



House of Commons  
Treasury Committee

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**Financial Stability and  
Transparency**

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**Oral and written evidence**

*Tuesday 6 May 2008*

*Witnesses:*

*Financial Services Authority*

*Tuesday 13 May 2008*

*Witnesses:*

*Mr Jon Moulton, Managing Director, Alchemy Partners*

*British Bankers' Association*

*Tuesday 20 May 2008*

*Witnesses:*

*Northern Rock*

*Ordered by the House of Commons  
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## The Treasury Committee

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

### Current membership

Rt Hon John McFall MP (*Labour, West Dunbartonshire*) (Chairman)  
Nick Ainger MP (*Labour, Carmarthen West & South Pembrokeshire*)  
Mr Graham Brady MP (*Conservative, Altrincham and Sale West*)  
Mr Colin Breed MP (*Liberal Democrat, South East Cornwall*)  
Jim Cousins MP (*Labour, Newcastle upon Tyne Central*)  
Mr Philip Dunne MP (*Conservative, Ludlow*)  
Mr Michael Fallon MP (*Conservative, Sevenoaks*) (Chairman, Sub-Committee)  
Ms Sally Keeble MP (*Labour, Northampton North*)  
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John Thurso MP (*Liberal Democrat, Caithness, Sutherland and Easter Ross*)  
Mr Mark Todd MP (*Labour, South Derbyshire*)  
Sir Peter Viggers MP (*Conservative, Gosport*).

### Powers

The Committee is one of the departmental select committees, the powers of which are set out in House of Commons Standing Orders, principally in SO No. 152. These are available on the Internet via [www.parliament.uk](http://www.parliament.uk).

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### Committee staff

The current staff of the Committee are Colin Lee (Clerk), Sïan Jones (Second Clerk and Clerk of the Sub-Committee), Adam Wales, Jon Young and Jay Sheth (Committee Specialists), Phil Jones (Committee Assistant), Caroline McElwee (Secretary), Tes Stranger (Senior Office Clerk) and Laura Humble (Media Officer).

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# List of witnesses

---

## Wednesday 26 March 2008

*Page*

**Sir Callum McCarthy**, Chairman, **Hector Sants**, Chief Executive, and **Margaret Cole**, Director of Enforcement, Financial Services Authority

Ev 1

## Tuesday 13 May 2008

*Page*

**Mr Jon Moulton**, Managing Director, Alchemy Partners

Ev 21

**Angela Knight CBE**, Chief Executive, **Paul Chisnall**, BBA Executive Director, Financial Policy and Operations, and **Alex Merriman**, BBA Executive Director, Wholesale Banking, British Bankers' Association

Ev 28

## Tuesday 20 May 2008

*Page*

**Ron Sandler CBE**, Executive Director, and **Ann Godbehere**, Chief Financial Officer, Northern Rock

Ev 41

# List of written evidence

---

1	Financial Services Authority	Ev 53, 59
2	Jon Moulton	Ev 63
3	British Bankers' Association	Ev 72, 77
4	Northern Rock	Ev 81, 92, 93

# Oral evidence

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## Taken before the Treasury Committee

on Tuesday 6 May 2008

Members present

John McFall, in the Chair

Nick Ainger  
Mr Graham Brady  
Mr Philip Dunne  
Mr Michael Fallon

Ms Sally Keeble  
John Thurso  
Mr Mark Todd  
Peter Viggers

*Witnesses:* **Sir Callum McCarthy**, Chairman, **Mr Hector Sants**, Chief Executive, and **Ms Margaret Cole**, Director of Enforcement, Financial Services Authority, gave evidence.

**Q1 Chairman:** Sir Callum, welcome to you and your colleagues to the session this morning on the FSA and financial stability and transparency. Can you introduce yourselves, please, for the shorthand writer?

**Sir Callum McCarthy:** I am Callum McCarthy, Chairman of the FSA.

**Mr Sants:** I am Hector Sants, Chief Executive of the FSA.

**Ms Cole:** Margaret Cole, Director of Enforcement at the FSA.

**Q2 Chairman:** Sir Callum, in your memorandum, you note the proposal in the Government's consultation paper is for the decision to activate a new special resolution regime to lie with the FSA. Why do you believe it is integral to the supervisory process for only you to be able to make that decision?

