in the mess we are in now.
Q1744  John Thurso: Can I put to you an alternative, which is that Lloyds always wanted to do an IPO—
Lord Levene of Portsoken: That is a different story.
John Thurso:—and that there was political encouragement coming in bucket loads, and the easiest way to see that off was to encourage you along and then drop you and then drop the Co-op? It is an equally compelling conspiracy.
Lord Levene of Portsoken: I agree with you. That is phase 2. 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 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.

Q1745  John Thurso: In that circumstance, the political interference is no more than the kind of pressure you get politically in many deals and it does not become the determining factor, and perhaps the politicians end up being used by those frightfully cunning bankers again.
Lord Levene of Portsoken: I do not know. As I say, I am not a politician, but I think that at the end of the day the bottom line is the Treasury—with whom I have had quite a lot of experience—says, “What really happened at the end of the day? We are going to sell off Lloyds now. We are going to get a lot of money for it, far more than it was ever worth because fortunately the economy is getting better, the banking sector has come up, so do not worry about all this niff-naff because we are going to get all our money back and more and, irrespective of whether UKFI did a good job or a bad job, we are quids in and everybody is happy”, and you can understand that.

John Thurso: I think you ascribe more confidence to Government Ministers than I do.

Q1746  Chair: You see what many of us feel, Lord Levene, is that perhaps we still do not have the full explanation of how we got to where we are. But that we do not necessarily need to go down the road of what you have pretty much described as a conspiracy in order to find a reasonable explanation, and you have just heard one, which is why we have spent so much time today exploring the murky deal, the dark forces, the summons to see the Governor, which it seems may not be needed in order to explain events.

Lord Levene of Portsoken: It depends at what point you decide that the music stops.
Q1747  Chair: At which point did you decide the music stopped?
Lord Levene of Portsoken: We decided the music stopped when we could not go on with it any further, and because we had seen that the politicians had decided to go their way whatever happens.

Chair: Okay. We have been round the chronology at some depth today, and there is still more to do to get to the bottom of this. There are now no less than six inquiries running. I think ours will shortly be brought to a close, although we have a few more people we need to call. Thank you very much for giving extended evidence today. I am glad we did take that intermission, in retrospect. It was extremely interesting evidence. Thank you.
Tuesday 28 January 2014

Members present:
Mr Andrew Tyrie (Chair)
Mark Garnier
Stewart Hosie
Andrea Leadsom
Mr Andrew Love
Mr Pat McFadden

Jesse Norman
Teresa Pearce
Mr David Ruffley
John Thurso

Examination of Witnesses

Witnesses: Rodney Baker-Bates, former Chair, Britannia Building Society, and former Deputy Chair, The Co-operative Bank and David Davies, former Deputy Chair, The Co-operative Bank, gave evidence.

Q1748 Chair: Thank you very much for coming in to give evidence this morning on this vexed question of Project Verde, the Co-op and what has now widened into a more broad-based inquiry—in fact, seven inquiries are now on the go, which is why this Committee, as was made clear a few weeks ago, is intending to wind up shortly and pose some questions for those other inquiries to look at. Could each of you begin by saying whether you thought this was a good quality, well-functioning board that you were serving on during your respective periods? I will start with Mr Baker-Bates and then I will turn to Mr Davies.

Rodney Baker-Bates: My own view is that the board functioned reasonably well, in the sense that there was a wide range of opinions on the topics we were discussing and everybody was there with a common intent to reach sensible conclusions. However, I think the problems with the board were several. The first is, of course, the size of it: it was a very big board, and as a result it was hard to have a discussion and interaction around an issue. That is the first point. Secondly, 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. Therefore the range, scope and complexity of the issues that we were trying to cover in a meeting made it difficult to get a focus on what I think were the key issues. The third point I would raise is that there was a wide spectrum of knowledge and ability. By that I mean that among the independent directors there was a good cross-section of knowledge of banking. Just on banking, when I arrived there, there were only two members of the board who had hands-on executive experience: myself and Peter Harvey. That was the interesting thing—that we were coming in new to the board, but we were the only bankers who had hands-on experience. Particularly among the democrats, as we call them, there was not really enough knowledge of the risks and opportunities in banking and financial services.

Q1749 Chair: Is there anything you would like to add to that or disagree with, Mr Davies?
David Davies: Nothing I disagree with. I agree with Rodney: the difficulty we had was growing the board and getting the right skill set on. By growing the board we also at the same time had to reduce the number of Co-operative delegates who were on the board. That was a struggle for the chairman—successive chairmen—to get the balance right and gradually change the balance and move more towards an IPNED, shorthand at the Co-operative Group for independent professional non-executive director, and to get the balance right between those who understood the business and those who were from the Co-operative Group board who added a wider dimension. I thought the Co-operative board members who came from the group were of good calibre and quality and were very diligent and tried really hard to master the issues that we were wrestling with.

Q1750 Chair: That is not quite the same as Mr Baker-Bates’ conclusion that was that, on the basis of quality and experience, there were shortcomings in that group.

David Davies: There were shortcomings in that group because they did not have the experience of financial services, which is why—

Q1751 Chair: You were describing them as diligent and trying very hard.

David Davies: Yes.

Q1752 Chair: So they were doing their best but not up to it?

David Davies: 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.

Q1753 Chair: Which individuals do you think were responsible for the bank’s near-collapse?

David Davies: You would have to start with Chief Executive. I am still not clear in my own mind as to whether the corporate loan book has deteriorated to the extent that our impairments show. If it is proven to me that that corporate loan book has deteriorated and is suffering significant losses, which is not yet the case, then one would have to look at the people who were monitoring the corporate loan book and say that they have some responsibility in this.

Q1754 Chair: We will come on to that in just a moment. Before I leave corporate governance, am I right in thinking that a report was prepared by an
outside consultant, Dr Tracy Long, on the quality of the board? Do you know anything about this?

David Davies: The report essentially was on board effectiveness.

Q1755 Chair: So there was one.

David Davies: Yes, towards the latter half of 2010.

Q1756 Chair: Trying to answer the question I just asked you?

David Davies: Yes.

Q1757 Chair: What did that conclude?

David Davies: Firstly, the balance of the board in terms of its discussions was geared more towards reviewing the minutes of committee meetings and the issues that came up in there, so there was a suggestion that we should relegate committee minutes to the end of the meeting. The balance of the papers was essentially too detailed—more quantity than there was quality—and we had to focus on changing the nature of the papers, and to bring the strategic issues more to the forefront. Broadly—and this seems somewhat ironic now—the conclusions of Dr Long and the people who reported into her was that the chairman was a very good chairman and was leading the board effectively.

Q1758 Chair: Have you seen that report recently or is that from memory? It is quite impressive, as it is nearly five years ago.

David Davies: I read the report again in October last year and since then I have reviewed the minutes.

Q1759 Chair: I think this Committee will want to take a look at that report rather than pursue that issue further with you both now. Unless there is something particular you want to add, I will turn to another subject.

Mr Baker-Bates, you resigned from the Co-operative in July 2012, did you not?

Rodney Baker-Bates: Yes.

Q1760 Chair: Was that because of their decision to push ahead with Verde?

Rodney Baker-Bates: Yes.

Q1761 Chair: Did you feel, given you came on specifically to the board to perform the task of taking a decision like that, that you were now being ignored?

Rodney Baker-Bates: I was ignored, yes.

Q1762 Chair: And you therefore had no choice but to leave?

Rodney Baker-Bates: I think as an NED your responsibility is to state your opinion and to apply your expertise to the issues. I failed to win the argument. I set out to convince the board that I felt Verde was a giant step too far when overlaid on another major error, which was the whole Project Unity and bringing the bank’s and the group management together, because that 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. I think there were two related major errors.

Q1763 Chair: You also went, Mr Davies. What would you answer to the same questions I have just posed Mr Baker-Bates?

David Davies: I knew that Rodney was standing down. I too felt immediately after the Verde vote in July that I could not in all honesty continue because—

Q1764 Chair: So the answer is yes, you went because of the Verde deal really?

David Davies: No, I did not go at that moment in time. Do you mind if I spell it out?

Chair: A little later, yes.

David Davies: The consequences of that was that I was asked by Len and Paul—Len Wardle, the chairman of group and Paul Flowers, the chairman of the bank—to stay on because they felt that to lose one deputy chairman post the Verde vote was inconvenient, but to lose two deputy chairmen—

Chair: Was carelessness.

David Davies: Yes. So the pressure was on me to stay on until the end of the year, and we agreed I would stand on until then, by which time they anticipated the SPA would come up and would be signed. I made it very clear that I could not and did not think that I would be “turned” so to speak and vote in favour of the SPA. Gradually, as the next few months unfolded, the tide turned in my favour and my discussions with other directors suggested that they were having similar misgivings.

Q1765 Chair: We are going to explore all the aspects of the points you are raising in more detailed questions from colleagues. Just one last general point: you both had a hand in appointing the chairman?

Rodney Baker-Bates: No, I had no responsibility.

Q1766 Chair: None whatsoever?

Rodney Baker-Bates: No. I was a candidate.

Q1767 Chair: Ah, Mr Davies?

David Davies: I was asked to be a candidate and I refused; I made it clear that I thought Rodney was the better candidate. I had a hand in it, however, in the sense that I was part of the board that approved Paul Flowers’ appointment.

Q1768 Chair: If you had a better chairman, do you think you might have come to a decision that could have prevented you having to resign—by which I mean somebody who had some general idea about the subject matter?

David Davies: I think it is quite possible, given that other well-informed and intelligent directors came to a different conclusion initially, other than myself, on Verde, but even another chairman might have concluded that Verde was worth pursuing. I am pretty sure that whoever you appointed as chairman would have got the picture in the end, because we ran out of steam and when we reached the end of 2012 it was clear to me, and I think other members of the board, that Verde was not going to happen.
Q1769 Chair: It takes guts to resign, Mr Baker-Bates. Is there anything else you want to add?
Rodney Baker-Bates: It takes guts to stay on. 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. They made the perfectly reasonable point that they had not made a final decision to proceed with the transaction, that they valued my opinion and experience and that they wanted me to stay on the board.
There was a second, slight complication in that under the original merger documentation between Britannia and The Co-op Bank, four directors had come across, of which I was one, and that was to look after the interests of Britannia members as part of our other roles. My position on that was that the decision had not been made and that frankly it was my duty to stay on and try to win the argument, which I did not.

Q1770 Chair: Things would have been very different if you had become chairman, judging by what you say.
Rodney Baker-Bates: Yes, they would have been.

Q1771 Chair: We would still have the Co-op.
Rodney Baker-Bates: Yes, I think you would, but that may be arrogant.
Chair: We are going to come on now to the question of whether the Co-op was already holed below the waterline by Britannia.

Q1772 John Thurso: Good morning. Mr Baker-Bates, can I come to you first? Just so that I have this right, you joined the board of Britannia in 2006?
Rodney Baker-Bates: Yes, the summer of 2006.

Q1773 John Thurso: You became chairman in April 2008?
Rodney Baker-Bates: Yes, after the AGM.

Q1774 John Thurso: And through, then, until the merger went ahead, when you went on to the Co-op board, Neville Richardson became the Chief Executive of the enlarged organisation, while the Co-op Bank’s chair remained the chairman. How was that arrangement arrived at? Was that part of the deal?
Rodney Baker-Bates: I do not remember it being part of the deal. What was laid out and discussed with me was that David Anderson wanted to stand down, and we knew that before, therefore Neville Richardson was the obvious candidate. The group appointed the chairman and there was no question that I would have a role there, but I put myself forward having strongly supported the transaction as one of the four directors to go on to the board.

Q1775 John Thurso: The critical point is that it was not an arrangement, as is very often the case with a merger, that one side gets the chair and the other gets the chief executive?

Q1776 John Thurso: When you and your colleagues from Britannia joined that board, do you consider that Britannia’s board had the greater financial services experience?
Rodney Baker-Bates: We certainly had greater banking experience. We had no insurance business, which of course David and Bob Newton represented, therefore when choosing the directors who would come across with us—it was a discussion among the Britannia directors—I clearly picked Peter Harvey because of his strong, quite recent corporate banking experience; myself with banking experience; Stephen Kingsley, who had very good financial services and accounting skills; and Chris Jones who had a legal background and had been very helpful for us on the board, who I thought would make an excellent NED.

Q1777 John Thurso: The point I am really making is that when any two boards come together there are obviously differences of culture, approach, organisation and so on and these have to be melded together into one. Reading particularly some of Neville Richardson’s evidence and indeed the note in relation to his script for his departure, it is quite clear that he views the Britannia as having had greater—I will not say superior but certainly greater—experience in financial services. Is that something that you would agree is a fair view?
Rodney Baker-Bates: Yes, I think I would, but qualifying it by saying banking rather than insurance and life insurance. That is the point.

Q1778 John Thurso: Regarding the commercial real estate loan book which was originated by Britannia and is now being said to be one of the principal sources of Co-op’s losses, do you share Neville Richardson’s surprise that these assets are turning sour now, and so badly, so long after their origination?
Rodney Baker-Bates: Yes, I do. Loan books generally do not function that way. If you make a poor loan—the word “toxic” has been used particularly—it is fairly obvious in the first two or three years, for whatever reason, and this portfolio was quite mature, even at the time when I came on the board.

Q1779 John Thurso: Just on that point, to give a rough idea of the maturity of the portfolio, many of these loans would have been originated three, four or more years before?
Rodney Baker-Bates: Yes. I have a broader range of experience, but when I came on to the board I had been in two particular areas. I had been chairman of, interestingly, the other half of the platform business,
which I had sold, and one of the recommendations I made in my first meeting was that we dispose of the platform business, because I felt the market was very topy. Equally, I was chairman of a property company at the time, which we were in the process of selling because again I shared the view that the property market was very topy and it was quite dangerous. The board took that on board—talking about maturity—so we were already not putting on new loans; we were winding down that aspect of the business, so by the time we went into the merger I would say the average life in that book was at least four and half to five years.

Q1780 John Thurso: Having a look at our report on HBOS will show you what happens to people who have had long experience in commercial lending and how they can be taken by surprise, so the fact that they were mature does not necessarily mean that they were good. To what do you ascribe the fact that those loans, which if they had behaved like HBOS or RBS would have been looking very suspect in 2010 to 2011, only started to appear to need such a large impairment? I think you said just now you still do not quite understand why that happened. To what do you ascribe the need for such impairment so late in the cycle?
Rodney Baker-Bates: I was not there but I do know that the regulator changed the criteria by which you would judge the likely outcome on any particular situation, especially on commercial loans, where, as I understand it, unless they could be refinanced within three years, then they needed to be impaired and written down to their market value, which would be a significant discount. Just to make the point, these are provisions—

John Thurso: Absolutely: you could end up writing it all back up again.
Rodney Baker-Bates: I could give you an example of one that has been. Lehman’s collapsed in 2008 and Britannia held a three-year certificate of deposit with four days to go. It was for $90 million and we provisioned it immediately by a third; on fair value it was written down to $10 million. My understanding is that was then sold subsequently in 2010 to another holder for $25 million, 35 cents in the dollar has been already recovered and it looks like the holder of that will get 100%. So in fact, although it was provisioned down to 90%, over the cycle they will get the whole lot back.

Q1781 John Thurso: Can I take you to a minute of a meeting between Andrew Bailey, Paul Flowers, Peter Marks and Barry Toop on 28 July 2011, which we published after our last session, where Andrew Bailey then set out his view that Britannia would have failed, had it not been for the Co-op, and Richardson had been lucky to survive not least as CEO of the merged entity? Did you share that view at the time?
Rodney Baker-Bates: I did not share it at the time and I do not share it now. Looking back over five years with hindsight, that assumes that had Britannia remained on its own the board would have taken no action, the board would have done nothing, and that it did not have the capability to change the course of history. I do not believe that.

Q1782 John Thurso: Your view as chairman of Britannia would be that if the merger had not gone ahead, you and your team would have successfully managed through the bumps ahead and not found yourselves in difficulty?
Rodney Baker-Bates: Under my leadership we would have made a good job of it, to avoid where we have ended up. That is what boards are for.

Q1783 John Thurso: Mr Davies, you were on The Co-op Bank at the time of the merger. Were you in favour of that merger, and did you vote for it?
David Davies: Yes, I was.

Q1784 John Thurso: Did you have any inkling of the difficulties that it would now seem were being imported into the Co-op?
David Davies: Not of the specific difficulties. We certainly were aware of the economic climate that we were in. Our advisers warned us—not that we needed any warning—of the situation we were in. We did ascribe the need for a very thorough piece of due diligence, both through the advisers and through our own team, and we came out of that due diligence feeling pretty confident of the future. Our overall conclusion was that the combination of the two entities was stronger than the two entities on their own.

Q1785 John Thurso: What scrutiny did the board pay to the due diligence on the deal, particularly the work of Britannia’s commercial real estate book, which Co-op Bank itself performed?
David Davies: I know you are aware that we gave KPMG doing the due diligence a list of 10 issues that we were specifically really interested in at the time. The commercial loan book was one of those issues. They came back and said they had not done as detailed a review of the commercial loan book as they thought they should do, and cited lack of availability of the data and of the people to talk to. Consequently we put our own commercial loan book team on to it, who reported back to us that they had done a line-by-line review of Britannia’s commercial loan book and could find very little that concerned them. At the time there were no arrears with regard to that loan book, and so we felt basically we were satisfied with the level of due diligence.

Q1786 John Thurso: Finally, if the board was content with the quality of the work, if the advisers had said they could not have done it so you had done it yourself, my question is the same as I asked Mr Baker-Bates: why is it that, if you had done so much due diligence on a relatively mature and established loan book, originated by to all intents and purposes a seemingly relatively conservative organisation, this should all appear so late in the cycle?
David Davies: I agree with the comment about so late in the cycle. Over the intervening four years our impairments on the corporate loan book climbed from £60 million to £140 million. When we went into
December 2012 we were forecasting that for the year end, being three weeks away, impairments totalling £185 million across not only the corporate loan book but all the other loan books. We then received a letter from the regulator advising us that they thought that a number of institutions had been sufficiently prudent—and that is too strong a word—but needed to be more prudent with regard to their corporate loan books, and inviting us to reconsider our impairments. I have to say that KPMG, our auditors at the time, expressed surprise at the letter, particularly coming so late in the day, given that we were now a week away from year end. But we set to and we agreed that we should make changes, and the outcome of those changes was that we increased our provisions to the tune of £470 million—in other words, an increase of over £300 million on account of the letter. Management told us that this was basically recognising the subsequent three years’ impairments early, and that future profits would improve as a consequence.

Looking at the evidence that I have seen from Andrew Bailey, I am less confident of that, and quite frankly worried about it. I understand why the regulator is saying what he is saying, and only time will tell if he is right or if we were right in terms of the provision that we have made for three years.

John Thurso: Knowing what you knew at the time, yes.

David Davies: Yes.

Q1787 Jesse Norman: Mr Baker-Bates, just to pick up on one point that the chairman raised, when you were expressing your concerns about Verde, did you write down any of the conversations that you had, or did you put in memo form any of the concerns that you had? Rodney Baker-Bates: I expressed my concerns in two ways and some of them I wrote down. I have speaking notes for all the intercessions that I made to the board. The nature of the board was a bit like this, question and answer, rather than a discussion, so I usually prepared what I wanted to say and I have all those notes, although they would not be intelligible to anyone except me. Secondly, that was in general forum talking to the board as I am talking to you now. Privately, I sought to influence three key opinion-makers as I saw it, or opinion-leaders. They were the Group chief executive, Peter Marks; the Group chairman, Len Wardle; and the bank chairman, Paul Flowers. Also, I had conversations with Ursula Lidbetter who I saw as a powerful influence, who was the chairman of the food business. I wrote a series of emails from September onwards to them expressing my concerns privately.