**Sir Callum McCarthy:** Because I think it is a decision that is absolutely integral with the normal supervision of banks and I think that the question of doing so is inextricably linked between the two. It is not simply a decision at the time of pulling the trigger. In order for someone to pull the trigger they have to decide over an extended period whether that trigger should be pulled and be in a position to defend that decision, so if you have more than one institution involved in that you would have an extended period during which a bank would be subject to interrogation and a degree of supervision by more than one institution. I think that that would produce ambiguity and a degree of uncertainty. I am not surprised that the major trade associations, both LIBA and the British Bankers' Association, see great advantage in there being unambiguous responsibility.

**Q3 Chairman:** But you screwed up the last time, Sir Callum, and the one who is responsible for the fault, that did not find the mistake, could cover it up, so what reassurance could you give this Committee that if you get these powers you are not going to screw up again?

**Sir Callum McCarthy:** I was making a difference between a decision in any one case and the argument about whether introducing ambiguity into the system will produce better results.

**Q4 Chairman:** But we did have ambiguity in the system with the Tripartite Authority because every one of you came to this Committee and said you did your job.

**Sir Callum McCarthy:** I am all in favour of having as much clarity and as little overlap as possible.

**Q5 Chairman:** But I am saying, Sir Callum, there was no clarity previously—

**Sir Callum McCarthy:** There are some questions, Chairman, which can be asked about that. Sorry, could I just reply to your question which I think is a very fair question. I think there are questions about what happened in the past but I see no advantage in introducing additional ambiguity into the system in order to deal with past failings.

**Q6 Chairman:** Okay, Sir Callum, I will put it to you like this then: do you have sympathy with the views of politicians who would be sceptical about giving these powers to the FSA given your track record with Northern Rock?

**Sir Callum McCarthy:** No, I think that the question of how we exercised our discretion and our responsibilities in relation to Northern Rock is something which we have examined and we have identified a number of things that we believe it is essential that we put right. We have started a programme to put those right and we are busily doing that.

**Q7 Chairman:** You see, Sir Callum, I took the opportunity when the Governor of the Bank of England was here last week, and no doubt your staff have brought to your attention his comments, when you make the point about the trigger, he is very clear and he is saying that they should have someone other than the supervisor with the ability to pull the trigger and that is because of the concerns about regulatory forbearance, "the natural reluctance of a supervisor to announce publicly that the supervision

regime has not been successful and the bank needs to go into a special resolution regime.” So there is a difference between you and the Governor on that?

**Sir Callum McCarthy:** There is a difference between the Governor and myself and indeed between the FSA Board and the Governor. I would point out that there is no evidence at all that we indulged in what was described as “regulatory forbearance” in relation to Northern Rock. The problems in relation to Northern Rock, which we have examined in considerable detail and with a great degree of rather brutal honesty, are different from the questions of regulatory forbearance.

**Mr Sants:** If I may make a comment on regulatory forbearance?

**Q8 Chairman:** Hold on a second, the Governor made the point as well about the basic argument about the special resolution regime, and in answer to my question he says: “I think you argue, correctly, in my view, that it should not be with the supervisor but with a different body. I think you can argue plausibly that it should be with an independent body, it could be with the Bank.” Given that legislation has to come in in front of us, Mr Sants, and politicians have to feel reassured that the FSA is on the job, then I would take a bit of persuasion that it has to lie with yourselves, and I would suggest to you that if it is going to lie with yourselves that it is not done by you sitting back but by convincing people, particularly the body politick in the House of Commons—all MPs, not just the Government—that you are the correct body to have that power.