Q1788 Jesse Norman: Could you let us have copies of any of that material, redacted as required? Rodney Baker-Bates: I would be delighted to let you have them, but I would ask that you treat them confidentially. They express personal opinions on situations and people to which they might object.

Chair: We will have to have a discussion outside this meeting about that because in general when evidence is provided it is with the intention to publish. We will take that further outside the meeting.

Q1789 Jesse Norman: Thank you, Mr Chairman, and thank you, Mr Baker-Bates. You have said that you were a candidate for the post of chair of the bank. Can you very briefly tell us what you thought of the selection process? Was it effective, impartial, detailed, thorough?

Rodney Baker-Bates: It was certainly different from the selection processes I have perhaps been through on plc boards. It started with an informal conversation with the chairman in November 2009, asking if I would put myself forward and he would welcome it if I did, and I agreed to do that. Not a great deal happened and there were, I understand three other candidates, I was interviewed on the afternoon of 24 February. 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. There was an announcement at the board the following day.

Q1790 Jesse Norman: That is interesting. Was that a political assessment? Were they trying to work out whether you were sound on the Co-operative in some way?

Rodney Baker-Bates: People who interview you ask the questions to which they want answers. They may have got answers to all the other questions they were asking other colleagues.

Q1791 Jesse Norman: If I look at your CV, you have had extensive banking experience as a non-executive of C Hoare and Company, in the insurance area with the Pru, before that with the Midland, then with the BBC and Chase before that, Glyn Mills. Why do you think Mr Flowers was appointed ahead of you? Rodney Baker-Bates: I was told afterwards that he had done very well in the psychometric tests.

Q1792 Jesse Norman: So he was psychologically well-balanced, although ignorant about finance?

Rodney Baker-Bates: That is a conclusion that you could draw.

Chair: Psychologically balanced but unbalanced, but psychometrically brilliant?

Jesse Norman: That is an inference, Mr Chairman, but that is interesting. You do not have any other insights as to the reasons he might have been chosen?

Rodney Baker-Bates: No. I was given a short debrief after the meeting by the Group chairman and I was given a copy of my own psychometric test and it was left at that.

Q1793 Jesse Norman: You were happy serving under Mr Flowers as deputy chair?
Rodney Baker-Bates: When you serve on a board, you make that decision to serve on it to the best of your ability. Colleagues have a wide range of skills and I think as my colleague, David, has said, Paul did really work hard—in fact I gave him some tutorials on getting through his SIF interview and so on—to learn about banking and to learn from me the skills he might need to take the role on. He 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.

Q1794 Jesse Norman: You coached him to get through the process of evaluation by the FSA?
Rodney Baker-Bates: Coaching might be too strong a word.
Jesse Norman: It is a gloss on the phrase that you gave him tutorials.
Rodney Baker-Bates: I tried to help him think about the questions that he might be asked.

Q1795 Jesse Norman: Otherwise he would not have made it?
Rodney Baker-Bates: I could not possibly make that judgment.

Q1796 Jesse Norman: Do you think he had sufficient financial experience to act as chair?
Rodney Baker-Bates: Of a bank?
Jesse Norman: Of a clearing bank, yes.
Rodney Baker-Bates: No.

Q1797 Jesse Norman: How about you, Mr Davies?
David Davies: I can add a bit of gloss. It is probably not very sensible of me to do so, but the 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. That was the explanation given by Group. I can confirm what Rodney said. There were four candidates, two very good independent candidates. Rodney was clearly a very good candidate, and there were two candidates from the Co-operative Group board who were also on the Co-operative Banking Group board.

Q1798 Jesse Norman: Who did you vote for?
David Davies: I did not get a vote. There was an interviewing panel of three members of the Co-operative Group board, because this was a group appointment. The group is the shareholder here. The financial services companies are effectively wholly-owned subsidiaries. They reserve the right to appoint who they see fit, so they led the process. I do not doubt the integrity of the people doing the interviewing. I know the three people who did the interviews and I would not question for one moment their diligence and integrity. When they say that they thought Paul was the best man, I believe them. I do not think there is any side to that. I am also convinced that the group tried to go through as transparent a process as possible, and that was the point of having the selection process, of keeping the board informed, and of having the psychometric testing.

I have to say the psychometric testing did surprise me in the sense that Paul was a clear winner. When I looked at the scores I was a bit concerned with a couple of the scores, but as Len pointed out to me personally afterwards even if those scores had been increased to what I would call average scores they would not have affected the outcome in the total of the numbers.

Q1799 Jesse Norman: And you thought psychometric testing was a useful way to evaluate potential board members and more useful than financial knowledge?
David Davies: Not more useful than financial knowledge, but it was clearly a Walker recommendation that you should employ objective methods when assessing a chairman, and group had tried to comply with that.

Q1800 Jesse Norman: Just to be clear, do you think Mr Flowers had sufficient financial expertise to be chair?
David Davies: No, and it was very clear that he was dependent on support from financial expertise around the board. When you go back over history, I think I am right in saying there has never been a Co-operative Group appointment to that chair who has had financial experience. This was a whole new departure for the group board. In previous appointments, they would have chosen without any discussion with the financial services board and without any involvement of any of the IPNEDs. At least this time—it sounds trite—they did try to go through a process when they involved Rodney and at least one other director. I was asked to stand, and I am quite grateful to say that I did not take up that offer.

Q1801 Jesse Norman: Mr Baker-Bates, you avoided answering the question of whether or not you were happy serving underneath Mr Flowers as deputy chair. Let me just ask you a question—
Rodney Baker-Bates: I am sorry, I disagree. I was happy to serve under him, because I stayed on the board. If I had been unhappy I would have left.

Q1802 Jesse Norman: Okay, as in due course you did. Can we just very briefly dwell on the character of the board? You have said that it was very large, that the relationships were more like one to many, rather than a conversation—more analogous to a select committee type hearing, as you have just described it. There was a contrast between democrats or what you considered Co-operative delegates, and outsiders, those who understood something about finance. We have also heard the board was described as unruly by Clive Adamson. Could you just talk a bit about that, and in particular whether there were groups within the board that were operating with different agendas?
Chair: That is a big, open-ended question but we would appreciate a relatively concise reply, if that is possible.

Rodney Baker-Bates: I would first say that the board was not unruly. It may have been unwieldy, but it was not unruly. Unruly implies throwing things at each other, and we never did that. In fact, it was a very decorous board. As I saw it, there were no other agendas; it is just there 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.

Q1803 Jesse Norman: But in that context, Mr Flowers’ supposed leadership skills were really those of the Charge of the Light Brigade, because they were bringing an unruly and disparate board without a clear sense of direction to a series of decisions that were ultimately ruinous.

Rodney Baker-Bates: I think he 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. I think he did make a real effort.

Q1804 Chair: On your own application for the chairmanship, did you have the feeling at any time that the interviewers were going through the motions and that you had been put up to create some competition?

Rodney Baker-Bates: I put myself up, sir.

Q1805 Chair: You were tapped on the shoulder, you told us earlier.

Rodney Baker-Bates: Well, there was a discussion. No, I think they were genuinely—

Q1806 Chair: You think you might genuinely have got it, had you done better in those psychometric tests?

Rodney Baker-Bates: That is a question I cannot answer.

Q1807 Chair: But you felt that?

Rodney Baker-Bates: Yes.

Q1808 Mr Ruffley: Mr Baker-Bates, you and Mr Davies, it turns out, were the two people appointed to mind the Reverend Flowers as deputy chairs. Who proposed that arrangement? Where did it come from?

David Davies: It is a bit unfair that Rodney—perhaps by the fact he is alphabetically ahead of me—is getting the lion’s share. It is not that I wanted to jump in. First of all there was a memorandum to the board about the appointment and it looked as if the initiative—

Q1809 Mr Ruffley: From whom?

David Davies: From Paul, the chairman, to the board, indicating that he was going to be chairman of the bank and the two insurance companies, which was a break in tradition. Prior to that there had been other chairmen of those, from within the financial services organisation. It was recognised in the memorandum that he did not have the requisite skills, both in bank and in insurance, and that therefore it was his recommendation that two deputies be appointed—one to cover bank, and one to cover insurance—and that it would be also very good if one of those came from a Britannia background and one from a Co-operative background. It is a surprise to me to see and read that the initiative was put to Paul by the FSA. I have no way knowing the accuracy of that.

Q1810 Mr Ruffley: Sorry, can you repeat what you just said?

David Davies: I am reading, both in the press and I think in Clive Adamson’s testimony to you, that it was an FSA suggestion—requirement?—I do not know the precise word. But certainly when Paul was interviewed as part of his process of becoming chairman, the idea was said to have been put to him that it would be good if he appointed deputy chairmen who had relevant experience. That got lost in translation, I am bound to say: when it was put to the board it came across as Paul’s idea. My memory of the time is that I thought this is a good sign for the future, that Paul has recognised that he needs help and therefore he is appointing two deputy chairs, which we had never had before, one to cover insurance and one to cover banking. I thought this was a good start.

Q1811 Mr Ruffley: So he appointed both of you two? What was the—

David Davies: Sorry, my apologies. There is a short-circuit here. He asked again for people to stand and be counted. Any volunteers for the roles should make themselves known to him and if necessary we would have an election process.

Q1812 Mr Ruffley: You both volunteered, but did anyone else volunteer to be a deputy chair?

David Davies: Yes, there was one candidate on the insurance side. I believe Paul had a quiet word to him suggesting that it was best if we did not have an election and therefore he stood down, and effectively Rodney and I were elected unopposed.

Q1813 Mr Ruffley: He asked for volunteers and you two emerged to fill those two posts?

David Davies: Again as part of the process we had to submit 500-word dissertations on why we would be good deputy chairs.

Q1814 Mr Ruffley: What did you understand your relationship with Reverend Flowers to be as deputy chairs? Did he write down how you were to operate? There has been a very interesting observation from Mr Baker-Bates that he prepped the Reverend Flowers and helped him do a bit of cramming for his test with the FSA. What was the nature of the relationship set out? What was he asking you to do as deputy chair? To give him weekly advice or tutorials in your case in preparation for the FSA test?

David Davies: In a similar work, a memorandum board paper, five tasks were listed, one of which was to be a sounding board. The second was to provide...
him with technical expertise and help. The third was to help him make the board more effective and to concentrate more on strategy. The fourth was to act very simply as his deputy. And the fifth was a catch-all—whatever we might be asked to do. I think the way that we interpreted that advice was to be in regular contact with him by email, phone, face-to-face meetings. We would always meet him prior to the board, on the night before. We would identify issues either at that meeting or separately that we thought were troublesome or worthy of more debate, or worthy of more intellectual rigour, if you like—it sounds very pompous. Speaking on behalf of us both, I think we did our level best to educate him and make the meetings more relevant.

Q1815 Mr Ruffley: Presumably you took this onerous responsibility very seriously, because you were, in a sense, more responsible than any other board member for keeping Reverend Flowers focused on what was financially important. You two were the most important on the board, in that respect, were you not?

David Davies: I do not think I got the impression we were the most important. I think if I had been aware—

Q1816 Mr Ruffley: You were deputy chair with these responsibilities. This is addressed to both of you. Is it not the case that both of you were more important than anyone else on that board for ensuring that Reverend Flowers was kept as far as possible on the straight and narrow and was advised on financial matters, about which we all agree he had very little knowledge?

David Davies: The short answer to that is yes.

Q1817 Mr Ruffley: Would you agree with that?

Rodney Baker-Bates: Yes.

Q1818 Mr Ruffley: All right. It seems to me that there were expectations placed on you—you have admitted that—to ensure that Reverend Flowers did not make mistakes, and he was a man more ignorant of finance than he should have been. Did you discuss with the FSA how your monitoring of his work was going? Did you keep in touch with the FSA to report back?

Rodney Baker-Bates: That makes an assumption that we were aware that the FSA had asked for us to be appointed, and we were not.

Q1819 Mr Ruffley: Throughout all of this, after your appointments as deputy chairs, how many discussions did you have with the FSA about Reverend Flowers’ performance, and when did you have those?

Rodney Baker-Bates: None.

Q1820 Mr Ruffley: Do you consider that surprising, that they did not get in touch with you?

Rodney Baker-Bates: I considered it surprising in light of the fact that they had asked for us to be appointed, but since I was not aware of that I did not consider it surprising.

David Davies: I will add to that, because you have put a slight specific on that.

Q1821 Mr Ruffley: Just to clarify, I am asking if the regulator took any interest in the two deputy chairs who, most people would now agree, not just in hindsight but at the time, as being really rather important in keeping tabs on the Reverend Flowers, a man without any obvious knowledge of banking.

David Davies: Okay. I don’t think I ever had any discussions with the regulator as being deputy chair. I had discussions as part of the regular interface with the regulator on Project Arrow, so I can recall two meetings that I would have had with the FSA’s case officer, if I can use that phrase, but nobody more senior than that. I do not recall being asked specific questions about how the chair was performing.

Q1822 Mr Ruffley: I am very specifically talking about how the chairman was performing rather than maybe routine discussions with mid-ranking FSA individuals.

David Davies: That is why I am clarifying that I had meetings.

Q1823 Mr Ruffley: That is very helpful indeed. Now, Mr Baker-Bates, when you were in these discussions with the chair—you said you met him before board meetings—could you give an example, if any, of where you disagreed with the Reverend Flowers on any of Project Transformation, Project Unity or Project Mars, now known as Project Verde?

Were there any fallouts or conflicts where after a long discussion you were convinced he was wrong and he was convinced he was right—any examples?

Rodney Baker-Bates: Well, there were discussions at two levels. The meetings we had before the board were generally around specific papers. We would be discussing an issue maybe in the bank; whatever papers were presented to the board we would go through them in detail, add our views and give context to them. Paul Flowers, Len and Peter Marks were well aware of my opposition both to Unity and Verde because that was expressed much more overall. It may come down on a specific paper where I would say, “I believe there are these risks in this and we should not be doing it,” but my opposition to Verde was known and expressed to the board and was overarching, so we did not have a specific argument about Verde at any point.

Q1824 Mr Ruffley: Final question: on something as important as that, you, as a very experienced financial player and as deputy chairman, clearly saw yourself as having a responsibility to look closely at what this chairman was doing. How often did you consider resigning when you had these disagreements that you have just referred to?

Rodney Baker-Bates: I think I have already said—maybe I have not—I went to see Paul and Len privately in October 2010 saying I wished to resign because of my opposition to Verde.

Chair: We are going to come on to that right now.

Rodney Baker-Bates: If you are on a board that is what you have to do.
Q1825 Mark Garnier: My question is addressed to both of you so feel free to chip in, whichever is more appropriate. What I want to concentrate on specifically is Project Verde and what was happening within the board. My first question is: when was this first discussed? When was the germination of the idea to bid for Verde?

Rodney Baker-Bates: My understanding was that there was an approach to the Co-operative Group in February 2011, it would have been, and that it came to the board I think for the first time in April.

David Davies: I would put it just a month later, but Rodney may have inside knowledge of that.

Rodney Baker-Bates: It was spring.

David Davies: Yes, spring of 2011.

Q1826 Mark Garnier: Who was that approach from?

Rodney Baker-Bates: It was from Credit Suisse.

Q1827 Mark Garnier: They were acting as corporate broker, touting around, and presumably that was part of a general salesman expedition where they were going around presumably seeing potential other bidders?

Rodney Baker-Bates: Well, it was public knowledge that this was going to take place, and I think they brought the idea to group, who then brought it to the board.

Q1828 Mark Garnier: Do you think you were particularly picked or do you think there were a number of other people they were talking to as well?


Mark Garnier: You do not know?

Rodney Baker-Bates: No.

Q1829 Mark Garnier: That is fine. Neville Richardson and Gary Hoffman have both said that Peter Marks, the group CEO of Co-op, was the key driver behind the Verde deal. Would you agree that that was the case?

Rodney Baker-Bates: Yes.

David Davies: Yes.

Q1830 Mark Garnier: Absolutely. Do you think he was doing this as group CEO or as a Co-op Bank board member?

David Davies: I think it was as group CEO.


Mark Garnier: He wanted to see the group that he was ultimately in control of become even bigger and more magnificent?

David Davies: This was very clearly a group matter. Clearly, he would want bank support because if he did not have bank support it would not have happened. Ultimately, the decision was going to rest with group. This was such a significant transaction.

Rodney Baker-Bates: 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.

Q1831 Mark Garnier: Yes, sure. It is quite an important thing. Because of his position as group CEO on the board of the bank, did his opinions carry more weight than anybody else’s because of that position he held?

David Davies: I cannot go back and look at a single instance. There is no doubt it carried weight. Whether it carried more weight than Rodney’s or mine? I don’t think I could answer that. I suspect within the group directors, yes.

Q1832 Mark Garnier: Your hesitation is quite interesting because I am trying to visualise the dynamic that is going on at a board meeting of the bank. You have one individual there who is a non-executive but he is also group CEO. He is talking about doing something that you know has support of the group. He is effectively speaking on behalf of the entire organisation, isn’t he, in the context of the board?

David Davies: Yes. The dynamics of the meetings, the format of the layout, was Paul, Barry, chief executive, Peter Marks. He was close to the centre of the action. As we were immediately post-Britannia, we were a board of 22 and we came down to 15 not quite by the time of the Verde discussions. The more central you are, clearly the more influence you seem to carry.

Q1833 Mark Garnier: Neville Richardson has also said that Paul Flowers was pushing for the Co-op bid. Is that the case?

Rodney Baker-Bates: I am less clear on that.

David Davies: Yes, I would concur with that. 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.

Q1834 Mark Garnier: That is very interesting and I think that is quite an important point. Your view is that—and this is almost in his favour, if you like—he was absolutely a neutral chairman; he was not necessarily trying to lead the board. As Mr Norman so openly pointed out, it was not the Charge of the Light Brigade. He was not leading that charge.

David Davies: 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.

Rodney Baker-Bates: Yes, I would agree with that.

Q1835 Mark Garnier: That is very interesting and very helpful. Neville Richardson has also said that Len Wardle, the Co-op Group chairman, was pushing for the deal. Again, is that fair?

David Davies: Again, I would characterise Len as being more in favour than Paul initially, but I think by the time we got to heads of terms, they were all very much ad idem. Certainly to start with, it was a slow burn.
Q1836 Mark Garnier: Yes, okay. How about anybody else within the Co-op or the Co-op Bank pushing for it? Was there anybody else who was a significant player in this?

David Davies: My recollection is initially the banking board were more in favour of it than the group board because the group board I thought 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.

Q1837 Mark Garnier: So the bank was more enthusiastic than the group?

David Davies: Because the 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.

Q1838 Mark Garnier: This is quite interesting because the bank was at this point trying to increase its size, ultimately in a three-year period tenfold. We obviously know about the stresses that were going on in terms of the integration of the IT systems and all the rest of it. It is interesting that the bank was trying to drive this forward. It must have been well aware of this.

David Davies: Drive is the wrong word: I said support. Peter was driving it. The bank supported it because they could see that this was going to be a step change.

Q1839 Mark Garnier: They were persuaded?

David Davies: This was early in the piece. As we got in the subsequent months the heads of terms, doubts began to surface. The nature of the deal changed shape from being plan A through to plan C—in other words, we reversed the system strategy here. As it got more complex, I think the banking board certainly started to get less sure. We got to the heads of terms. We had the vote; two voted against. In the subsequent months after the heads of terms vote, I am convinced that more and more directors saw the folly of this.

Mark Garnier: Directors of the bank?

David Davies: Yes, sorry. I am speaking personally of the bank now because I did not have sight of the group at this stage.

Q1840 Mark Garnier: Just to be clear, though, Peter Marks was very enthusiastic about this and he was effectively pushing it forward?

David Davies: Peter was leading the negotiations and he was dealing with Lloyds.

Q1841 Mark Garnier: He was leading the negotiations, but the board that he was the chairman of, the group board, was not as enthusiastic about it as the bank board, is that right?

David Davies: To begin with. I think as we got to heads of terms, it changed. The 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 in the sense of the strategy for the group should support this acquisition.

Q1842 Mark Garnier: The group does not know much about banking. Okay. Then we get to the stage where we are still pushing forward and the bank is presumably led by you two, trying to wind back a little bit on this. Yet there is this momentum that has gathered behind it.

David Davies: Again, heads of terms vote is crucial here. Up until the heads of terms vote there was not a great deal of dissension within the banking board. That brought matters to a head, particularly the change in strategy from plan A to plan C, which occurred in April of 2012 and then the heads of terms vote in July 2012. I certainly became more opposed to it in those three months. Rodney will speak for himself, but I am pretty sure he was more opposed to it before me. 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.

Q1843 Mark Garnier: Why did it not come to a vote? Why wasn’t it pushed for?

David Davies: Because we had yet to get to the signing of the SPA. The SPA was going to be the crunch point and that was being—

Q1844 Mark Garnier: When was that due?

David Davies: This is one of the problems of Project Verde. If you start from the beginning in November 2011 when we became preferred bidder, optimism was abounding and it was suggested SPA would be signed in March of 2012. That was clearly not doable. We got to July of 2012. We signed heads of terms. At that stage it was confidently expected SPA would be signed in December of 2012 and that required us to submit to the regulator by the beginning of December 2012 our paper asking for his support.

Mark Garnier: Sorry, SPA stands for?

David Davies: Sale and purchase agreement. We got to December. We were well short of having an SPA ready to be signed. It then was forecast for March and gradually, as we know, things were beginning to get worse within the organisation. In the end, we got to April and Peter pulled the plug and said it cannot be done.

Q1845 Mark Garnier: Just a couple more questions. Did Paul Flowers or Peter Marks share with the board the impression given by Lloyds of the bid? What were Lloyds thinking about how things were moving along? Because, of course, as we know, Lloyds was in November 2012 starting to—

Chair: Clearly, that is quite a big question, but if you have something specific to say, please say it. If not, speculation will not help.

Rodney Baker-Bates: I have nothing to say. I was not on the board.

David Davies: Shared with the banking board? All I can say is that Lloyds thought that our offer was the best offer. That is why we got preferred bidder.

Q1846 Mark Garnier: As far as you were concerned, all the way through the process you were given the impression by Peter Marks and Paul Flowers, where he got involved, that Lloyds were
fully behind all of this? There were no problems; there was nothing going wrong; no doubts; it was all tickety-boo?

David Davies: That is a slightly different question. Peter Marks was the main conduit of information from Lloyds. Peter gave us the impression that we were preferred bidder. We knew we were preferred bidder and that Lloyds was supportive of our bid. We got to the end of 2012 and Rod Bulmer rather than Peter Marks, I believe, said to the risk committee, of which I was a member, that Lloyds had ceased engaging with us on capital and conduct issues. That is quite a fundamental statement.

Mark Garnier: Yes, it is.

David Davies: You get the impression, therefore, that Lloyds had said, “Guys, this is not going to happen.” We were at that stage unable to get a satisfactory explanation from Rod as to why Lloyds had done that, and it became pretty clear that basically Lloyds now had misgivings about the capital strength of the Co-op Bank and the deal was in jeopardy. That came to me and the risk committee from Rod Bulmer—I do not think from Peter. Paul certainly gave no indication that he had been in touch with Lloyds.

Q1847 Mark Garnier: That was before Christmas 2012 because I believe that it was delivered—

David Davies: No. I understand your question. To my knowledge, it was post-Christmas 2012. It was in January when Lloyds said to us—this is information to the risk committee, not to the Co-operative team. I do not know when the Lloyds team said to the Co-operative team, “We are not engaging.”

Q1848 Mark Garnier: There is a bit of ambiguity about this, but as I understand it Lloyds gave the indication in early December but it was not notified to the board until the board meeting in January. That sounds pertinent.

Chair: But you do not know about that?

David Davies: I can’t speculate on what happened before the January board meeting.

Q1849 Mark Garnier: But in the January board meeting that was the first you officially heard about it?

David Davies: I think it was the risk committee first, because I was not at the January board meeting.

Q1850 Chair: Can I clarify whether at any point you had a sense or were told of any political preference or pressure on this deal?

David Davies: No. Personally, I was aware that there was—

Chair: The answer is no?

David Davies: No.

Chair: Okay. If the answer is, “No, but” something substantial, please say.

David Davies: I was aware there was contact but no pressure.

Q1851 Teresa Pearce: Good morning. Mr Baker-Bates, Neville Richardson resigned in July 2011. He said that he spoke to you about his concerns on the telephone shortly before that departure. Do you recall that?
Q1859 Teresa Pearce: Mr Richardson to this Committee intimated that he resigned because of Project Verde. What you are telling us now is that you do not think that is correct. You think he had major concerns about his own position?

Rodney Baker-Bates: No, not about his own. What he had concerns about was we were embarking on a project that he was equipped for if we were to carry it out, but he was not going to be allowed to carry it out, in his mind—that was the Unity project—but both of us, I think, shared the view that it was a huge step, so there were a lot of risks.

Q1860 Teresa Pearce: Reverend Flowers told us that he believed that Mr Richardson resigned because he did not want to report to Peter Marks. Is that a fair assessment?

Rodney Baker-Bates: That is his judgment.

Q1861 Teresa Pearce: Is it your judgment?

Rodney Baker-Bates: Oh, it is much more complicated than that.

Q1862 Mr McFadden: Mr Baker-Bates, you have made clear this morning—you both have but I will begin with you—that you thought Verde was the wrong thing to do and that you were consistently opposed to it. You described it to my colleague, Mrs Pearce, as a huge step and a step too far. Why were you so opposed?

Rodney Baker-Bates: You have to look at it at two levels. We have to look at it at a group level and at the bank level. At the time of the Britannia merger—in fact almost when the merger was completed—the group announced the acquisition of Somerfield. Previous to that, the group had had a pretty strong balance sheet, low current ratios, strong capital ratios. One of the most important things in Britannia for me was the strength of the group. In order to complete that transaction, they geared up the balance sheet to the point of about £1.3 billion, so they significantly weakened or used the availability in the group balance sheet. 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-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.

Q1863 Mr McFadden: It was really that limited capital was the heart of your concern?

Rodney Baker-Bates: Yes, and competence.

Q1864 Mr McFadden: Capital and competence, okay. You said your opposition came a little bit later, Mr Davies, but was it for the same reasons?

David Davies: In essence, yes. In November 2011, when the concept was debated for the first time among us all, I voted in favour. I sent an email to Paul, “I am voting in favour of this from a Co-operative Bank Group position as a director. If I was a member of the Co-operative board I would have significant misgivings because of all the risks and capital.” I was in favour of it from a strategic sense.

As I have said, we 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 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.

Q1865 Mr McFadden: What kind of error? How much money are we talking?

David Davies: We are talking hundreds of millions of pounds.

Q1866 Mr McFadden: Your estimates of the IT costs were out by hundreds of millions of pounds?

David Davies: Yes. As I say, we were creating a new platform, which we had been doing for some years. It was not the platform that was the problem. It was the peripheral systems that interfaced with the platform. There was an error of some hundreds of millions of pounds of integrating Lloyds on to our platform. 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. This came on very late in the day and further undermined my confidence in the doability of the management of being able to do this. 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.

There was a worrying subplot that management now were saying that Verde was the least-risk option for the bank—that if we did not do this deal the bank would not survive. I found that a statement that I could not possibly agree with and something I took up with the chief risk officer. I did not think it was the least-risk option. In fact, I thought it was quite high risk.

My point 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, which Rodney has mentioned and I have mentioned. 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. The regulator was, it seemed to me, mindful to keep adding capital to us until we broke, frankly. You could see that in the life fund release, where we had built into our plans £200 million from moving the life fund out to Royal London. It took us an age to get approval for that and the £200 million was not going to be available at least until 2014. 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. That is in July of 2012.

Q1867 Mr McFadden: That is a very full and helpful answer. Now, the regulator shared these concerns about capital. We have heard that Mr Bailey shared his concerns about a number of aspects of this deal, including capital, in 2011. Do either of you recall a presentation given by Mr Bailey and his team in July 2011 citing capital as a potential problem with the deal?

David Davies: I will take that. July 2011 we were offsite in Nantwich. Remember, there is a backdrop here that Neville was having his discussions with Rodney, Paul and Peter about Unity and Verde and leaving. I do not think we had a presentation—well, presentation implies slides and things like that. I think it was more like a fireside chat in an environment rather like this. Mr Bailey sat over there and we sat—I am trying to think whether it was auditorium style. Anyway, he did indicate five areas. I do not have notes and I do not have board minutes of those things, but the five points that you have picked up in previous evidence were areas that he wanted us to demonstrate to him that we could get on top of, and capital was one of those items.

Q1868 Mr McFadden: Did he mention the figure of £2 billion?

David Davies: No—well, not in my hearing. One of the things that was quite difficult to get was the scale of the issues of capital. That was the problem. The Co-op Bank had always run on a relatively thin capital base. We were a wholly owned subsidiary; capital resided in the parent. We always knew that we had to keep capital under very tight scrutiny and we did that. How much capital Mr Bailey thought we needed to do this deal, I do not think was ever spelt out to me.

Q1869 Mr McFadden: Do this deal, I do not think was ever spelt out to me. How much capital Mr Bailey thought we needed to keep capital under very tight scrutiny and we did that. Resided in the parent. We always knew that we had to base. We were a wholly owned subsidiary; capital Co-op Bank had always run on a relatively thin capital of the issues of capital. That was the problem. The things that was quite difficult to get was the scale.

No—well, not in my hearing. One of those items.

Q1870 Mr McFadden: Do you think the regulator should have done more or should have acted earlier to stop this deal given that you, as directors with significant financial expertise, had, first, voted against it and then, secondly, gone out of your way to raise your concerns directly with the regulator?

Rodney Baker-Bates: Well, I am not the regulator and I do not know the range of information that he had, but I think the regulator does have the power to stop a deal if they wish to.

David Davies: That is quite a hard question. In July, when we had the vote, information was put to the board that the regulator did not have enough evidence at that stage to say, “Do not do this deal.” Therefore, he was not going to intervene. That point was made very clear to the board at the time we had the vote. My own view was that the regulator was sufficiently uncomfortable with the deal that he would keep pushing at the capital position and keep gradually, a bit like the lobster in the pot, turning up the heat to the point at which we cracked. When I look back now, I think in a sense that is what happened. Whether it was deliberate or whether it was just the regulator responding to the economic conditions, I do not know.

Q1871 Mr McFadden: There is a curious thing here. When the chairman of the bank is appointed, there is a deal struck that there will be two deputy chairs with significant financial experience who will, if you like, ride shotgun to help the chairman because of his lack of financial experience. You are those two people, but you are not told about this deal, although that is specifically your role. Yet, despite that, you then go and see the regulator to tell him your worries about the Verde deal and it trundles on for a significant number of months after that before the plug is pulled. It is a curious situation, isn’t it?

Rodney Baker-Bates: One thing I should say is that David and I, following the vote, were intending to go together at a date on which we could fix it, so we had a shared view. I said to David that I advised Clive that David had wanted to be there but could not and had voted against it. As I said, I do not know what other information. I rather agree with David that they were just pushing and pushing and pushing until the terms. There is a concept called “no objection,” isn’t there, David?

David Davies: Yes. It is very difficult to speak on behalf of the regulator here. On the basis that two people voted against this deal, I cannot see that that is justification for the regulator intervening there. He probably had formed his own impression that there were severe stresses on this deal at that stage, but he wanted a bit more evidence, I suppose, and he would want more opposition, if you like. That was emerging—gradually, as we got to the end of the year, more and more directors were beginning to question it—and I am sure if there was any interaction with the regulator they would have picked that message up.

Q1872 Chair: In any case, it is the regulator’s job not to save a particular institution but to save the system?

David Davies: Absolutely, yes.

Q1873 Chair: It is not their job to take your decisions. Speaking of those decisions just for a moment, it does strike me as somewhat odd, which is
a related point to the one that Pat McFadden made, you two were brought in specifically because more banking experience was needed, or at least you were elevated to the role of deputy chairmen with that function in mind. But then, through this crucial deal, it seems that you were briefed as a board member but you did not seem to be intimately involved in the discussions as they rolled forward at every stage. Or do I have the wrong impression of the basis—

David Davies: Discussions with whom, Lloyds or the regulator?

Chair: For every aspect of the Verde deal and, of course, the Lloyds negotiations would be the most important.

David Davies: It is a valid point, but the discussions with Lloyds were principally Peter and the group team. With the regulator, there were continuous weekly meetings, every Friday, between the team and the regulator. You are right that it is surprising, bearing in mind that—

Q1874 Chair: You did not raise it or raise concerns that you were not in that loop?

David Davies: No, because I did not—

Chair: This is a major transaction. When transactions are on, the atmosphere on boards is completely different. The non-execs become extremely active to the point where they are thinking about the deal every day, aren’t they? They are not sitting waiting for the next monthly board pack.

David Davies: We were. You will see by the meeting notes there were meetings after meetings after meetings between the board and the risk committee on this subject. Am I surprised that the regulator did not talk to me and Rodney? I am a bit surprised, given that he apparently suggested that we should be deputy chairmen, but I was not—

Q1875 Chair: Even within the corporate governance structure that you were working, did you feel you were fully in the loop, as much in the loop as in retrospect you should have been, in those negotiations?


David Davies: Yes, because this was a group-led project.

Rodney Baker-Bates: We were very clear it was a group-led project.

David Davies: I think 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.

Q1876 Chair: There are many things that are puzzling me about this whole story still, but I will just throw out one more and see if I get an answer to this. You were joint senior independent directors, were you not?

David Davies: Yes.

Rodney Baker-Bates: Yes.

Q1877 Chair: Have you ever been on another board where there are two SIDs?

Rodney Baker-Bates: No.

David Davies: No.

Q1878 Chair: Did that strike you as an unusual arrangement bearing in mind the combined code provides for a chairman and a SID? Or whatever it is now called? I cannot remember.

David Davies: The Co-operative Bank is a strange animal. It is a wholly owned subsidiary. The SID concept and talking to the shareholders is not so straightforward.

Q1879 Chair: Perhaps it might have helped if there was one man on point as the SID who should have been more intimately involved in these negotiations?

David Davies: Yes, but it would have been quite heroic for one man to have covered insurance and banking. I was very clear that I was covering insurance and if anything went wrong with the insurance part of the business I would be pretty much in the dock.

Q1880 Chair: I do not want to prolong this but this is quite an important question. We have a chairman here who we now know was not up to snuff. The primary role of a SID is to do something about it, but here we had two SIDs so we had divided responsibility for blowing that whistle.

Rodney Baker-Bates: There is no doubt in my mind that the shareholder was aware of my deep concerns about Unity, Verde and the transformation.

Q1881 Chair: You went to the shareholder to explain that?

Rodney Baker-Bates: Because they sat in the board.

Chair: But you said individually—

Rodney Baker-Bates: Yes, I wrote to them.

Chair: —and you had meetings lest they had not got the message, which was the key point in your earlier evidence.

Q1882 Andrea Leadsom: I would just like to clarify some timing. Andrew Bailey attended a Co-op Bank strategy awayday in July 2011 and at that meeting he gave some stark messages about the FSA’s view of Co-op Bank, its capital position and risk management. In particular, he questioned the ability to bid for Verde. At the time, did his views come as a surprise to you?

David Davies: Expressed in that way, yes. He expressed concern about our ability to do the deal. He linked it with the notion that it might be a good idea if we linked up with another institution. That was the strength of that. My impression was that he did not think that we could not do this deal. He wanted to be persuaded that we would address the issues that he raised as part of his giving approval—the issues about risk framework, capital, liquidity and stretch. I do not think he had formed a judgment at that stage that we could not do this deal. He was identifying for us things that we needed to work on to demonstrate to him that we could do that, and I think that was very fair.

Q1883 Andrea Leadsom: Okay. Had the board been sufficiently briefed by the chairman and chief
executive prior to Andrew Bailey coming to that strategy awayday on the questions that Andrew Bailey might have about the deal?

David Davies: No, because at this stage it was still quite a gleam in the eye that this was a worthwhile thing to put in an indicative offer for, so that we could see just what the nature of this potential animal was that we might want to develop. At that stage, we had only had the gleam of an idea. I would not say that Neville had objected to it because I do not think he had. This is when we started to think seriously about whether we should do this, and it was not until we got to October/November that we had the joint discussions with the group board about capability and the size of our offer.

Q1884 Andrea Leadsom: When you say, “We started to think if we should do it,” are you talking about you and Mr Baker-Bates?

David Davies: No, I am sorry, I am talking about the organisation.

Rodney Baker-Bates: The organisation, the bank board.

David Davies: At this stage, speaking personally, I did not have a view as to whether we could do this deal or not. The deal on the face of it sounded attractive and sounded a positive thing that we should be thinking about and certainly tossing our hat in the ring.

Q1885 Andrea Leadsom: Would it be true to say, then, that Mr Bailey’s concerns sparked concerns in the minds of board members? Which came first, the chicken or the egg? Was it his concerns or their concerns?

Rodney Baker-Bates: Let me answer. I think he listed out five perfectly sensible and clear criteria, which I already had in my mind because I was looking at the transaction in the same way as he was. To make this work, particularly as you are integrating, you have to be very sure about a whole series of key risk parameters. He was expressing something that I felt was perfectly natural and saying we needed to convince him—that was early days—that we could do that.

Q1886 Andrea Leadsom: Okay. Then Andrew Bailey sent a letter to Paul Flowers in December 2011 reiterating his concerns over the Verde deal. Was this letter shared with the board? Were you privy to that letter?


Q1887 Andrea Leadsom: Were you aware of it?

David Davies: No.

Rodney Baker-Bates: No.

David Davies: I was not aware of it until I saw the evidence. I have asked the Co-operative Group to provide me with a copy and so far nothing has emerged.

Q1888 Andrea Leadsom: So you still have not seen it.

David Davies: No, and it was not registered. I have tracked the board papers and I can find nothing in the board papers to show it was shared with the board.

Q1889 Andrea Leadsom: A letter was sent to Reverend Flowers, who had no banking experience, expressing grave concerns over this banking transaction. Neither he nor the regulator shared it with anybody else in the board and you were not even made aware of the existence of that letter?

David Davies: There were some statements in there that I do not know if I can answer because I am not aware of them. All I can tell you is that I did not see a letter and I do not know whether anybody saw it.

Rodney Baker-Bates: I certainly did not see it.