**Mr Sants:** I would absolutely agree with you that we should ensure that we have the confidence of all MPs and indeed of all depositors and savers. I do believe the programme we have set out should generate that confidence. On the point, if I may, of regulatory forbearance I would just like to expand a bit on that. I am afraid I do not really understand that argument. It seems to me that under the new proposed regime, if anything, the incentive for the supervisor is to place the bank early into the special regime, not late, because our objective is to actually protect depositors; that is what we are here for. With regard to your point about ensuring we have the confidence of Parliament; we are here to protect the depositors and under the new proposals, if anything, the incentive for the regulator is to put it early into the regime to ensure that there are no issues for depositors. A disorderly unwinding of a bank would inconvenience depositors, so I do not agree at all that there is some incentive here for us to delay placing a failing bank into the regime. But, as I say, to your first and most important point, I absolutely believe that we can and are ensuring that we are well-placed to do our job effectively. I would echo one point the Governor made, he talked about the importance of not giving an organisation responsibility without authority. I think the issue of having two separate triggers then creates the possibility that we as a supervisor are not able to do our job and I am sure that Parliament would not want to place the FSA in a position where it has responsibility without the necessary authority.

**Q9 Chairman:** Given the different views that have been expressed by the Governor last week and yourselves this week, I think it is incumbent on you to go back and discuss with the Governor so that we as a Committee can feel some reassurance that two legs of the Tripartite Authority agree with each other on a particular issue, otherwise there is no confidence in the future. To date, I do not think that you have given us sufficient evidence to give us any confidence that you are the correct body to have these powers, so I think you have a big job to do on that in the next few months.

**Sir Callum McCarthy:** Could I make one distinction which may help. We have been answering questions about the use of the trigger. One thing we are in complete agreement with with the Governor is that once a bank goes into the special regime we do not believe it should be the FSA that administers that bank because we believe that it would be an undesirable and incorrect conflict of interest to both regulate an institution and to run it, so on that point there is complete agreement.

**Q10 Chairman:** I understand that but there is a big gulf between you yet and I think it is important that you get together and if there is a possibility of a joint submission to this Committee with which you agree, only then I think will we as a body start to have some confidence in those two legs of the Tripartite Authority. In terms of conflicts of interest, if you are given the powers for the special resolution regime you would be in charge both of regulating institutions and shutting them down should they fail (potentially because of your poor regulation), so if you were given these powers, how would you deal with those conflicts of interest? Maybe that is for a later time when you are giving us your submission but if you could give us a flavour today it would help, Sir Callum.

**Sir Callum McCarthy:** I think that the regulation of an institution once it has moved into the special resolution regime is not actually a terribly difficult set of issues provided we are not also running that institution, and it is because of that that we have made it clear that we think it would be inappropriate to do both. Once an institution is in the regime we would be concerned to look at the same aspects that we look at normally, ie things which determine whether it is breaching threshold conditions.

**Mr Sants:** I come back to my earlier point that our role is to protect the depositors not to protect the shareholders. I think there seems to be a little bit of a misunderstanding here. There is no question that the purpose of setting up the special regime and the Bank regime reform proposals in general, is to better enhance consumer and depositor protection.

**Q11 Chairman:** Although I would just make one point there, in a sense you could be protecting the shareholders if through your poor supervision you do not want any of your mistakes uncovered or one does not want one’s mistakes uncovered, so there is a potential there, that you want to have a clean record in supervising banks.

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6 May 2008 Sir Callum McCarthy, Mr Hector Sants and Ms Margaret Cole

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**Mr Sants:** Any time you take on responsibilities you have to be accountable for discharging those responsibilities effectively.

**Q12 Chairman:** I am highlighting the conflict of interest there. Could I go on to one area where we are agreeing and that is market abuse—and we are going to come back to that at a later time—the FSA has successfully prosecuted only two firms and 12 individuals for market abuse since your inception in 1998. Does this mean that the UK has a very clean market or does it demonstrate that the FSA is ineffective in clamping down on market abuse? I am mindful of the comment that Howard Davies made in 1999 when he said: “Perhaps London’s markets have been perfectly clean through this period; I beg leave to doubt it.”