David Davies: From memory, I have a feeling that Barry Tootell said the letter had gone to him, but I have not checked the evidence. It is from memory.

Q1890 Andrea Leadsom: Okay. Just coming back again, would you say that Andrew Bailey’s concerns about the Verde deal affected both of your individual concerns about the deal or just confirmed what you already feared?

David Davies: Personally, no. As Rodney says, these were issues that I think were things that you would think about. We had thought about them—and forgiven me opening up another can of worms—in the Britannia deal. These were not new issues. Capital, liquidity, risk management and capability of doing a deal was something that we thought through when we merged with Britannia. It was natural that we would continue to think through them. They cropped up at pretty well every discussion we had on doing the Verde deal—quite clearly in the November discussions when we made our indicative bid and from then on in every meeting thereafter.

Q1891 Andrea Leadsom: After the December 2011 letter that you were not aware of and never saw, were you aware of any other contact from Andrew Bailey? Did you get the impression that he was warming to the deal at all between December 2011 and June 2012, or did you have the impression that he was cooling even more, expressing even more concerns, or did you just have no contact with him?

David Davies: The feedback that we got was that the FSA were engaged and I use the phrase “supportive and positive.” That does not mean to say that they were in favour of doing the deal, but they were genuinely trying to help us get to the end point to reach a decision. I am aware that Paul Flowers had some meetings with Andrew Bailey. I cannot tell you how many. All I know is that there were occasions when Paul said, “I am meeting Andrew Bailey. Give me your advice, please.”

Q1892 Andrea Leadsom: Is it not odd that since he was expressly aware of his own lack of knowledge and experience as a banker and that you were both expressly taken on to be that expertise and knowledge, you were not part of those meetings or at least involved in what was being discussed at those meetings?
**David Davies:** It is odd if the FSA’s requirement was that two deputys be appointed to help Paul with the technical aspects. As I say, that was news to me and I was not aware of that. I did not really feel put out that I was not part of the team with the FSA because I had no belief that I was—I am going to say it—a valued member of the team. The contact was between the chief executive, the chairman and the group chief executive. I do not even know whether his chairman met the FSA.

Q1893 **Andrea Leadsom:** At your respective exit interviews, what did you say to the FSA? Did you both individually at your exit interview make very clear the fact that you were gravely concerned about the Verde deal?

**Rodney Baker-Bates:** Absolutely, and I ran down the criteria. As I have already explained, I thought the group simply did not have the capital and the competence. You could go through those headings and you could talk about the risks in systems; you could talk about the risks in integration. Something that has not come up is that, in the mergers and acquisitions I have done, normally the institution you are acquiring or merging with has a track record—you can look at its performance over five years; you can look at how the management performs. In this transaction, it was a carve-out. By the time I resigned I did not even know who the management were that were coming across, except for Paul Pester. To me, that is the sort of questions I was saying needed answers. I am afraid I felt that I could not continue on something that I thought was just a slope to disaster.

Q1894 **Andrea Leadsom:** You made it very clear to Clive Adamson that you thought this was an absolute disaster waiting to happen?

**Rodney Baker-Bates:** I would not use those terms; I was a bit more subtle than that. As he said, I did not tell him anything he did not know, but I thought I was trying to tell him that here is somebody who is a deputy chairman telling you this deal is not going to work.

Q1895 **Andrea Leadsom:** Your appointment as deputy chairs was part of Mr Flowers’ arrangement with the FSA for being approved as chair, and yet when you both offered your resignations as a result of your grave concerns about a banking transaction that the FSA recognised he did not have the experience to understand, the FSA did nothing to take into account your concerns? Are you aware that they did anything differently or responded in any way whatsoever following your very clear—

**Rodney Baker-Bates:** Well, I had obviously no further involvement. I had resigned from the board so I have no knowledge of what they did.

**David Davies:** I had my interview as part of an Arrow interview in October and I laid it out very clearly. Frankly, I was certainly given the impression that they understood my problems and why I voted against. Andy Cope, who did my interview, knew of my concerns. I presume that was because I was three months after Rodney had spoken to Clive Adamson. They were very well aware of my concerns. I do not know whether directly they did anything different as a consequence of our votes. I suspect it confirmed or reaffirmed their concerns—

**Rodney Baker-Bates:** Hardened their views.

**David Davies:**—and they would just let the scenario play out to the point in time when it became clear that this was not going to happen.

Q1896 **Andrea Leadsom:** Is that, in your opinion, what a regulator should do? To hear absolutely overwhelming evidence from people of experience and then do nothing with it, is that the right way to defend the taxpayer?

**David Davies:** I think it is slightly over the top to say “overwhelming evidence” because do 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. The heads of terms was not a clear break. When you got to the SPA, that would have been a clear break when, if you like, any doubts would have had to have been surfaced. We 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.

Q1897 **Andrea Leadsom:** Just one last point: I certainly recall with various of the witnesses that we have had here an overwhelming sense that they all felt that on the board of Co-op there was a lack of experience and a lack of accountability. In effect, what the FSA did was appoint you two gentlemen to provide the expertise and then they disregarded your explicit concerns. Do you think that was a reasonable action for them to take in hindsight?

**David Davies:** Well, I do not think they appointed us. I think they pressed upon Paul it would be a good point in his favour to appoint some expertise. I think Paul seized on that and did exactly that, but I do not think they made it—well, I do not know. I am speaking of something here I am only speculating on. I do not know if they did make it part of the deal.

Q1898 **Chair:** Sorry to interrupt but just on that point, Clive Adamson said in his oral evidence, “It was not the Co-op Bank’s idea. In recollection, it came from Mr Flowers’ idea, because he recognised that he did not have sufficient technical experience. I think, as he has disclosed to the Committee, he put that agreement into practice afterwards. He viewed it as an agreement that would be necessary.” Is that consistent with what you know?

**David Davies:** All I can say is the paper that went to the board asking for volunteers made it look as if it was Paul’s idea. There was no mention of the FSA’s involvement.
Chair: Okay. Is there anything else, Andrea?
Andrea Leadsom: That’s it.
Chair: Andy, do you have any quick things you want to add?

Q1899 Mr Love: Yes, I want to go back on a few issues. Let me, first of all, as usual, draw the attention of the Committee to my designation as a Labour and Co-operative Member of Parliament. Can I just be absolutely clear about this signal that the regulator, Andrew Bailey, was sending to the board? It has been characterised by them as being a stark message: grave concerns have been raised. How do you remember Andrew Bailey’s intervention? I do not know exactly when the letter was drawn to your attention, if it was. Did you get the impression that this was a stark message from the regulator?
Rodney Baker-Bates: We never saw the letter so I presume you are referring to July. 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.

Q1900 Mr Love: Mr Davies, it seems to have had little impact. People were already convinced of what the regulator was saying in his five points, but it did not seem to convince much of the rest of the board. Would you agree with that?
David Davies: Convince is not the right word. There were a number of activities that were launched on the back of that: risk framework design; liquidity management, trying to tighten it up—although I think that is one area where we would disagree with the regulator; our liquidity management was not that bad—capital we were clearly very much aware of and it was under the microscope, with a regular review on a monthly basis; management actions to raise more capital; the sale of the life fund; the potential sale of the general insurance business; the deleveraging of the balance sheet. Things like that were all there on the table to be considered—even the potential for group to provide a capital injection, albeit the last resort.
On management stretch, the risk committee in particular had a number of meetings both with Paul and Peter Marks to say that we were concerned with the number of resignations and the way the organisation was stretched. We kept management stretch as a regular item on the risk committee and on the boards and got reports from human resources about how we were coping. Things on that front seemed to be improving towards the end of 2012 when we were recruiting into the organisation some very good, experienced individuals.
Governance was an issue that was ongoing. There were meetings between Paul and the regulator on improving the governance, slimming down the size of the board, bringing on to the board specific skills. We were aware that we had a balance issue of being more banking expertise. We did not have any treasury expertise on the banking board. We did not have any large systems expertise on the board. We were looking to recruit people on to the board that covered both those positions and that was due to happen around about the end of 2012, although it did not actually happen until much later on.

Q1901 Mr Love: I want to come back to that in a second. You mentioned earlier on when asked about political involvement in this whole process that there had been contact. I think that was the word you used. Could you elaborate on that for us? Where did this information arise?
David Davies: I can only do it from memory and it is in the board papers. The board papers refer to Peter Marks having contact with a Treasury Minister. There was a phrase used in the board papers that referred to “goodwill” from the Government towards the deal.

Q1902 Mr Love: But you had no board discussion about that?
David Davies: No.

Q1903 Mr Love: You accepted the report as given in the board papers?
David Davies: I would have expected there to have been interaction between the group board and the Government or the Ministers.

Q1904 Mr Love: Mr Baker-Bates, let me go back to the issue of the chairmanship of the merged entity. It is a fact that Neville Richardson was appointed as the chief executive officer. In your experience, would that normally mean that automatically the other partner to the merger would choose the chairman? Would that be normal?
Rodney Baker-Bates: Well, normally the chairman is appointed by the board, that is how it works, and then confirmed by the shareholder when he is re-elected as a director. It is customary sometimes to do that, but I would not say it was normal. You have to look at the individuals involved.

Q1905 Mr Love: I understand that, but the point I was trying to make was it would be, I think, normal practice in order to meld the merged organisation together for one of the two most senior people on the board to be from each of the organisations, wouldn’t it?
Rodney Baker-Bates: It seemed to me perfectly natural, given it was a wholly owned subsidiary of the Co-operative Group and it was a merger. That seemed to me like a perfectly sensible division.

Q1906 Mr Love: You also mentioned a shareholder appointment—the chairman should reflect the shareholder—which is rather unusual, as you both commented, in this regard. Would it be unusual in the selection of a chairman to ask questions that related to knowledge and experience of who the shareholder was? You mentioned earlier on in your comments that you had been asked a lot of questions about the Co-op Group and the wider Co-operative movement. Wouldn’t that be normal that there would be an expectation that if you were to represent the shareholder, you would have some understanding of the shareholder and who the shareholder was?
Rodney Baker-Bates: Yes, absolutely. Obviously, I come from a plc background and it is slightly different. In a wholly owned subsidiary it was clearly an important skill, which was not my strong suit, I absolutely acknowledge that.

Q1907 Mr Love: Can I ask you, Mr Davies, how independent, in your view, was the bank board? After all, it is a plc within a wider co-operative governance arrangement. It had its own executive, its own chief executive, and its own board with many non-executive directors. How independent was it? You were on the board for quite some time through various mergers and changes and, indeed, a slimming down of the board as you mentioned earlier on. How would you characterise it as an independent board?
David Davies: I would regard it as independent. I do not think we were instructed to do anything that we would not have wished to do. My only caveat on that is Project Unity and the overlap that was created. Some functions that were bank and insurance ended up being merged with group functions and so we lost an element of independence there. I am also sorry to say that I think the requirement for Neville to report into Peter also damaged the relationship between the chief executive and the board, because he had basically two masters to report to. I have worked in a situation like that as a chief executive and it can work. It is not comfortable if the group chief executive you are reporting to does not see things in the same way that your board does and then you find yourself getting squeezed. In hindsight, I wish I had thought more deeply about that and tried to somehow accommodate Neville because—a personal opinion—I think that was the major reason that Neville gave in and gave up: he did not like the reporting lines.
Chair: One more question.
Mr Love: I thought we had until 11.15 am.
Chair: Yes. I have one rejoinder I want to come back to.

Q1908 Mr Love: Okay. I will try to be brief. I want to ask two more questions if that is possible. Mr Baker-Bates, could you foresee any circumstances where Project Verde would have gone ahead without the approval of the bank board?
Rodney Baker-Bates: No, I am absolutely clear. Otherwise I would have resigned earlier. I stayed on because I wanted to make the argument and persuade the bank board not to proceed with Verde. If I believed that the group board would override that decision, I would not have stayed on.

Q1909 Mr Love: Even though the executive and the people that were doing the negotiation were primarily from the group board, they would have sought and it would have been necessary to have approval of the bank board before they could be given the green light?
Rodney Baker-Bates: I cannot imagine that any independent would have remained on the board if the bank board had voted against it.

Q1910 Mr Love: Can I ask you one final question? This is posed to both of you. The board slimmed down from 22 to 14. On my estimation, nine of those board members had either financial banking experience or insurance experience. Was that your view? I am turning to you first, Mr Davies. You mentioned the whole issue of balance on the board. Did they have enough financial expertise on the board to take these decisions? Were you confident, even accepting the shortcomings of the chairman, that the board was adequately experienced and knowledgeable in these matters to take these decisions?
David Davies: Yes, I would be happy to confirm that. My only concern was that they were spread thinly across all the committees. 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. Another issue about governance is we covered three separate organisations: life company, general insurance company and the bank. Therefore, expertise was being more thinly spread because of that. We improved the situation when we started to create dedicated boards for the general company and for the life company, but we were too late in doing that—well, we were late in doing it, not too late.

Q1911 Mr Love: Do you wish to add anything, Mr Baker-Bates?
Rodney Baker-Bates: No, I would share David’s view. There was enough expertise but it was too thinly spread.

Q1912 Mr Love: On your basis, Mr Davies, they were taking action at the time you came off the board to address those issues?
David Davies: Yes. My test is: are there any decisions in hindsight that we took that I would not have taken?
The Verde decision is one that I would not have taken, but I would have got there earlier than I did. I think we were right in pursuing it so far. I only wish we had stopped it sooner.

Q1913 Chair: That is very helpful. There is one further issue that comes out of that to some degree—many, actually, but one that I want to ask you about that I am still puzzled by. It is clear that the bank board was not the key driver of this transaction at key points. This was being done through the group board and your evidence has been unequivocal on that point. Correct me if I am wrong.
Rodney Baker-Bates: No, you are right.
Chair: The bank board could have stood up for itself, couldn’t it? The bank board could have said, “Look, this just will not do and we want to be much more closely involved in this deal. This is, after all, a financial transaction and it is absolutely essential that we have a bigger role.” Why didn’t the bank board do that?
David Davies: I would question where you think it did not have a big role. The risk committee and the bank board were meeting every month on the Mars subject and were heavily engaged. Where we were not engaged was the financial terms of the offer.

Q1914 Chair: That is the key issue, isn’t it, of any deal? That is the heart of the matter.
**David Davies**: In a sense, I could look at that and say the financial deal was a very good deal. Here we were providing £350 million financed by the vendor, so we were not dipping into our own pockets. It was when we got to capital that the banking board—

**Q1915 Chair**: I can ask this question many different ways but it amounts to the same question, which is, as you have said, the main board was driving the deal, not the bank board. I am saying why didn’t the bank board say, “We should be”—

**Rodney Baker-Bates**: 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, 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.

**Chair**: That is very helpful. We are very grateful to you for giving evidence this afternoon. It has been extremely interesting, enlightening and, in one or two places, surprising, as it always is when we take evidence on this subject. We now have Treasury questions on the floor of the House so we will bring the meeting to a close. Thank you very much.

**Rodney Baker-Bates**: Thank you.

**David Davies**: Thank you.
Tuesday 11 February 2014

Members present:
Mr Andrew Tyrie (Chair)
Mark Garnier
Stewart Hosie
Andrea Leadsom
Mr Andrew Love
John Mann
Mr Pat McFadden
Mr George Mudie
Jesse Norman
Mr David Ruffley
John Thurso

Examination of Witness

Witness: Andrew Bailey, Deputy Governor of the Bank of England for Prudential Regulation and Chief Executive Officer of the Prudential Regulation Authority, and former Managing Director of the Prudential Business Unit of the Financial Services Authority, gave evidence.

Q1916 Chair: Thank you very much for coming to give evidence to us this morning, Mr Bailey. We have a lot of ground to cover on Verde. Before we do that, I have two initial questions and it is possible that one or two colleagues may want to cover similar ground coming to straight after me.
First of all, on the bonus cap, we are in the bonus season. I want to be clear on whether you agree with what the Banking Commission concluded on this issue, which it did after looking at it in great depth. It opposed the bonus cap, not on the grounds that it might make the UK less competitive nor because it might be easy to avoid, although those may or may not be true, but because it would not tackle the key problem of bonuses, which is that they were incentivising the wrong kind of behaviour. Do you agree with those conclusions?
Andrew Bailey: I do.

Q1917 Chair: The second question is, do you think that the bonus cap effect on the current bonus round is bearing out that concern?
Andrew Bailey: I do. I should say, of course, it is looking forward to the next bonus round. This bonus round is the last of the old regime in that sense, but banks have to put in place what they are going to do in the next round. To be strictly true, that is an important distinction to make. I do detect, as we have discussed before, a pressure to increase the fixed element of remuneration at the expense of the variable bonus element of remuneration, and that has two concerns for us. One is that it risks reducing the flexibility for banks to adjust remuneration and therefore build capital. Secondly, to the point that you specifically raise, it has the risk that it creates the wrong incentives.
We have done a lot of work in the last three or four years to adjust the remuneration structure to improve the incentives; to create greater deferral of remuneration, a point that the commission that you chaired put emphasis on and I agree with that; a pressure to reduce the amount of what I call cash out of the door, because that is directly relevant to capital retention; and a pressure, in the context of that deferral, to use the tools subsequently in the period of deferral of malice and also—and we are going to consult on this very shortly—claw-back, which is the bringing back of remuneration that has been paid out. Malice is where it is deferred but not paid out. I agree with you on all of these.
There is a question that you have seen covered, which is: are banks seeking to evade the rules, these so-called allowances? My view on that is that is all about the fact that the bonus cap then forces a definition of what is fixed remuneration and, therefore, where the boundary is. These allowances are not things that can vary as a result of the performance of the bank or the performance of the individual—that is strictly not allowed under the CRD IV regulations—but they are being used and I think this is sensible, going back to my two points about why we care about this. For instance, in a situation where the bank suffers a shock to its capital position, we want to be able to get them to adjust future remuneration downwards. That must be the right answer.
Chair: Therefore, it makes the task of keeping the banking system secure more difficult.
Andrew Bailey: Yes.
Chair: Making the job of prudential supervision more difficult.
Andrew Bailey: Yes.

Q1918 Chair: Unless other colleagues want to come in on this point, it might be helpful to have clarification on one other point. Do you therefore want to see the bonus cap overturned in the courts?
Andrew Bailey: I have supported the UK legal action. I have provided a so-called witness statement, which is largely drawn from things I have said to this Committee in the past because they are on the record. So, yes, my position is clear.

Q1919 Chair: Unless colleagues have other points they want to raise on that, I would like to move on to one other issue that has put the Bank of England as a whole in the news, which is that the bank might have condoned manipulation of foreign exchange benchmarks as a result of the way the market shares customer information. Are you investigating this? What is going on?
Andrew Bailey: Yes. The Bank of England does not condone any form of market manipulation in any context whatsoever. We are supporting the FCA’s investigation. We have done so from the outset. We are also playing a leading role in work, which of course goes much more broadly than the FX
benchmarks, into the reform of the process of setting benchmarks in financial markets; something that Mark Carney is leading in his capacity as Chairman of the Financial Stability Board. The governors, in the plural, of the bank have taken the claims about the meeting with bank officials extremely seriously since we first heard about these allegations. Just so you know, we first heard about them in October. We have released a minute of that meeting, but there are now allegations that there are different versions of what happened at that meeting.

What I can tell you is that the governors immediately initiated a full review into it. That is being led by the Bank of England’s legal counsel, but also supported by external legal counsel and it is working in close co-operation with the FCA. On the evidence that we have currently, we have no evidence to substantiate the claim that bank officials in any sense condoned or were informed of price manipulation or the sharing of confidential client information but, like the investigation that the FCA is doing and obviously bearing in mind what has been said in the last week, we do not regard that review as over. We will take into account any information that we get. The review is not over until the information has all appeared, and we do not know what is yet to appear.

Q1920 Mr McFadden: As part of this investigation, Mr Bailey, you are investigating yourselves because the allegation in the Bloomberg report from a few days ago is that the meeting of the Bank of England’s Foreign Exchange Joint Standing Committee with traders in April 2012 condoned information sharing before they are fixed and that report says they even said it could be a positive thing.

Andrew Bailey: Just to be clear, it was a sub-committee of the standing committee, but that is obviously a technicality. We are investigating it because, as I said, we take that very seriously. I should say we have no evidence yet and we have not seen the evidence that was in the Bloomberg report. It has not been submitted.

Mr McFadden: Have you spoken to the person who wrote the Bloomberg report?

Andrew Bailey: No. We have spoken to the FCA because they are conducting the investigation, including the investigation into the individual. They have not seen that evidence, but we have said to them that we take it extremely seriously and if that evidence does materialise or if the individual would now like to provide that evidence, if they have not already done so, that will be part of our investigation.

Q1921 Mr McFadden: You understand the context of this. The bank has just taken over greatly increased regulatory responsibilities. After LIBOR, people now have doubts about the honesty of the foreign exchange fixings, and indeed other benchmarks that we asked Mr Wheatley about last week. If there was corruption that the bank had somehow turned a blind eye to that kind of activity, it would be enormously damaging to confidence in the bank in this new regulatory environment, wouldn’t it?

Andrew Bailey: That is one of the reasons why we take it so seriously. I agree with you on that. That is why we have set up this investigation and this process. You are right; in a way I would say it does not turn on the issue of whether the bank is a regulator or not. It turns on the issue of the central bank’s position. Obviously becoming the regulator adds to that, and I agree with you on that, but you can be assured that the governors take the whole question of the reputation and the integrity of the central bank extremely seriously. It is the most important thing we have, so I can’t emphasise to you enough how much, first, I agree with you on this point but, secondly, we take this seriously.

Mr McFadden: I suspect it is an issue we will return to.

Andrew Bailey: I am sure we will.

Q1922 Chair: Can we turn to the main subject of the hearing this morning and begin by asking you, with respect to the Co-op, who among the senior people, who we have all heard from now, do you think is primarily responsible for the collapse of the Co-op? I don’t want to exclude anybody but just to include four names: Peter Marks, Barry Toottell, Neville Richardson or Paul Flowers.

Andrew Bailey: I think the answer to this question has to go to the root cause of the problem and that, in my view, is not the Verde transaction. We can come on to the Verde transaction because it is important, but it is not the root cause of the problem. The root cause of the problem goes further back. In my view, there are two root causes that relate to the two parties that created the Co-op out of the Britannia merger and they are different root causes.

I have written to you on this question because there was a disagreement between myself and Neville Richardson on this after my previous evidence here and his evidence here. I think the root cause in Britannia was the problem of the loan book and obviously I wrote to you on that. I think the work that has been done more recently on that loan book, and particularly the commercial loan book, has tended to reinforce that. 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.

I have been all the way through the records of the supervision of these institutions, going back at least to the immediate pre-merger, and you see comments from very senior people in Britannia. Indeed the then chairman of Britannia was saying that he did not understand why the bank had gone into the commercial lending business, but it was quite clear that this was a set position within the board before he became chairman. Secondly, you had a mortgage book that had a very low proportion of prime mortgage lending with high impairments, a point that I think has come out in your previous hearings. So that was an embedded problem.

I think the root cause with Co-op is quite different and does not have the same what one might call culpability, because the problem with Co-op was that it was a full-service retail bank but very small. Prior
to the merger with Britannia, I think it had a balance sheet of just over £16 billion. For a full-service retail bank, that is extremely small.

Chair: Just give us an idea of the size of a full-service retail bank.

Andrew Bailey: If I am right, Lloyds, pre-merger with HBOS, had a balance sheet of about £350 billion. Lloyds was probably at the smaller end of the big banks. Nationwide today has a balance sheet of just under £200 billion. This is one of the issues in the whole competition debate. Being in the personal current account market has expensive overheads attached to it. Obviously there is debate about whether some of those are justified or not. I think you have had it said to you, and it is very clear in the records, that 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. They felt they had to do something. That led, in a sense, to the merger, but the problem was that 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 happened over a year between summer 2008 and summer 2009, the most febrile period in the whole of the financial crisis and in those days I was responsible for resolution. I was not a supervisor in those days. I had to resolve the Dunfermline Building Society that failed end of March 2009. It was much smaller. Bear in mind that Britannia was the second largest building society, although there is a huge gap between Nationwide and the others but it was still the second largest. If I remember rightly, it had a balance sheet of just over £35 billion. The merger happened during this febrile period. The Dunfermline had to be resolved. The West Bromwich Building Society had what these days we would call a bail-in of subordinated debt; a little bit like what has happened with Co-op, but it was much simpler in that case because there were a relatively small number of holders of it. Today it has a new management team that I think is doing a very good job to bring it slowly out of that problem. The big question, which we keep going back to, was that the 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. The question is, was that the right thing to do in 2009? I think it would have been very difficult to have done a full resolution of Britannia at that point were it necessary—frankly, I think it would have risked undermining more building societies because it was so much bigger—but it left the problem unresolved.

The problem could have been dealt with, and I think these were assumptions that underlie the business model, had the economy recovered, particularly had interest rates risen and therefore the squeeze on net interest margins been alleviated. That has not happened and, therefore, the problem was there. Verde was a further attempt to build up the Co-op into something that was sustainable and larger. Putting the Co-op and Verde together met the independent commission’s test on a challenger bank. If you remember, there are recommendations on Verde in the independent commission report that the Government accepted. Ultimately, Verde could not be done anyway without solving the underlying problem. The underlying problem went back to capital and the other things that we discussed when I was last here in answer to Mr Norman’s questions, but the other things were more capable of being dealt with. Risk management and governance could be dealt with and they were dealt with progressively. There are two things: the capital question and whether they could generate a business model that could generate earnings to sustain the position of the bank and build it out of these problems ultimately defeated it. Sorry, that is a long answer.

Chair: I am going to pass the question to David Ruffley but, before I do, the question was, which of these individuals was responsible?

Andrew Bailey: I know I am unpopular in some quarters for saying this, but I think more of the responsibility for the embedded problems goes back to Britannia.

Chair: Meaning?

Andrew Bailey: The management of Britannia.

Q1923 Mr Ruffley: Mr Bailey, I find your arguments very compelling. I think this is the first time this Committee has had such an unambiguous statement on the prime cause for the Co-op’s difficulties. Just to clarify this, it seems you have launched an Exocet at the chief executive, the chairman and the former board of Britannia. Are you saying that the Britannia assets were the prime cause of the Co-op’s troubles?

Andrew Bailey: The root cause, yes. The second thing that came along—

Mr Ruffley: But is the root cause the same as the prime cause?

Andrew Bailey: Yes, I think it is. The second thing, which is a point I probably should have mentioned and I apologise, is that the losses on the write-off of the information technology transformation programme—I think there was some confusion in one of your hearings on this—which I think are now about £598 million, are 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 situation.

Q1924 Mr Ruffley: The question of write-offs must have been foreseeable by the Co-op management.

Andrew Bailey: Foreseen?

Mr Ruffley: Foreseeable, if they were acquiring Verde with all the Lloyds’ IT infrastructure.

Andrew Bailey: Yes, I think the question here goes to another issue that has come up in the hearings, which is the letter that we sent to all banks in December 2010 following an FPC recommendation concerning the interpretation by banks of the provisioning standards. I think Barry Toottel has referred to this as the shock. Bear in mind that this letter went to all the banks. As you know, there is a huge debate in the accounting standard-setting profession about the

Correction by witness: figure should be £298 million.
question of incurred versus expected loss provisioning. As regulators we think the standard needs to be forward looking and, therefore, more in the expected loss world, but that was not the issue with this letter. The issue was we felt that within the existing standards there were practices that were leaning towards underprovisioning, i.e. not looking at questions on a more forward-looking basis, such as refinancing risk. Bear in mind that we 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.

The reason I raise this in the context of your question is that I think it goes exactly to the point you make. 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.

Q1925 Mr Ruffley: Understood. I want to come back to a letter you wrote to this Committee on 10 September regarding Neville Richardson’s evidence. You talk about your concern was “not just that the former Britannia assets had contributed a significant proportion of the Co-op Bank’s loan losses”—we knew that—“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.” Just so I can clear about this: were you saying and thinking what I have just read out? Was this on the 12 July 2011 away day with the Co-op?

Andrew Bailey: No. I must be clear on this. Mr Ruffley: I want to pin down, when were you saying that the Britannia assets were vulnerable to further stress?

Andrew Bailey: To be honest, July 2011 was very early in my time in this role. I had a view—and the supervisors had sympathy with the view—that there was an inherited problem in Britannia. The reason for me holding that view, going back to what I said a few minutes ago, was my view of the problem we saw in 2008–09 and how near it got to a very difficult situation, but we had not done the detailed asset quality review work in July 2011 that has been done subsequently or indeed the stress test.

The reason I made the comment in the letter was the two things I mentioned earlier as examples. One was that the asset quality review work has revealed the problems of refinancing these loans. To give you a metric, the share of these loans—bear in mind that these are commercial property loans, but you can use similar metrics—that have loan to value ratios of over 100% are going to be inherently very difficult to refinance. Secondly, we felt, as a result of the asset quality review work, that the degree of structural subordination in these loans, because these loans typically have more than one bank providing the loans, or the structure of the lending was not appreciated. The reason that I stress structural subordination is it is just more likely that these loans are going to be impaired if they are structurally subordinated.

The final point I would make, and I think this is a point that Co-op executives have made, is that Britannia had a policy of taking more concentrated loan positions in single loan exposures than, say, Co-op did. When you had Barry Tootell here, I think he pointed in answer to a question that he now realised that there were far more problems in that loan book than they did at the point when they did the fair value adjustments in the context of the merger.

Q1926 Mr Ruffley: You have said now very clearly why you thought the Britannia assets were vulnerable to future impairments in your opening answers to Mr Tyrie and to me. The shortfall exercise revealed Co-op’s £1.5 billion capital black hole. Do you think it is likely that there are more Britannia asset-related losses to come or do you think we have seen the worst of them?

Andrew Bailey: We have no evidence to suggest there are more to come. I should say, because who knows what the future will hold, it is possible that the future will turn out better. If we see a sustained recovery of the economy and the commercial property market—and we are seeing the beginnings of some signs of that, although the commercial property market in this country is very tiered so you have to be very careful what bit of commercial property and what particular type and area of the country you are looking at—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.

Q1927 Mr Ruffley: A final question, because I know lots of colleagues want to get in on what I think is incredibly powerful testimony that you are giving to us. Would Britannia have failed had it not been for the merger with Co-op? Let me tell you why I ask that question. It seems to me that there were some real systemic structural problems with their loan book, and you have articulated that very clearly. Do you think they were incompetent in missing this? I am talking about the board and management of Britannia in the run-up to merger. Were they incompetent or do you think that it was a desperate throw of the dice to avoid Britannia itself collapsing? Is that why they did the merger?

Andrew Bailey: 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. One of the reasons for that was the activities of institutions like Northern Rock.
This was a model in which there was a severe squeeze on lending margins, particularly in the prime mortgage market because it tends to happen more there. What that had led to was institutions that were not the strongest and largest players in the market—I will come back to one of the largest players—therefore looking to diversify their lending activities to earn larger returns. To simplify it, they were doing one of two things. They were either going into what you might call the fringes of mortgage lending, so into the self-certify non-conforming market, or they were going into commercial property lending. Dunfermline, which I had to resolve, had gone into both of those and Britannia had. The problem was that they did not have the risk management skills to manage those sorts of businesses and, as a result, they do not have the same flexibility to raise capital to manage those sorts of lumpier risks.

By the way, the same is also somewhat true of the HBOS story. HBOS moved out of their traditional prime mortgage lending market because the returns on it were being squeezed and, disastrously, moved into other lending markets that they did not have the skills to manage. The long answer to your question is there is a common theme there.

Q1928 Mr Ruffley: That is a very useful response, but I just want to repeat the question. In the run-up to merger, were the Britannia board and management incompetent in taking the course of action you have described? Did they miss it through incompetence or do you think they pressed ahead with the merger with Co-op because they thought this was the only way to stop their own implosion? Which was it?

Andrew Bailey: They deny the second.

Mr Ruffley: What about the first?

Andrew Bailey: I think they were completely convinced of the rightness of their business model.

Some of the evidence you have had before you is that they still are, to a degree. It is quite interesting. Rodney Baker-Bates, who I think became chairman of Britannia in its last two years and joined the board for about the last three years, said to the supervisors at the time, “I don’t understand why Britannia has gone into commercial lending. It doesn’t look like a good thing to have been done, but the board is clearly convinced that it is right and doesn’t seem to be shaken of that judgment.” He also described the loan book as “racier”; I think that was the word he used.

Chair: To be clear, you said that they are still convinced of their business model. Just translating that a little, do you mean they are in denial?

Andrew Bailey: I have read all the transcripts of your hearings and I have to say that was one of the conclusions I drew from it, yes.

Q1929 Jesse Norman: Thank you very much indeed, Mr Bailey, for what is proving to be a gripping session. You have drawn a picture in which, in the middle of the first decade of this century, Northern Rock and other institutions were putting a squeeze on traditional margins.

Andrew Bailey: Yes.

Jesse Norman: These institutions are hunting for returns and they are therefore diversifying outside their traditional areas. Might it be fair to add that some of them have been carried away by great dreams of investment banking-type glory and potential remuneration?

Andrew Bailey: There was probably some of that as well. Not on the same scale but some of that, yes.

Jesse Norman: It is hard to imagine anything being on quite the same scale. You can comment on that if you like, Mr Bailey. When you said that, it seems to be an implication of that the mutual model is not broken. It has simply been very badly abused in the context of these unusual market conditions.

Andrew Bailey: I think the mutuals were put under stress particularly by what was happening in the institutions that had demutualised.

Jesse Norman: My colleagues will come on to that. I just wanted to be clear, briefly, that is the kind of implication that you are gesturing towards?

Andrew Bailey: Yes. To be clear, of course, we should not tar all building societies with this brush because some of them took actions that have stood them in good stead. Some of them 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.

Q1930 Jesse Norman: Good. You did not address the specific question, as far as I understood it. Would Britannia have failed had it not been for the merger?

Andrew Bailey: Bear in mind I was responsible for resolution at the time and bear in mind the febrile conditions at that time, my view at the time was, yes, it would.

Jesse Norman: It would have failed?

Andrew Bailey: Yes. I think the merger essentially took it out of the limelight, and that was the key. In that sense, of course, it achieved its objective.

Chair: Britannia was rescued.

Q1931 Jesse Norman: I just wanted to be perfectly clear. That is helpful. The second thing about that is you also said that, based on your considerable understanding of resolution—I doubt if anyone knows more about the issue than you do, Mr Bailey—it would have been difficult to do a full resolution of Britannia. To me, that implies liquidation or nationalisation.

Andrew Bailey: I agree. This is a key point. Had we had to do the same thing for the Britannia that we did for the Dunfermline Building Society, which was, in your term, liquidation—a transfer of deposits to another institution and the rest goes into an insolvency process essentially; some assets went over but not that many—bearing in mind that Dunfermline had a balance sheet of about £4 billion, if I remember rightly, and Britannia had a balance sheet of about £35 billion to £37 billion—

Jesse Norman: Yes, it is nine times the size.

Andrew Bailey:—you are talking about a wholly different order of magnitude. The other thing I would...
say, and this is an issue that remains to this day, is that, had we done that with Britannia, we would have increased the burden on the Financial Services Compensation Scheme. That is relevant because today one of the statistics that is important in the competition context is that, if I remember rightly, about 25% of the earnings of the building societies collectively go to the FSCS to pay the legacy costs of Bradford & Bingley, Dunfermline and some Icelandics.

**Jesse Norman:** So this might have sunk the FSCS?

**Andrew Bailey:** Yes, and that is a burden on the building societies. When I quote that 25% figure, it is important to remember that earnings in the building societies are low because of the squeeze on net interest margins because of low interest rates. It is 25% of a smaller number. The point I am making is, had we put Britannia in there, I think you would have had a much larger number than 25% and you would have seen more building societies disappear because they would have found it unsustainable.

Q1932 **Jesse Norman:** Anyone looking at the situation of Britannia in a fairly cool-eyed way in 2008–09 would have concluded that, from a political standpoint, there was a compelling incentive to tidy away or somehow prevent either the liquidation or nationalisation of Britannia because it might well have taken out the general scheme and therefore the wider industry.

**Andrew Bailey:** The only point I would disagree with you on that is the word “political” judgment. I don’t think you should tar politicians with this brush. I think there was a broader reason for this. I don’t want in any sense to think this was a judgment made by particular politicians with which later they disagreed. I still think today, if we faced that situation again, it would not necessarily be the wrong thing to do, bearing in mind the tools we had available to us at that time.

**Jesse Norman:** Just to be clear then, not merely political but public interest?

**Andrew Bailey:** Yes.

Q1933 **Jesse Norman:** That is very helpful. When you talked about responsibility for the catastrophe of the current circumstances surrounding the Co-op you said that the responsibility for the embedded problems, the main cause, lay with Britannia. I want to suggest to you that the embedded problems are only part of the general problem and that there does seem to me, from what you have been saying, to be very clear culpability on the Co-op side on two grounds.

One is because they took over the Britannia with its embedded problems in a way that, in retrospect, looks extraordinarily reckless at a time when the market was febrile. Would you agree with that?

**Andrew Bailey:** Yes.

**Jesse Norman:** The second is because they themselves did so at a time when they were looking down the barrel of a gun on a whole series of other sources of loss within their own operations and businesses, notably the IT losses that you have mentioned.

**Andrew Bailey:** The IT losses predominantly emerged from the bringing together of Co-op and Britannia.

**Jesse Norman:** That was a collateral cost that they should have anticipated with the merger.

**Andrew Bailey:** Yes, but if you go back and replay history—I set out these two problems—I think the Co-op’s problems were slower burn. Because of this point about being a full-scale retail bank with a very small balance sheet compared to others, the Co-op would have had to deal with that issue eventually. I am not saying, however, that they had to deal with that issue in 2008 or 2009. I suspect they could have gone along relatively out of the limelight, earning fairly low returns but not critically low returns from the point of view of the business model they had. Eventually, as I think a number of people from the Co-op have said in these hearings, they had to deal with that issue but I don’t think they had to deal with it at that time.

**Jesse Norman:** Just to be clear, this has been a total disaster for the mutual members of the Co-op. They have gone from having a small high-cost bank to having at least a £1 billion hole in the balance sheet, of which half would be from the Britannia underperforming assets that we know so far and half from the IT costs associated with the merger.

**Andrew Bailey:** You are right and also, to pick up your point, they have gone from being a small high-cost bank to being a larger high-cost bank. They have never solved the cost problem.