**Sir Callum McCarthy:** I absolutely agree with Howard Davies that there is no evidence to suggest that the London market, the British market, is uniquely clean. Indeed, the evidence that we have produced, and which we are determined to keep on producing, shows that this remains a significant problem. I would say that I think that successive administrations and successive attempts to deal with this have not been very successful in dealing with insider trading and market abuse, and it is because of that that we have determined to increase our resources to attack this, to change the technology that we have available to enable us to identify this more effectively, and why we are seeking from the Government additional legal powers in relation to plea bargaining which we believe are essential if we are to make a step change which, as your question implies, Chairman, we believe is very necessary.

**Q13 Chairman:** How does your track record compare with, say, the United States’ track record in prosecuting?

**Mr Sants:** It is not very easy to make comparisons because, as the Chairman has already indicated, we do not think we are as well-equipped as we would like to be with respect to achieving prosecutions, but certainly on the key point of criminal prosecutions clearly it is the case that the US has a longer track record than we do since at the moment in terms of completed criminal cases our track record is zero. What we have stated is we find the current level of market abuse, at least as best as we can measure it, unacceptable. We need to address it and we can see that the measures we have taken so far have not addressed it, and going forward we intend to be more determined and more effective, and in particular to pursue criminal prosecutions in this area to significantly increase the deterrent effect. As you rightly point out in respect of the US, that has been a difference which we intend to rectify in the future.

**Q14 Chairman:** This is one area where we agree because in the Budget debate I made the case for you having this plea bargaining, so I am interested in this, and first of all, in terms of the Government’s proposals, do they go far enough for you in terms of achieving that objective?

**Sir Callum McCarthy:** I was very grateful for your remarks in the Budget debate, Chairman, thank you very much.

**Q15 Chairman:** We can get on sometimes, Callum!  
**Sir Callum McCarthy:** I am genuinely grateful. The Chancellor’s statement when he made clear that he thought it would be a positive step to give us the powers of plea bargaining is an admirable statement. We are in the hands of the Government to give us the legal powers and that has not yet happened.

**Q16 Chairman:** You are in the hands of the Government and that is what worries me because I am told that there could be some seizure in terms of getting the legislation here. The Chancellor has given us the rhetoric but it is still to be implemented and I am told it could be getting held up somewhere. Do you know anything about that? The reason I am asking this today is to ensure that we get a move on with this so that everybody is listening.

**Mr Sants:** We have no timetable to date so we would obviously very much welcome a timetable being forthcoming.

**Q17 Chairman:** So it is disappointing that we have not got a timetable yet?

**Mr Sants:** From our perspective, given the importance we attach to this issue, yes.

**Q18 Chairman:** I will write to the Chancellor after this meeting today to see if we can get this moved on in terms of legislation.

**Sir Callum McCarthy:** I am very grateful again, Chairman.

**Q19 Mr Fallon:** Coming back to the supervision of Northern Rock and the report you have done, it appears to be a catalogue of failure. You identify a lack of sufficient supervisory engagement, a lack of adequate oversight, a lack of specific resources directly supervising the firm, and a lack of intensity by the FSA, Sir Callum, at the point you were supervising Northern Rock last summer you employed 2,600 people; how many have been dismissed?

**Sir Callum McCarthy:** None has been dismissed. Of the people who were responsible for supervision of Northern Rock at the relevant period, none is now involved in supervision and a number of them have left the FSA.

**Q20 Mr Fallon:** But the ones you have kept have simply been shuffled sideways have they?

**Sir Callum McCarthy:** Some of them have been moved.

**Q21 Mr Fallon:** They have been shuffled sideways?

**Sir Callum McCarthy:** Some of them have been moved. They have been moved out of direct supervisory responsibility.

**Q22 Mr Fallon:** So they have failed at supervision but they are still being kept on the books doing something else?

**Sir Callum McCarthy:** There are people who have been moved to other places where we believe that they should remain as employees of the FSA. If we had not been of that judgment they would have left the FSA.

**Q23 Mr Fallon:** How many senior managers were paid bonuses in the year 2007–08?

**Sir Callum McCarthy:** It is a question I would be grateful if the Chief Executive could answer because I am not sure I know the answer. Most managers in the FSA, indeed all staff in the FSA, qualify for bonuses. I do not know how many senior managers in total.

**Mr Sants:** It would depend on how you chose to define “senior managers” but I assume the question you are asking is about non-Board members of the FSA and were they paid bonuses in the period in question, and the answer is yes.