Q1934 **Jesse Norman:** Good. Then I want to ask you another question. There is another person, who I am sad that we have not had a chance to call to this Committee but who ought to be put in the frame for responsibility, and that is Len Wardle, the chairman of the Co-op itself. We know that the Co-op Group was driving the merger on Verde, as well as some of the other changes in the bank. Of course he was the chairman of the group and he will undoubtedly, as such, have taken a close interest in the appointment of Paul Flowers as bank chairman and so on. Do you think he bears a degree of responsibility and, if so, how much?

**Andrew Bailey:** I think the Co-op Group do. My reading of this and my evidence on this would suggest that Peter Marks was the driving force behind the Verde thing.

**Jesse Norman:** He said that himself.

**Andrew Bailey:** Of course, to your point, you can say that Len Wardle was the chairman of the Co-op Group. The role of the chairman is to rein in the chief executive when the chief executive is going beyond the limits of what the business should sustain. So in that sense, yes.

**Jesse Norman:** After all, the situation with Britannia was hardly hidden in 2008–09 and the wider circumstances with institutions getting into difficulty all around the marketplace was hardly hidden.

**Andrew Bailey:** Yes, I have to confess to you I can’t remember the date when Len Wardle became chairman of the Co-op Group.

**Jesse Norman:** No, but the general point about group responsibility must be perfectly clear.

**Andrew Bailey:** Yes.

**Jesse Norman:** You must have been amazed, in retrospect, that they consummated that, given what people knew about the Britannia.
Andrew Bailey: I think it is and you have had evidence, particularly from Barry Toote, that indicates that it was a mistake.

Q1935 Jesse Norman: You have said that in your judgment Peter Marks was the driving force, as well as him having identified himself as such. Students of history will recall that the Co-op made a previous large acquisition, which was Somerfield, a completely different kind of business, a retail business. That has turned out to be a disaster for the Co-op. Some of the evidence that we have had suggests that Peter Marks thought running a bank was like selling groceries, like running a retail chain, and that all retailing was automatically sui generis even though the differences existed. Do you think that contributed to part of the catastrophe of merging with the Britannia?

Andrew Bailey: I think we have to be a bit careful here. I have no evidence about Peter Marks’ involvement in the Britannia transaction. By the way, it is all before my time as supervisor so I can only tell you from what I have read in the files on that point. I don’t have any evidence to point to Peter Marks in the context of the Britannia transaction.

Jesse Norman: Thank you for that. It is the wider point about the association of banking and retail that I wanted to get to.

Q1936 Stewart Hosie: Mr Bailey, could you describe your view on how the Co-op’s capital position developed over the period between 2011 and 2013? How did you see that deterioration and how did you see the capital position move?

Andrew Bailey: I would say that in the summer of 2011, when we quite clearly put the board on notice on the capital position, the evidence for that was two things. One was that we were pointing out to them that they were relatively less well-capitalised than the other major UK banks. I have to be clear that Neville Richardson’s response was, “That is because the others have all raised capital. We used to be at the top of the heap and now we have gone down to the bottom.” We said, “Yes, but you know that, with the introduction of Basel III, you have the period of time; you are going to have to add capital”, and I think at that time we put that number at a bit under £1 billion. That is the first thing.

Q1937 Stewart Hosie: I will come back to the regulatory changes in just a moment. When did the regulator’s view change from the general concern that the Co-op might have to strengthen its capital position, which you have described, to a very serious concern that they had a significant capital shortfall?

Andrew Bailey: Let me quickly accelerate through the story. The second thing we said to them was that, “If you want to do the Verde transaction, you are going to have to be in a position to support the capital that will be needed for it”. The Verde transaction was then reconstructed because the bigger version of the Verde transaction fell apart and Co-op pulled out as the exclusive bidder in March-April 2012. The Verde transaction was then reconstructed in a smaller form, which was more beneficial to the Co-op in terms of capital. The Verde transaction, for which I think I am right in saying the heads of terms were signed in late June or early July 2012, was a more favourable transaction. As I think I said last time I was here, we then did the stress test of the Co-op. Bear in mind, as I was saying earlier, alongside that stress test we were also doing quality review work. It was at that point that the scale of the capital issue within the Co-op, separate to the Verde issue, became much clearer.

Q1938 Stewart Hosie: The cause of the change, in the regulator’s mind, from having a problem to having a serious problem was at the period when you undertook the stress test and thought, “Goodness, something isn’t right”. Co-op say, and you alluded to this in the last answer, that it was the change to the regulation, the additional burden of holding more capital in relation to Basel III. Is the truth somewhere in between or is the Basel III capital requirement just an excuse?

Andrew Bailey: No, it is not a Basel III point. It goes back to what I was saying earlier and it goes back particularly to this question about the interpretation of the letter we sent out to all the banks on provisioning. We reached the view that Co-op were taking much—I will use this word carefully—looser approach towards that than others, and indeed looser than the standards we felt they should have taken. That is one of the key moments.

Q1939 Stewart Hosie: That is helpful. In July 2011 you warned the Co-op that it might need to raise an additional £900 million of capital. That figure rose to £2 billion in the event of a successful Verde acquisition. First, how do those figures relate to the £1.5 billion capital shortfall ultimately announced in 2013? Secondly, why did the hole in the Co-op’s balance sheet, the level of distressed assets, come to light much later than the other banks or other financial institutions?

Andrew Bailey: Let me say that the £900 million and the £1.5 billion are different. The £1.5 billion is added to it in that sense.

Stewart Hosie: Sorry, the £1.5 billion was added?

Andrew Bailey: Yes, because the £900 million is the Basel III requirement. The £1.5 billion is recognising the issues within the Co-op balance sheet, which, by the way, the IT issue becomes part, as you understand. 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.

We intend to come out of this approach this year. The FSA had built, following 2008, the ability to do sequential stress testing of the major banks so that, essentially, every major UK bank could be stress tested about every two or two and a half years, because they did not have the technology and the
capacity to do it. Had that capacity existed, I think the £1.5 billion would undoubtedly have come out sooner.

Stewart Hosie: I hope at some point in the next few years we will be asking you why it has been such a great success.

Andrew Bailey: We will see, but it is a big point for us.

Q1940 Stewart Hosie: One final question. You said that the second iteration of Verde was much more favourable for the Co-op. Did you take the view at that point that Verde was a means of filling the Co-op’s capital gap?

Andrew Bailey: I think Verde had the potential to do three things. It would have helped with the capital gap because Lloyds, under the reconstructed Verde for instance, were going to underwrite the IT cost, bearing in mind that it is now just under £300 million. Lloyds had also entered into a commitment to ensure that Verde met the capital requirements on day one, but I don’t think you should interpret that as Lloyds saying they will fill any hole the Co-op find in the transaction that is important. The second thing is that Verde reconstructed meant that in essence Lloyds were providing a management team for Co-op, so the core of the team that is going to be managing TSB today under the IPO in essence would have become the Co-op’s team.

Stewart Hosie: Does that imply that the regulators were much happier with a Lloyds’ management team than what was being proposed previously by Co-op?

Andrew Bailey: This is what you might call a version of planning blight. The problem that Co-op faced was that they were increasingly relying on a management team that was interim. The third thing was IT. The reconstructed Verde transaction meant that the Co-op Verde bank would have run on Lloyds IT systems not Co-op IT systems.

Stewart Hosie: It would have been more akin to TSB—

Andrew Bailey: It would, yes.

Q1941 Andrea Leadsom: Good morning. I would like to ask you a few more questions about the capital, some fairly specific ones. When Barry Tootell was before this Committee he said that you did not raise capital as an area of concern with the Co-op Bank in December 2011 but as an area that Co-op Bank would have to specifically address in order to proceed with the transaction. Is that a fair characterisation?

Andrew Bailey: I wrote to Co-op in June 2011 and December 2011. They are pretty similar letters and, on both occasions, capital was raised as one of the five issues that they would have to address to convince us on Verde. I don’t think there is any question around that. But I think it goes back to the line of questioning we have just had, which is that the very specific impairment issues, and of course the IT issue that only emerged later, were yet to emerge at that point. The answer is that we put the capital issue on the table because we saw that they were going to have to work hard to meet the Verde capital needs. The specific work that followed made that task more difficult.

Q1942 Andrea Leadsom: Mr Tootell said that the capital shortfall only emerged in 2013. As you will realise, what I am trying to get to is, was he being deliberately obtuse about the capital issue prior to that? He claims, therefore, that he should not have been able to reasonably foresee the capital problem ahead of 2013. Do you think that that is right?

Andrew Bailey: Let me say two things on that. In fact, our records indicate that the first time he was informed that the stress test was going to lead to a quite markedly larger capital requirement was in November 2012. To be fair, we had not put the exact number on it but he was put on notice at that point. The second thing—and I think he said this to you in his hearing—is that he, certainly when this capital requirement came out, was realising the misjudgments they had made on the Britannia assets.

Andrea Leadsom: When was that? About when was he realising?

Andrew Bailey: I don’t think he put a specific date on it, but I would guess it was during the period December, January, February, going over 2012–13.

Andrea Leadsom: To be very specific, is it reasonable for the board of Co-op to suggest that they had no real awareness of the extent of the capital problem before 2012? Is it reasonable for them to say that or not?

Andrew Bailey: The difficulty with this is that a number of them are now saying, “Now we look at it, we realise there was a problem.”

Q1943 Andrea Leadsom: The issue here is that an awful lot of entirely innocent investors have lost an awful lot of money and we still seem to go round the houses as to who should have known, who did what and who in fact did do what. It is enormously frustrating for this Committee to constantly find that nobody was responsible and everybody did what they should have done and made the right decision at the time, but clearly it has all had catastrophic results. I will just ask you again: is it reasonable for the members of the Co-op board who have appeared before this Committee to suggest that their account of the regulator’s concerns about capital over the period between 2011 and 2013 is accurate? Are you comfortable with their testimony?

Andrew Bailey: The problem with that is that if you strip that comment down they are essentially outsourcing risk management to the regulators.

Andrea Leadsom: Exactly. Is that reasonable?

Andrew Bailey: 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.

Q1944 Andrea Leadsom: Yes. In many ways now, with the responsibility that you have under the new environment, arguably a failing bank in the future could put that point even more strongly, couldn’t they? As you have just said, now you do have the ability to carry out more accurate stress testing within a shorter period of time. Arguably, are we creating a problem for the future where a future failing bank will say, “Andrew Bailey didn’t tell me my capital risk?”
Andrew Bailey: It is a very good point. Out of what you might call bitter experience, we are certainly having to create a regime where we are much more activist on asset quality reviews and stress testing. If you sit in my chair, you would think, “Well, you would be mad not to do that because otherwise you are a bit defenceless”. I think you raise a very good point. Are you then setting up a system that is almost outsourcing the identification problem, because the regulator is going to come along once a year and work you over and tell you what the results are? Of course, this is a problem that exists in other countries. The US has this issue with its stress testing regime, which is a black box regime, as well.

Q1945 Andrea Leadsom: What are you doing about that? If you are aware of that risk then is it for you to be able to write to boards and say, “Guys, it is absolutely on your shoulders. Don’t wait for us to come and tell you what the problems are”. Are you doing any of that?
Andrew Bailey: The answer to that is we have to be much more engaged with boards. We don’t have to be distant in that sense. I think you are absolutely right that we have to go to boards and say, “Look, this is what we see” and, in the nicest sense of the word, “why aren’t you on to this?”
Andrea Leadsom: Yes, exactly. Notwithstanding that you are the backstop, you have to make sure that it is very clear to them that they are where the buck stops and that they have to be on to it.
Andrew Bailey: Yes, absolutely. We can’t have a world where it is outsourced to us.

Q1946 Andrea Leadsom: By the same token, therefore, the other completely horrendous thing about this whole Co-op debacle is the clear and apparent lack of expertise of those who should have been looking after the interests of investors and clearly were not, because they had no expertise in the banking sector. Again, while your regime of approving directors may have improved dramatically, are there some kind of red lines where you would say, “If you have no banking experience there is absolutely no way you could ever in future be the chairman of a bank”? Andrew Bailey: Yes. We would not approve somebody today. First of all, even in advance of the senior managers regime being introduced, of which I am a very strong supporter, we have changed the approach towards approval of senior persons. We would not have somebody in the role of chairman of a large bank who had no financial services experience. Moreover, the process for all senior appointments at major institutions, chairmen and chief executives being a typical case in point, involves a much more senior level of interaction from us. To be clear, I do the interviewing with a very senior adviser, typically, and that is a very big contrast to the arrangements that were in place when the Reverend Flowers was approved.

Q1947 Andrea Leadsom: Again then, is the balance right? Are you now being responsible for the next chairman who appears to be allegedly taking bribes and so on, or is the board of the bank that is responsible ultimately for the behaviour and capability of that chairman? Where does that balance sit?
Andrew Bailey: The first line has to be the board but again you raise a very big question and important issue for us as we go forwards. I am acutely aware that there is a real danger that we become effectively the people who appoint and select chairmen—
Andrea Leadsom: Who are running the banks, yes.
Andrew Bailey:—who run banks. Sometimes institutions approach me and say, “We have two candidates for this position. Can we send them along to see you?” I say, “I am sorry, I am not going to choose between the last two. That is not what we do.” We have to watch this. The other thing we have to watch, because it is not only a very high profile area but it is an area of intense personal interest—we do not neglect people, because they withdraw. You may know, because this has appeared in newspapers, when people do withdraw and sometimes these names get out—often they don’t but sometimes they do—we have come under quite heavy criticism. There was one particular case about a year ago: what right is it of ours to exercise that function when the person has failed to clear our bar of what we think the competence to do the job is. I am very acutely aware that in the public eye this is a controversial area and one where we walk a fine line between rejecting and accepting people. You are right, it is not an easy area.

Q1948 Andrea Leadsom: On that point, it has been put to me by people in the industry that in fact you are inadvertently discouraging people from applying for jobs, particularly senior risk jobs in banking, because of the implications for their entire career family, reputation and so on if they are found to be wanting. I would appreciate your comments on that.
Andrew Bailey: I think it is true of more than just senior risk jobs. It is true of being on boards of banks, frankly. We do have to watch that we do not create a regime where these jobs are so unwelcome that no right-minded person would do them. I would say that there are still people, certainly in executive jobs, whose technical skills and expectations and ambitions are lacking. It is true; it can sometimes be quite hard to recruit for these jobs. I am also concerned about the pool of people who are willing to be non-executive directors. It is a much more demanding role nowadays than it was before the crisis, and rightly so. As some of them rightly say to me, there is not a lot of upside in that role.
Chair: But they are still coming forward?
Andrew Bailey: They are, but I think if you talk to most of the chairmen and senior independent directors they would say it is harder than it used to be.

Q1949 Chair: You touched on one point a moment ago where you said you need to be much more engaged with banks and that you are attending board meetings to do the interviews. Do you attend the annual report of the regulator to the major banks?
Andrew Bailey: I do. The boards, yes.
Chair: I was surprised when I asked Martin Wheatley whether he attended and he said no. Do you think it would be helpful if the two regulators worked together
more to ensure that you are both reporting at the highest level?

Andrew Bailey: I saw your exchange with Martin. As he said, he chooses to do it a different way. We have adopted a particular approach; I have adopted a particular approach. I think it works quite well for us. I don’t want to criticise Martin. I think that is unfair. We have a different approach.

Q1950 Mr Love: Could I go back to the issue of the two letters that you sent to the Co-op Bank and Barry Tootell’s interpretation of them? We also heard evidence from other members of the board who similarly misinterpreted the message that was coming through from them. Do you accept that there was ambiguity there and would you accept that perhaps the letters needed to be a bit more robust according to the lights now that are put on these responsibilities?

Andrew Bailey: 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. Funkily 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 and so blunt with them because I would have warned the board”. So, no, I am afraid I don’t accept that proposition.

Q1951 John Mann: When did you first hear of the Co-op’s intention to bid for Verde?

Andrew Bailey: I first heard about it when I came into the role in supervision. I came into that role at the end of March 2011. To be honest with you, I can’t remember the exact date but it was some time between then and the middle of May, because I first met the Co-op in the middle of May.

John Mann: Neville Richardson says that you never raised the issue of Britannia with the Co-op.

Andrew Bailey: Bear in mind that Neville stepped down not that long afterwards. I think there was only one meeting with Neville, because he stepped down in July.

John Mann: Yes, but you addressed the Co-op Bank’s strategy away day.

Andrew Bailey: Yes, I did.

John Mann: Did you raise Britannia then?

Andrew Bailey: I didn’t raise Britannia on that occasion but we did raise the capital issue.

John Mann: Why didn’t you raise Britannia then?

Andrew Bailey: I think for the reason that I gave earlier, which was that the full extent of our assessment of the problems in the Britannia loan book has come out subsequently.

John Mann: Are you saying that the regulator did not know that there was a problem with the Britannia three years after the Britannia had merged with the Co-op?

Andrew Bailey: No. I think you have a record of a meeting—and if not I will repeat it now—that I held with Peter Marks, Paul Flowers and Barry Tootell at the end of July 2011 when I said that, in my estimation, Britannia would have failed and there was a problem. The point is that Neville had stepped down. Neville stepped down very quickly. I don’t think these things are related, by the way, but the point is that Neville was off the scene at that point.

Q1953 John Mann: What I am asking you about is that it seems rather surprising that the issue of the impaired Britannia assets was raised so weakly by the regulator, and yourself specifically, during this whole period when the Co-op was considering bidding for Verde.

Andrew Bailey: We had raised the issue of the capital need but, as I have said before, at that time we did not have the extent of the evidence that we subsequently had. Just to go back, I said earlier that I hold my hand up on this point. If we had had the technology then, as we have now, to do the stress tests, I would have been able to show the Co-op that 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. I am sorry, I do not accept the point that we were doing nothing. Moreover, there was capital put into the business by the Co-op Group and there were plans, as you know from previous hearings, I think, to effect the sale of the insurance companies, which would put further capital into the group. I am sorry, I do not accept that proposition.

Q1954 John Mann: Whatever technology is used, you have a building society in huge problems with a dodgy loan book that merges with another institution and takes it over and that itself has problems. You are informed they are going to bid for another part of an institution and you sit on your hands for the following 18 months. That is what happened, isn’t it?

Andrew Bailey: No. I am sorry, I do not accept that. Let me say why. First of all, the letters made clear what the issues were. Secondly, we set about making and requiring the firm to make changes in respect of the issues we raised on that. Let me give you two examples. First, immediately 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. Secondly, we said that we were not happy with the constitution of the board. 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. I am sorry, I do not accept the point that we were doing nothing. Moreover, there was capital put into the business by the Co-op Group and there were plans, as you know from previous hearings, I think, to effect the sale of the insurance companies, which would put further capital into the group. I am sorry, I do not accept that proposition.
John Mann: The Co-op Bank’s debt has been downgraded to junk status.
Andrew Bailey: Yes.

Q1955 John Mann: Did you put any hierarchy in those five issues that you raised with them and what criticality did you stress of any one of those five issues?
Andrew Bailey: I wanted them all dealt with. They were all critical issues. It goes exactly back to the conversation we were having a few minutes ago. It is no good having capital if you do not have proper governance and it is no good having capital if you do not have proper risk management. You have to deal with those issues.
John Mann: What are you saying to us now is there were five critical fault lines, five, and you allowed their bid for Verde to carry on regardless.
Andrew Bailey: Let me take that in two parts. First of all, we did not sit on our hands. As I have just said to you, we set about requiring the firm to take actions. Secondly, let us look at the question of Verde. It was not obvious at that point that undertaking the Verde transaction would have been bad for the Co-op—not obvious. What would have been bad for the Co-op is had they undertaken that transaction and not dealt with the issues that we had highlighted. Moreover, as you will be aware, the Independent Commission on Banking had highlighted that a challenger bank would be more successful if it had a larger share of the personal current account market, and Co-op-Verde took it into that position. The answer to that question is by no means obvious, I would suggest.

Q1956 John Mann: What assessment method did you use for judging the Co-op’s ability to overcome the five critical hurdles that you identified?
Andrew Bailey: We undertook a risk assessment of each of them individually, because they each require different methods. They are quite different issues in that sense.
John Mann: Can we get copies of those risk assessments?
Andrew Bailey: They are now subject to the enforcement investigation and I am pre-constrained by the legal advice that I had on what documents we can share while that process is going on, but after that process is done, of course you can, yes. I have no desire to withhold information from you.

Q1957 John Mann: Why didn’t you intervene and make clear that this bid was doomed to failure?
Andrew Bailey: 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. I do not think that is a true proposition whatsoever, I am afraid.

Q1958 John Mann: Did anyone lean on you at any stage in relation to this?
Andrew Bailey: No.
John Mann: Nobody leaned on you?
Andrew Bailey: No.

John Mann: Did anyone lean on anyone in the process that you are aware of?
Andrew Bailey: Sorry, did I lean on people?
John Mann: Did anyone lean on anyone in the process that you are aware of?
Andrew Bailey: If you are going to the question of political involvement, if that is the point that underlies this question—and this is a comment on the course of the first half of 2012—I come back to my point about the Independent Commission. 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. Therefore, I do not think it is unreasonable for the Government to say, “We do have a public interest in this transaction”, but nobody learnt on me. I can tell you that.

Q1959 John Mann: Others may come back to that, but this is my final question. I put to you regulation in this country is not fit for purpose if you can now tell us that this bid for Verde all the way through was perfectly valid, acceptable and doable, and still maintain that now. How can we have trust in regulation in this country and the new regime when you are maintaining that it was viable?
Andrew Bailey: No, I am sorry, you have misinterpreted what I was saying. What I was saying was that we set out conditions. Those conditions had to be met. By the way, that was a very big change from the system of regulation that pertained when the RBS-ABN transaction went through. We set out the conditions. 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”. I do not think that is at all unreasonable. 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.
John Mann: So we are back to light-touch regulation.
Andrew Bailey: No, we are not back to light-touch regulation. I am afraid that is quite wrong, in my estimation. If you compare the intervention that we made on Verde and the conditions we set with what did not happen on RBS-ABN, you will see a difference.

Q1960 Chair: Just a couple of points I want to pick up from those exchanges with John Mann. The first is, why was the full extent, or at least a roughly accurate estimate, of the impairments on Britannia’s balance sheet not picked up much earlier? Why does it surface so much later than the impairments on other bank balance sheets?
Andrew Bailey: Two things. First of all, perhaps the management of Co-op were not scrutinising their balance sheet and their asset quality in the way that we would assess others were, by virtue of the fact that, when we intervened, others did not have to make the same sort of adjustment. Secondly, as I have said a couple of times, we have developed a much more rigorous approach and we are still developing it—
Andrew Bailey: Yes. 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.

Chair: The basic answer is, “The Co-op management were not up to it and we did not have the technical capacity to do the stress testing”.

Andrew Bailey: At that time.

Chair: So we have been quite exposed a long time on the regulatory front?

Andrew Bailey: Oh, it is legacy, I am afraid. When we—

Q1961 Chair: You are saying we are still not yet in a position where we can have sufficient confidence in these sequential stress tests because you do not have yet the technology in place. Isn’t that what you have just told us?

Andrew Bailey: Two things. We are in a much better place on asset quality review work and that is already showing. I fully expect that we will have the first set of sequential stress tests done by the end of this year. In fact, the process has begun. The banks are now engaged on it.

Chair: I will not open it up now, but a very big issue is whether the continental European banks are anywhere near—

Andrew Bailey: That is a very different issue.

Chair: That we might raise on another occasion.

Q1962 Mark Garnier: Can I turn specifically to corporate governance, possibly drawing in some of the conversations we have had with other members and trying to summarise it, in fact? First of all, David Davies and Rodney Baker-Bates made some comments when they came in that, while there was there was some financial services expertise on the board, it was pretty thinly spread. Did you agree with that with regard to the bank board?

Andrew Bailey: Yes.

Mark Garnier: Do you see that as a problem?

Andrew Bailey: Going back to the point I made to Mr Mann, one of the things that we insisted on after the summer of 2011 was the restructuring of the board to achieve that end. There was not adequate experience on the board.

Q1963 Mark Garnier: Prior to that you felt there was a problem. Again, I appreciate that some of these questions refer back to a time before you were the regulator, but I am very interested in your opinion on this. We have heard, I think in answer to Mr Norman’s questions, that you rated that Mr Peter Marks was kind of the dominant member of the board. In comparison, how did you rate Barry Tootell’s performance?

Andrew Bailey: I do not think Barry Tootell was at all dominant. He was, of course, appointed as interim CEO when Neville Richardson left for the reason that the outcome of the future of the chief executive of Co-op would depend on Verde. I think Barry was perfectly competent, but I do not think he was in any sense a strong chief executive. No, I do not.

Mark Garnier: Although he had financial services experience and he was an accountant—

Andrew Bailey: He had a lot, yes.

Mark Garnier: Yes. He knew what he was talking about and Peter Marks was a retailer. The dominant factor was the bloke who liked to open shops, if you like.

Andrew Bailey: Yes, but let me be clear that we were very clear and they were very clear—and this is a point that Paul Flowers was very clear on—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.

Mark Garnier: No, but he could influence it.

Andrew Bailey: He could seek to influence it but, of course, in the end the bank board did not agree with him.

Q1964 Mark Garnier: How do you rate Paul Flowers?

Andrew Bailey: I will give you my personal view on Paul Flowers. I think I met him probably six or seven times. I thought he was pompous, to be honest. I thought that he, as we know, had no financial background, but let me give the other side of the coin: 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. To be frank with you, I was as surprised as you were when he made the errors in the hearing with the Committee, because it was not my experience with Paul Flowers. My experience with Paul Flowers was that he seemed, to use a phrase, well-briefed. On the whole, he did not display ignorance.

To go back to my exchange with Mr Mann, when I put to him, “The chief risk officer is not up to it”, he said, “Yes, I will deal with that”. The only point he made to me was, “Look, in the Co-op we do these things with dignity. Let me do it with dignity”. I said, “Fine”, and the person was out within a few months. I was as shocked as anybody else when the whole thing came out, but the Paul Flowers scorecard is distinctly mixed, frankly, in that sense, more mixed than you obviously get from the popular camps.

Q1965 Mark Garnier: It is quite interesting, because one of the things that made this Committee slightly speechless was the revelation from Rodney Baker-Bates, I think it was, that, of the four candidates to be the chairman of Co-op Bank, three of them with financial expertise were discounted in favour of Paul Flowers, who did best on the psychometric testing scores. What did you make of that?

Andrew Bailey: It goes back before my time, so I can only offer an observation.

Mark Garnier: No, sure.

Andrew Bailey: It is a sign of the times. I think my reading of it is that the reason Paul Flowers was chosen was to do with what one might call sort of the internal workings of the Co-op, but I think also they wanted a chairman who could manage the relationship
with the group and I think Paul Flowers saw that as one of his roles. To be honest with you, he said to me he saw one of his roles as managing the group chief executive.

Q1966 Mark Garnier: I think all of us have probably had lots of people volunteering information from one form or another, but one of the pieces of information that was volunteered to me was that Paul Flowers was given the chairmanship of the bank in order to stop the confrontation with Len Wardle in terms of being chairman of the group; that Len Wardle was given a second shot, a second three-year period, and Paul Flowers was given the second-best by way of compensation for not being group chairman. Does that sound plausible to you?

Andrew Bailey: Look, others are much more expert on the workings of the Co-op Group than I am. What I could detect was there is a lot of internal politics.

Mark Garnier: So it is not an unreasonable assumption?

Andrew Bailey: It is not an implausible proposition, but I cannot substantiate it because it is before my time.

Mark Garnier: No. I would not expect you to, but from what you know, it does not sound way out?

Andrew Bailey: Yes.

Q1967 Mark Garnier: I know one of my colleagues wants to come forward particularly on governance in general in this type of area, but specifically on the Co-op governance model has this been a perfect example of a failure in a governance model when it comes to a financial services institution?

Andrew Bailey: I think it is an example of a governance model that does not work for a bank because, in its earlier form, it has relied far too much on too heavy a weighting towards what I think is called the democratic members, who are the Co-op Group members. My reading of it is that you had two groups on the board post the Britannia merger. You had the sort of democratic members, who were the Co-op people, and then you had the ex-Britannia people. Some people have said that they were quite distinct in terms of groups. We have also had the observations made by one or two of the current board members who were brought on later of two things. First, the whole discussion in the board of the Britannia assets changed once the ex-Britannia directors left the board. That has been said by a number of people who straddled that period.

Mark Garnier: Is that a suggestion that, while the Britannia members were still there, there was a will to say, “No, no, it could not have possibly have been anything to do with us”, and after that it was—

Andrew Bailey: Yes, it was a defensive thing.

Mark Garnier: So they confronted the problem essentially.

Andrew Bailey: Yes, I think that is right.

Q1968 Mark Garnier: That is very interesting. Just one sort of final question, if I may, following on from Andrea Leadsom’s question, and this is the role of the regulator when it comes to the construction of the board. I was very struck by what you were saying to her in terms of delivering accountability to board members and how you strike that balance. Clearly there is a possibility that you could be accused of being a shadow director as the regulator if you start intervening and throwing your weight around, but how on earth do you find the balance between not being a shadow director and yet exercising sufficient oversight to make sure that we do not see a repeat of this type of cock-up?

Andrew Bailey: It is not easy. I have written to you on the question of shadow director status because it was a point made by the Parliamentary Commission, where you requested it. In many respects, the letter is a legal argument as to why we do not believe that we are in the position of shadow directors, given our status as a public authority. That is fine, but you are right; in the real world we 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, whatever the legal position about shadow directorship, we are exercising more control and more influence than we should be in our position. I think the earlier line of questioning went to that. I am very conscious of this. It is something that we have to watch very carefully.

Q1969 Teresa Pearce: Could I just take you back to something I think you said earlier? You talked about the Britannia and you said you think that Britannia would have failed without the merger. Is that correct?

Andrew Bailey: Yes.

Teresa Pearce: Yet you say that it was reckless for the Co-op to take them on. Is that correct?

Andrew Bailey: I think that it was a mistake, because I do not think the Co-op had the balance sheet strength to support the Verde—

Teresa Pearce: Yet you seem to intimate, even with hindsight, that it was the least worst option.

Andrew Bailey: Yes. That may sound a contradictory thing to say, I agree with you. You have to put yourself back in the position in late 2008, which was a very bad time from the point of view of—

Teresa Pearce: The Co-op took the risk that would have fallen elsewhere?

Andrew Bailey: Yes. If you follow that line of argument through, then yes, of course it would.

Teresa Pearce: Yes. It was the least worst option as far as the rest of the industry is concerned?

Andrew Bailey: It is a very hard thing to say because obviously the bondholders were saying, “That is outrageous”, and I would have some sympathy with them (several inaudible words 06:42 file 9—11:36:49 PTV) provided a very good service in this whole exercise in terms of making clear the views of bondholders. How can you reach that decision? Of course, if you put yourself back into the problem, if you put yourself back into 2008 and knew everything that would happen subsequently, you would find it very difficult to make the judgment that was made then, but we did not know, of course.

Q1970 Teresa Pearce: When you talked about the Britannia, you said that they had moved themselves
into the fringes of a mortgage market with self-certification and you also said they did not have the risk management in place and they did not have the skills to manage, particularly in that febrile environment; yet from 2005, the FSA were meant to regulate the mortgage market. Do you think they failed in the case of the Britannia?

Andrew Bailey: I think you have to say that it must follow from that and, of course, Britannia is not the only institution. There are things that went on in that period in terms of financial institutions and the regulation and, yes, there were big shortcomings.

Q1971 Teresa Pearce: Do you think that the resulting problems with the Co-op are caused by it being a mutual or by it being just the Co-op itself? Do you think that it is exceptional circumstances in one bank?

Andrew Bailey: I think you have to pick that apart a bit. As we were just discussing a few minutes ago, there were particular issues around the governance of the Co-op that you do not see in building societies. The governance issues you see in building societies tend to be a bit different. There is the question of the appointment of board members and the relationship between the group and the bank: that is not a feature. I think that is particular to the Co-op. Yes, you are right; there are more generic issues around the position of mutuels and the generic issues, in many ways, are all to do with the constraints on raising what we call core tier 1 capital, because they cannot go out and raise equity in the way that a bank can. Nationwide has now done an issue of a new core tier 1 instrument, which is encouraging, but they are restricted. 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.

Teresa Pearce: Are you saying that what happened in the Co-op was unique to the Co-op and is not the same issue with mutuals? Mutuals have a problem with raising capital, as you say, but the governance issues are particular to the Co-op?

Andrew Bailey: I think the governance issues were particular to the Co-op, yes. I do not see those sorts of issues in building societies.

Teresa Pearce: Would you say that the issues with Britannia were not an issue of a mutual acting like a mutual; it was a mutual acting like a bank that caused its issues?

Andrew Bailey: The traditional building society is a prime mortgage lending model. Obviously that was their rationale for existing. The pressure that was being put on to that caused a number of them to diversify the risks they were taking, but in ways that they found very difficult to manage.

Q1972 Teresa Pearce: You have mentioned the problems for mutuels. What are the problems for the regulator in regulating mutuels? Clearly you have to regulate the whole industry. Do you have to have different ways of dealing with them or different risk management? Do you have to have different expertise? Is it a challenge for the regulator?

Andrew Bailey: It can be a different challenge. 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. In that sense, yes.

Teresa Pearce: Have you made changes to that in the last—

Andrew Bailey: It is new. It did not exist if you go back to the period that we are talking about—

Teresa Pearce: Right.

Andrew Bailey: Yes, absolutely.

Teresa Pearce: Since when has that existed?

Andrew Bailey: The source book is entirely new. It was brought in after all these experiences.

Chair: Is it public?

Andrew Bailey: I am pretty sure. You have me there. I will confirm that one. All our books are—

Chair: If we could have it, we would like to look at it.

Andrew Bailey: Yes, of course.

Q1973 Teresa Pearce: Can I just ask one final question? Clearly you regulate the banks and then you have the Co-op, which is different, and then you have mutuels that are different. You also regulate 600 credit unions.

Andrew Bailey: We do.

Teresa Pearce: Is that a risk and how do you do that? Some of the poorest members of society have small amounts of money.

Andrew Bailey: Yes. They too are very different as well.

Teresa Pearce: Do you have a source book for them?

Andrew Bailey: I am not sure if we call it a source book, but we have a particular credit union supervisory approach. You are absolutely right, and it is set down. They are different in that sense, yes. Of course, the thing about credit unions is that they are quite restricted by their own articles and by law as to what they can do.

Teresa Pearce: But they are also, in the general, run by people who are not experts.

Andrew Bailey: Absolutely they are, and they do, by the way, fail. I am trying to think off the top of my head, it not unusual for probably for eight or 10 credit unions to fail every year.

Teresa Pearce: Could you get that number down, possibly?

Andrew Bailey: You might do—

Teresa Pearce: Did you try?

Andrew Bailey:—but you might find you have fewer credit unions as a result, because there is a sort of trade-off between—

Teresa Pearce: But when people in credit unions lose their money it is a disaster.

Andrew Bailey: No, but they do not because the restriction on the business model means that they cannot take deposits in excess of the FSCS limits.

Teresa Pearce: Right.

Andrew Bailey: That is one of the protections.
Q1974 Chair: In summary, the Co-op governance model was a disaster for trying to run a bank, and the mutual model can be made to work but only with quite a radical re-engineering of the way you regulate it. Is that a summary of what you have said?

Andrew Bailey: We have had to do quite a lot of work on building society and mutual regulation and, of course, over this period you have seen a continued shrinkage in the number of building societies, because we have been talking about some of the bigger ones. I can send it to you, if you like. I cannot remember how many building societies there were in 2007 but it is quite markedly lower, because we have lost a number of small ones. Usually they go through arranged mergers, big and small.

Q1975 Mark Garnier: Carrying on from where I was talking about the appointment of Paul Flowers, Clive Adamson gave us some evidence about how he interviewed Paul Flowers, an hour and a half of general chit-chat. Given what we know about Paul Flowers, given what has happened, given all the kind of revelations, does Clive Adamson still have your confidence?

Andrew Bailey: Clive is a close colleague. I think Clive would say to you that, like a lot of people—and I put myself in the same category—he has learnt a lot during the crisis. He has had a lot of experiences, some of them very difficult. I regard Clive as a very wise counsel on these issues. He is an effective supervisor and I think he would say to you he has learnt a lot.

Mr McFadden: A simpler answer to Mr Garnier would have been “yes”, but you did not use the word “yes”.

Andrew Bailey: That is because I wanted to say a bit about Clive, but if you want me to say yes, I will say yes.

Q1976 Mr McFadden: I want to change tack a little bit.

Andrew Bailey: Sure.

Mr McFadden: Most of the questions for the last hour and a half have understandably been about the Co-op and their strengths and weaknesses in relation to the Verde bid. I would like to ask you about their rivals, NBNK. What discussions did you have with NBNK about their bid and do you think they were viable alternatives to the Co-op?

Andrew Bailey: We had quite a continuous discussion with NBNK and it came and went because NBNK were in the bidding in late 2011, early 2012. Of course, then the Co-op was settled on and then the Co-op withdrew and NBNK came back in. During both periods we were involved with them. I think Lord Levene said to you when he came here that he has had a lot of experiences, some of them very difficult. I regard Clive as a very wise counsel on these issues. He is an effective supervisor and I think he would say to you he has learnt a lot.

Mr McFadden: When you say “a bit of experience” I assume you are going back to the time when you had António Horta-Osório and Win Bischoff here—is that what we said to NBNK clearly. “Look, if you emerge as the preferred bidder”—I did not say in these words, obviously—“you will get a letter. You will not get the same letter as the Co-op, but you will get a letter because there is a lot that we do not know about you, obviously. You do not have the capital at this time”. I do not think they could have sustained the Verde mark 1 proposition that the Government had agreed with the European Commission under the state aid rules any better than Co-op could, which is why it had to be restructured.

I should say Verde mark 1 always struck me as a bizarre arrangement, because it involved selling of a £16.5 billion funding gap. I remember saying to Eric Daniels in 2009, “I do not know who you think will be out there that could buy a £16.5 billion funding gap”. It had to be restructured. I think the big questions were obviously around, “Is the capital going to be there? Is the funding there? How are you going to run the bank?” We went some of the way down that track with NBNK, but I would not want to over-exaggerate that. We did not get that far with them, because obviously they dropped off the scene.

Q1977 Mr McFadden: The engagement with NBNK was not as detailed and direct because they were not in pole position for most of this time. They never received a list of five things that they had to satisfy in the way that the Co-op did?

Andrew Bailey: No. I can tell you the major point of engagement with NBNK. Lloyds today enjoys, under the Basel regime, what they call advance models treatment for its capital adequacy and risk asset ratio. Broadly speaking, there are two regimes. There is the so-called standardised regime, which tends to have high-risk assets, and then there is the models regime, which tends to generate lower risk assets and therefore a lower capital requirement. It depends how you measure risk. NBNK were very concerned as to how they, as a de novo institution, would get that models treatment and we worked with them quite a bit to explain to them what they would have to do to prove to us that they could manage that. That was the major point of engagement they wanted to have with us.