**Q24 Mr Fallon:** The bonus information for senior manager is not in your annual report, it is only there for the directors.

**Mr Sants:** Is that the question you are asking, whether or not we list individual bonuses for non-directors in the annual report? That would not be normal practice.

**Q25 Mr Fallon:** The question is how many senior managers received bonuses in 2007–08 and how does that compare with the previous year?

**Mr Sants:** I was saying if you would like to define to me how you want me to define senior managers, whether you wish me to define them as directors or heads of department or the total pool, then I will happily answer the question. Perhaps I could put it in witting back to you.<sup>1</sup>

**Q26 Mr Fallon:** Did you pay more in bonuses in the financial year just concluded than you did in the previous financial year?

**Mr Sants:** Again, it is a matter for the Board’s decision but we paid the same percentage of bonuses to the employees of the FSA for 2007–08 as we did in the previous year.

**Q27 Mr Fallon:** Percentage of what, total remuneration?

**Mr Sants:** Of salaries, yes, that is the way we look at it.

**Q28 Mr Fallon:** Not of people but of total remuneration?

**Mr Sants:** Yes, the bonus percentage of their salaries across the whole of the FSA was the same for the two years in question. It was a decision that was made by the Board on the recommendation of the executive and was reflective of the excellent work across the entire organisation and the executive thought that was a fair recommendation to make to the Board, which was accepted.

**Q29 Mr Fallon:** You have shuffled a lot of these people sideways because they have failed and you have hired 100 new supervisors. How can you give us confidence that the 100 new supervisors will be better than the last lot?

**Mr Sants:** We have not completed the hiring programme. We have indicated our intention to increase significantly the number of supervisors, a number of whom have been hired. In terms of ensuring that the quality is at a level we require going forward, one of the measures we are taking is to further improve and tighten our overall training and competency regime. We will have higher standards to be achieved for supervisors and a tighter regime to ensure that those competences have been achieved and if they do not achieve those competences they will not continue as supervisors.

**Q30 Mr Fallon:** Does that mean they are being employed on shorter contracts than previously?

**Mr Sants:** We do not use contracts in the way I think you are implying. People are employed in the FSA as they are in all normal organisations. What I am saying is if they do not achieve the required level of competency, ie do not achieve the qualifications we require in order to be a supervisor, they will not be allowed to continue in supervision. This is a change from where the FSA was before. Going forward, we will have a formal competency requirement with testing for supervision.

**Q31 Mr Fallon:** Sir Callum, do you not think it would have been an acknowledgement of the extent to which you recognise the failure of supervision of Northern Rock and the confidence you want to give everybody in claiming these new powers if at least one person had been dismissed? Out of 2,600 people not one has been sacked.

**Sir Callum McCarthy:** There have been various people who have left the FSA. Some have left by mutual agreement. There have been a number of people who have been moved and I think that if some people had not earlier left we would also have had more people who would have left by mutual agreement.

**Q32 Peter Viggers:** The internal audit says that the FSA was operating prior to August 2007 with a presumption that “in the event of a crisis like that experienced in August 2007, general market liquidity provided by the Bank of England would be increased and, *in extremis*, liquidity would be provided for systemically important institutions.” Is that a fair summary of the FSA’s attitude at that time?

**Sir Callum McCarthy:** Yes it is.

**Q33 Peter Viggers:** Why did such a seemingly dangerous mismatch between the expectations of two of the members of the Tripartite Authorities exist, because that was not the way the Bank of England saw it, was it?

**Sir Callum McCarthy:** If you look at the provision of liquidity to a solvent institution, which was what happened in relation to Northern Rock, liquidity

<sup>1</sup> Ev 59

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6 May 2008 Sir Callum McCarthy, Mr Hector Sants and Ms Margaret Cole

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was provided by the Bank of England. The problem in relation to Northern Rock is that the actual use of a weapon that has always been part of the armoury of central banks and of supervisors, namely the provision of liquidity to an institution that was solvent, instead of having the effect of giving confidence, had exactly the opposite effect. I do not think the problem was the refusal of the Bank of England to provide liquidity, because after all that is what happened; the problem was that when that liquidity was provided, it actually triggered the retail run that undid Northern Rock.

**Q34 Peter Viggers:** Did the presumption about the provision of liquidity affect the way in which you regulated liquidity?

**Sir Callum McCarthy:** In one respect yes, because the sterling regime that we have, which is the quantified aspect of our liquidity regime rather than more qualitative aspects, essentially is a regime which presupposes that if there is a catastrophic failure and a problem institutions will have a short buffer of liquidity until the central bank actually takes action, and that is something that is well established and has been there for years. Incidentally, it is a quantitative measure which Northern Rock comfortably exceeded so that was not the problem.

**Q35 Peter Viggers:** One of your responses to the internal audit is to seek to improve working level relations with the Financial Stability Directorate at the Bank of England. How are you going about implementing such improvements and what are the results that you wish to see?

**Sir Callum McCarthy:** I think that one of the things that the Governor made clear when he gave evidence to you was that he regarded the involvement of the Bank in relation to Northern Rock as having happened rather late in the day. There is nothing institutional in the arrangements that prevented that happening. The Governor for example saw the then Chairman of Northern Rock on exactly the same day that Hector and I saw the Chairman of Northern Rock, which happened to be 30 August, considerably in advance of the point at which liquidity was actually announced. I think there are some important questions in terms of the detailed working arrangements between the Bank and FSA to make sure that in future if there were ever to be a case comparable to Northern Rock the Bank is encouraged to raise all questions that it wants to raise about the actual eligible collateral assets, et cetera, of the institution at an early stage, and those are things which are being worked on as the Governor's evidence made clear.

**Mr Sants:** I think you are also asking about improvements going forward. We are also putting in place an improved technology platform so effectively in the future our vision would be that the Bank officials would have the same access to data as if they were sitting in the FSA, ie everybody working off the same database. We would obviously be

obtaining the data from the institutions to simplify that data collection process but effectively it will become, in virtual terms, a single department.

**Q36 Peter Viggers:** I think it is common ground that in the case of extreme difficulty it will be the Bank of England that will step in and deal with the administration of the bank because only the Bank of England has the financial levers available. The point of dispute which I think colleagues would agree is the thrust of our report on the run on the Rock is that the Bank of England should remain sufficiently close to the situation overall so that it can, if it feels appropriate, trigger the special arrangements. I take it from answers to previous questions that you do not accept that and you feel that this must be something entirely within the purview of the FSA?

**Sir Callum McCarthy:** The difficulty that I see in giving two separate triggers, which is what would actually be involved, is that if I were responsible not in the FSA but in some other institution for deciding whether I was going to pull the trigger, and I knew that for example I would have to quite properly appear before this Committee some time to justify that decision or justify why I had not taken it earlier, it would inevitably push me into a degree of interrogation and quasi supervision of banks over an extended period. It is not just at the moment when you pull the trigger, it is an extended period of duplication, and I see very significant disadvantages in terms of clarity of responsibility, I see disadvantages for the banks involved who would be subject to that, and I do not think it is the sensible way of doing it.

**Q37 Mark Todd:** Reading the internal audit report on the supervision of Northern Rock, Michael listed some of the failings that were identified and he was not as harsh as one might have expected. I think poor recordkeeping was conceded; a very high turnover of staff without proper monitoring of what happened when that was happening; very few visits and little personal engagement with the particular institution, very poor risk analysis and an acceptance that, in your words, an outlier in this industry was not treated as such; and very poor challenge mechanisms at senior management level of those who were directly involved in the supervision of the bank. If I read that in another institution I would regard that as a description of systemic failure and not a criticism of a particular group of individuals carrying out a function. Would you accept that view?

**Sir Callum McCarthy:** I regard what has happened as having two deeply worrying aspects. One is there was a misjudgment of the risk involved in the Northern Rock business model and the second thing, which is of a different dimension, is that there was a failure by the management within the FSA to actually control a group of people who were not doing their job properly.