Q1978 Mr McFadden: Lloyds said in their evidence to us, and I am quoting, “NBNK had no platform or infrastructure. NBNK’s bid was supported by letters of intent from investors, but there were explicitly not guaranteed commitments of finance and, although the board contained members well-known in the City, their bid was dependent on raising the full purchase price in the public market at a time when the public equity markets were effectively closed”. Would you have shared some of those worries?

Andrew Bailey: That is all correct. I think Peter Levene would say to you that he would have dealt with all of those issues, but I think they are all correct as observations.

Mr McFadden: Does this explain why, despite your warnings to the Co-op and despite those warnings at some point being passed on to Lloyds, Lloyds...
continued to want to stick with the Co-op because of their doubts listed there about the NBNK—
Andrew Bailey: You have to ask Lloyds, but I suspect the answer is yes, it does.

Q1979 Mr McFadden: Do you think this series of questions about Co-op governance, the lack of financial experience for Reverend Flowers and so on has been convenient for NBNK; it has meant that their alternative bid has got relatively unexamined because of the obvious problems that have been exposed in the Co-op?
Andrew Bailey: I think the NBNK bid has always been subject to far less scrutiny, as you say, because they were not in pole position. I think that is broadly true, but that is a comment obviously on the period. I do not think Mr Baker-Bates was referring to that because that obviously postdates all of that, but yes, it was subject to a lot less scrutiny in that sense.

Q1980 Mr McFadden: We have also heard that the two deputy chairmen of the Co-op Bank, who did not have faith in the Co-op going forward with the Verde transaction, made quite exceptional efforts to alert Mr Adamson and the regulators; not just normal exit interviews, but specifically. Did any of them come to see you?
Andrew Bailey: This is in the period after I had come on the scene. I did not conduct the two exit interviews, but I have the records.
Mr McFadden: But they went over and above the exit interviews, did they not, to try to impress upon you certain views?

Q1981 Mr McFadden: Yet the transaction trundled on for some months after that. Have you considered whether at that point you, as the regulators, should have done more to step in?
Andrew Bailey: Yes. Can I tell you what was said to us in those two separate meetings, because I think this puts it into some perspective? I will start with Rodney Baker-Bates. There is no question that he voted against the Verde transaction. There is no question that the reasons that he raised were capital management and governance. Indeed, he said they were essentially the same issues that were in our letter. Here we are talking about the restructured Verde—the summer of 2012 version of Verde. He said, “Actually, I welcome this new plan. It is more attractive. It makes Verde more feasible”. What he said to our supervisors was, “I recommend that, as it approaches the signing of the sale and purchase agreement”—and that would have happened in the spring of 2013—“the FSA should exert leverage on the Co-op to force changes in governance and management”. He did not say, “Stop now”. Indeed, he said something quite different, in my view.
Let me move on to David Davies. David Davies, too, no question he voted against the Verde transaction. Bear in mind Rodney was a Britannia board member, David Davies was a Co-op board member by background. David Davies said, "The Co-op Bank is struggling for its identity. Verde is a massive opportunity", but he had concerns. He had concerns particularly about the sustainability of the business model in the low-interest rate environment and the capital question. He also said that the Co-op’s history of acquisitions and reaping the benefits, particularly Britannia, is not good. But then he said, as our record records—and, as I said, I was not there—“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”. So you have to take from that a rather different message that they were giving us. I should say for the record he also said he did not see eye-to-eye with Peter Marks; he would be worried if Peter Marks was solely in control of the Co-op Bank, but he felt that the new board structure had enough checks and balances. He also said at the end of the day he thought that Peter Marks would not put the Co-op Group at risk.

Q1982 Mr McFadden: Thank you. Can I just ask you one final thing? Was this reported discussion between Lord Levene and Mervyn King about collective pressure ever reported to you? Do you remember that?
Andrew Bailey: The discussion itself was not, but I had a discussion with Mervyn, prior—as I now know—to him having a discussion with Peter Levene, because I was obviously responsible for supervision at the time. Although I was formally in the FSA reporting line in terms of day-to-day supervision at that point, I was still a director of the Bank of England. We did have a discussion and I did say to him, if we go back to the point about the Independent Commission on Banking and the Government’s views, “There obviously is a lot of political interest in this transaction and, obviously bearing in mind what the Commission has said and what the Government’s response to it is, the Co-op bid passes the test in terms of the share of the personal current account market that it would have had, which is the 6% threshold, and NBNK does not”.
Mr McFadden: That is a slightly different point from saying Ministers specifically—
Andrew Bailey: It is putting a bit of context on it, which I hope is helpful.
Mr McFadden: Okay, thank you.
Chair: That was exceedingly interesting evidence, which you are telling us is supported by written material that I suspect you are going to argue, too, should remain in the hands of the regulators while the enforcement action continues.
Andrew Bailey: I am afraid that is the injunction I am under from the lawyers at the moment.
Chair: No, I understand.
Q1983 Mr Love: Can I refer the Committee to my designation as a Labour and Co-operative Member of Parliament, as normal?
Can I come back again to this issue of Lord Levene and the meeting with Lord King? Were you aware of that meeting and are you aware of the contents of the discussion?
Andrew Bailey: I am aware of the contents of the discussion. I was not aware of it at the time, but I am aware of the contents of the discussion, yes.

Q1984 Mr Love: You have indicated the view that you took, and I suspect that Lord King took at the time, related to the Independent Commission’s recommendation. Was that the sole basis on which you agreed that there was political—

Andrew Bailey: That was the point I made. I cannot speak for Lord King on this. I think you are going to ask him some questions in writing. I think he is in New Zealand at the moment. I obviously cannot—

Mr Love: I think we have written to him, but I am not sure we have received any reply as of yet.

Andrew Bailey: No, he is on the other side of the world, I think. I can only relate to you my own sort of interpretation of that and what was said, but I think it is consistent with the record of this conversation with Peter Levene.

Q1985 Mr Love: Peter Levene was very bold in his assertions about political involvement and it would seem that if the discussion merely referred to the Independent Commission report and the need to create challenger banks there were clearly strong banking reasons for supporting the measure, but he chose to focus on the political involvement.

Andrew Bailey: Yes.

Mr Love: Why would he have done that?

Andrew Bailey: Because it is interesting to do. 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.

Q1986 Mr Love: Lord Levene indicated the commitment in the document prepared by the Coalition at the time of the 2010—

Andrew Bailey: Yes, the coalition agreement.

Mr Love:—to supporting mutuals and co-operatives. Do you think that that was an important consideration in regard to this merger?

Andrew Bailey: I think it featured in that. Yes, I think it did. I was aware certainly, because I have read the coalition agreement, that one of the clauses—there are a lot of clauses in it—was the encouragement of mutuals and yes, I think it did feature somewhere. Not quite as explicitly probably as the Independent Commission, but, yes.

Q1987 Mr Love: Can I ask you about Paul Flowers? It has to be said we have heard mixed evidence on this. Most people have said there was no political involvement whatsoever. Lord Levene was very robust. Paul Flowers was a little more subtle, if that is the correct word. He indicated that there had been a private conversation between you and him. I am sure you have read the record where you indicated that there was considerable political support. Was that related to the Independent Commission recommendations or—

Andrew Bailey: I did not use those words to him. He is absolutely right in recording the conversation. It was as we were leaving a room after we had had a meeting on the Co-op and his recollection was correct. I do not think I raised the Independent Commission with him at the time, but that is what was in my mind, yes.

Q1988 Mr Love: Can I ask you, looking at it almost the opposite way around, did the fact that you believed there was support through the Independent Commission recommendations at a political level have any influence on the way that you treated the Co-op Verde merger?

Andrew Bailey: It did not cause any change to the conditions that we set out in the letter, 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. We could debate that, but possibly not now. The fact is we now have the objective. We are content with that, but yes, we 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.

Q1989 Mr Love: Did you have any discussions to try to and clarify these matters with the Treasury in relation to the—

Andrew Bailey: Yes.

Mr Love: To what extent did that discussion go? Did you seek clarification as to whether there was support at the Treasury level and get an interpretation from them of the coalition agreement and the Commission report?

Andrew Bailey: Yes.

Mr Love: What did you do to strengthen your opinion as to how the Treasury felt about the merger?

Andrew Bailey: We had many conversations with the Treasury, and I will come on to a particular issue that was the subject of conversations. We did have conversations around those issues. They were clear on the challenger bank point as well, because obviously they were the Department responsible for that. They always made it clear to me though that the judgments on safety and soundness were for us to make and they would not interfere in those judgments and they did not. There was one particular issue, and I think this has been covered a little bit in the outside coverage. It is a bit technical, but I know it has been taken up, and that is on the question whether the Co-op group, under European law, would be a financial holding company and we did have quite intense discussions. They took a somewhat different view from us on some occasions on that. In the end, of course, the issue never came to a head because the bid did not go
forward, but we did, and we also had a discussion around ring-fencing, as to whether that was a way to take into account the European law point.

Q1990 Mr Love: Comment has been made by previous witnesses on the role particularly of Mark Hoban. Lord Levene said that he asked Mark Hoban, who denied it, but indications seem to be that there was contact. Whether that stretched into support or lobbying on behalf, we are not absolutely clear. What role did Mark Hoban play in relation to the regulator? Andrew Bailey: Mark Hoban was the junior Minister at that time responsible for financial services, so it naturally fell into his patch. When I took over from Hector Sants—so this is around about April 2012—I met with Mark Hoban at least once a month, as I do with the junior Minister responsible for financial services. Yes, we did discuss it, but I can assure you that Mark Hoban never put me under any pressure in respect of our primary obligations.

Mr Love: Were you aware of his contact with the parties concerned? Andrew Bailey: I was aware that he was in contact with Co-op. I have to say that the number of contacts that have been quoted in some of these hearings strikes me as quite large, but I think you would have to ask him whether that is a true recollection. I cannot substantiate that. He will know.

Q1991 Mr Love: Just for the record, I presume you never had a conversation with him as to what the conversations and the contacts were about? Andrew Bailey: I never asked him explicitly to tell me what he had discussed, but he gave me the sense as to the issues that he was interested in, which are competition and then this particularly technical issue about the financial holding company status under European law.

Mr Love: But you would not have stretched that into whether he had explicit support for a Co-op merger; he was merely interested from the point of view of creating a challenger bank? Andrew Bailey: That, and I think he did have an interest, as you say, in the fact within the coalition agreement there is a clause on mutuels.

Mr Love: So you can kill two birds with one stone, you get a challenger bank and get promoted to—

Q1992 Andrew Bailey: Yes, I think that is a reasonable point to make, yes.

Q1993 Chair: Can I just go back a moment to the evidence that you have just given with respect to the meeting between Rodney Baker-Bates and Clive Adamson? I have the transcript of what Rodney Baker-Bates said in front of me here. He said, and I am paraphrasing because it is in two adjacent places, that his meeting was about pretty much explaining the deal was "just a slope to disaster". That does not seem to square with the note of the meeting.

Andrew Bailey: No, it does not, and the problem is it is not the same meeting. This is the issue. We are now talking about two different meetings. There was a meeting with Clive Adamson and then there was an exit interview with Rodney Baker-Bates with our supervision team, which I have the record of.

Chair: Okay. In a nutshell, having read the evidence that we have had from Mr Davies and Mr Baker-Bates, is that evidence consistent with the notes that you have read, which we will see eventually, or not? Andrew Bailey: I think what did not come out in that hearing was their view that, first, Verde had merit as a transaction for the Co-op if the conditions could be satisfied and, as far as I can see—and they said it—they shared our view on what those conditions were, and as I say, I think the interesting twist to it is that they did not advocate calling it off immediately. You have to remember I was not at that meeting. I am reading from the record.

Chair: No, I am only asking for your opinion. Andrew Bailey: I have no reason to believe it is an inaccurate record at all.

Q1994 John Thurso: Can I just come back to the points that were being raised by Andy Love about the political pressure? The central thrust of what Lord Levene has been saying to us all along is that there was sufficient political interference that NBNK were denied the opportunity to bid for Verde and Co-op were preferred, and that that was as a result of political pressure. Is there anything at all that you have seen or heard to substantiate that allegation?

Andrew Bailey: No and, honestly, I do not think Peter Levene has direct evidence. I think the comments are somewhat indirect. No is the answer.

Q1995 John Thurso: You would concur that it would be perfectly proper, where a Government has decided that it would like to see a mutual flourish, for it or indeed, any Opposition politician to express that publicly and this would be quite normal and not construed as being pressure?

Andrew Bailey: Yes. As I say, I draw the line when, if you do not mind me saying so, politicians seek to try to influence our statutory objectives, but for people to express preferences without doing that I think is what you do.

John Thurso: Thank you. Yes, that is what I think. Andrew Bailey: I am not a politician, but it is my interpretation of what you do.

Q1996 John Thurso: Can I go back to the very early evidence that you gave this morning where you talked about the root causes, the first one of which was that, frankly, the Britannia was pretty well holed below the waterline and would almost certainly have found itself—had it not gone ahead—in trouble? I think that is a very quick but accurate summary of what you were saying.

Andrew Bailey: Yes. I will perhaps just expand on that in one respect. In a sense of course you say, “Well, if it was holed below the waterline, it was a slow leak”, but the point is that—and I perhaps should have said this—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.
John Thurso: You then went on to say that, of course, the Co-op itself, the other root cause, was a very small but full service with too high costs.

Andrew Bailey: Yes.

John Thurso: This was two cars looking for a crash, wasn’t it?

Andrew Bailey: I suppose the logic would be that if you could have put them together, if you could have had a number of things fallen into line, a very strong management that could have brought costs down, a very strong management that could have delivered new systems and a recovery in the economy such that we would have had a normalisation of interest rates and a normalisation of interest margins, it was a scenario in which it could have worked. The problem is none of those things came to pass.

John Thurso: But it was a sensible strategy, if both sides understood the predicament they were in, to come together to—

Andrew Bailey: If they thought they had the wherewithal to get themselves out of it.

Q1997 John Thurso: You have two groups that have quite serious problems and have come together with a chance of winning through, but with very significant headwinds. If you then add in a substantial takeover, which is the Verde, doesn’t common sense tell one that that was doomed to stress the organisation to the point where it could not possibly do it?

Andrew Bailey: In a way, that is exactly why we put the five conditions down, “You are going to have to tackle and address these five conditions”, to get over exactly the hurdle that you identify.

John Thurso: Therefore, from the moment you put the five conditions down, this was doomed not to go ahead because nobody seriously in the FSA or later the FCA could have thought that those conditions could have been met.

Andrew Bailey: I did not think the probability was very high, frankly, but—

John Thurso: So the putting down of the conditions was the handbrake?

Andrew Bailey: I think that comes back to a discussion we had much earlier in this hearing and it goes back to sort of the role of the regulator. I was not involved, but in the RBS-ABN case the regulator basically took their hands off. At the other end of the spectrum the regulator can live in a sort of—it is sort of pejorative terms—central planet world, where we take views and it follows and, frankly, we will get some right and we will get some wrong, and that’s life. What we did instead—and I was in a sense responsible for this—was to say, “We cannot have the ABN world. We will set the conditions. We will give them a reasonable chance to meet those conditions and that is an appropriate approach to take”. As I say, I am very much trying to balance here the role of the regulator and the fact that we have a market economy.

Q1998 John Thurso: I completely accept that point—it would be quite wrong if the natural operation of a good market became whether or not you would say yes or no to something. You are there to see the market function, not to tell it what to do. I completely understand that, but you have two entities that have problems. They come together. They have a chance, but you then add in a highly complex, large takeover—

Andrew Bailey: You are referring to Britannia and Co-op or Co-op Verde?

John Thurso: We will start with Britannia and Co-op. You have some inherent faults to start with, which everybody has recognised, at least with hindsight. You then add in a massively substantial takeover, which has to be reconfigured in iteration 2 to include capital to make it all work, and every time you are just going further and further away from something that might be realistic. The question therefore is did that time pressure, effort and money distract from the possibility of a different outcome, which was at the point of the five conditions saying, “If you cannot demonstrate you can meet those pretty sharpish, then stop doing this and concentrate on your own”? That is the question.

Andrew Bailey: Yes, that is a very fair point. As I think I said when Mr Mann was questioning, we did not take our hands off the Co-op and say, “We will come back to you when you have determined whether you do Verde or not”. We dealt with risk management and board governance. By the way, capital was put in during this period; in retrospect, not enough. It was during that period that the group put, I think, around £350 million of core tier 1 capital into the bank between 2010 and 2012. Moreover, they committed to the sale of the two insurance businesses, which I think is estimated to be worth about £500 million in terms of core tier 1.

Q1999 John Thurso: The final point, if I may. One of the very first hearings we had was with Sir Win Bischoff and António Horta-Osório, at the end of which Sir Win produced a marvellous chart demonstrating the market’s view of Co-op.

Andrew Bailey: I have never seen this chart, but I have read about it.

John Thurso: It was on the TV. Basically they did that to say, “How could we have known what was going on in Co-op? Look at what the market thought. This is only just appeared”. Since then, all of the evidence that we have had regarding particularly the regulator shows very serious and growing concern between 2011 and 2013. The question therefore is, did you or any of the regulatory team share any of those concerns at any time with Lloyds?

Andrew Bailey: I think I alluded to this in the hearing last summer. When I wrote the second letter to Co-op in December 2011, I was concerned about the situation with Lloyds and also, by inference, obviously in terms of the position of NBK in terms of them having a fair chance. I can’t go to one bank and say, “Let me tell you what you do not know about another institution that I regulate”. That is obviously legally out of order, but I did take the step of saying to Co-op, “You have to show this letter to Lloyds. Lloyds needs to understand the reservations that we have, because I do not want this thing to end in a crash and for Lloyds, quite reasonably, to come to us and say, ‘If only you had told us, we would have obviously done something different’”.
It was a requirement of Co-op that they show the letter to Lloyds. I have written evidence, that Co-op did that, so there is no question. I have written evidence. I have also had evidence from Lloyds executives. I have to say to you what was a surprise in your hearing was that Win Bischoff did not know. When I heard about your hearing, I said, “Well, that is odd”, and that is obviously an issue within Lloyds, but I have written evidence that Lloyds executives have seen it. 

**John Thurso:** If I just have it absolutely straight, you are testifying that Lloyds knew.

**Andrew Bailey:** Yes.

**John Thurso:** But it would appear from the evidence we have gathered that Win Bischoff did not?

**Andrew Bailey:** That is exactly what he told you, yes.

**John Thurso:** Therefore, that there was a gap in communication between the team that was receiving information from Co-op and the top level. That would be the logical—

**Andrew Bailey:** You would have to ask them, but I think that is the logical conclusion, yes. You would have to ask Lloyds that question.

**John Thurso:** Okay, thank you very much.

**Chair:** We have no other questions. You can tell that there was a good deal of interest in this session from my colleagues and, no doubt, beyond this room. Thank you very much for the evidence, which has run on over two hours and which has been both informative and detailed. This will be the last of our public hearings on this, given that we now have half a dozen inquiries or at least the fact that we have been looking at this seems to have contributed to the spawning of a good number of investigations, both internal and external, in what is going on in the Co-op. We are very grateful to you for the detailed evidence you have provided.