**Q38 Mark Todd:** Most of whom you have retained in employment.

**Sir Callum McCarthy:** No, I actually think most of whom, for one reason or another, are no longer with the FSA. What does concern me however, and what concerns the Board and what we have spent a lot of time looking at, was to try and establish whether this deeply worrying set of events that you have described was characteristic of the way in which the FSA supervises institutions overall or whether it was an outlier, and it is clear from the work done by internal audit and it is clear from the work that has been done elsewhere—and Hector can comment on this—that the Northern Rock experience was an outlier, a deeply worrying outlier, but it was not characteristic of the whole.

**Mr Sants:** I would just make two points. Could I pick up on this “most of whom” of “the management” and could we just take that off the table. I have done the calculation in my head, and there are five managers in the chain involved here, and four of them are no longer with the FSA, and in my book one out of five is not “most”, so I would be grateful if we do not use that terminology going forward.

**Q39 Mark Todd:** I am glad you have quantified it.

**Mr Sants:** On to the second point, we could dance around a pin a bit as to what we think “systemic” means, but I think we should be absolutely clear, and I think I have been absolutely clear about that, that the way the Northern Rock was supervised was unacceptable and to ensure that that does not happen in the future requires us not just to make changes with regard to the people who were specifically and directly involved in that set of events but also to make a number of changes across the whole organisation, both with regard to culture and system. I do believe we do need to make some general changes to ensure we can deliver going forward. I am confident we can but I am absolutely open about the fact that some general changes are required.

**Q40 Mark Todd:** I take that as an answer saying, yes, systemic failure is a reasonable criticism. To give an example, the poor recordkeeping which was revealed, which I think to an outsider was startling, where rather important meetings were not minuted in any way so you could not get a proper picture of what had actually happened; was that unique to the Northern Rock team?

**Mr Sants:** I think a degree of failure to keep records, on the basis of the analysis that we have done was unique. Certainly there is a key aspect in respect of Northern Rock, without getting too much into the technical details, concerning the fact that the team did not keep up-to-date the necessary risk database where the key issues should have been recorded. As the data shows with regard to the high impact firms, that was a unique failure and that was a major contributor to the problem here, so I think you can say based on that analysis that, yes, there was a high degree of specificity here.

**Q41 Mark Todd:** And the revelation of rather poor challenge mechanisms so that those at a more senior level actually discussed issues raised within an individual firm and challenged the team directly—because I think we all recognise that those closely engaged may not necessarily have the most objective perspective and require challenge—is the picture that you are presenting to us that management discipline was in place elsewhere in the FSA but was not in place in this particular instance?

**Mr Sants:** Yes, correct. I am confident, as you would expect, that that is not to be found across the whole of the FSA. That was not found in some of the other divisions.

**Q42 Mark Todd:** Some of the other divisions?

**Mr Sants:** To be specific to your question, that was not found in the wholesale business unit but it would have been found to a degree elsewhere in the retail area. Given there was more than one firm in that retail area responsible to the relevant senior managers, clearly if they were not challenging with regard to Northern Rock it would be a reasonable deduction to assume that the challenge was also not necessarily found across the board.

**Q43 Mark Todd:** That has been rectified since?

**Mr Sants:** That has absolutely been rectified already.

**Q44 Mark Todd:** It really follows through on the Chairman’s line of questioning that a reading of this report, which I think you described Sir Callum as “painfully candid” or something like that—

**Sir Callum McCarthy:** I think the words I used were “brutally honest”.

**Q45 Mark Todd:** Okay, pretty similar, but people reading this would certainly have considerable doubts about the functionality of the FSA and its ability to perform its duties. I must admit I am mildly surprised that I have not had correspondence from little IFAs saying, “They are all over us like a rash and look at what happens when they are looking at much higher risk institutions.” I think I have only had one of those. Can you see the damage that has been done to your organisation in a corporate sense?

**Sir Callum McCarthy:** I absolutely recognise that what has happened has been damaging both to financial services and to the FSA. Could I just make one point however that throughout the world in relation to the present problems there have been regulatory failures, but the only institution which has set out in detail what went wrong and has set out a programme very determinedly to change those and to put them right is the FSA.

**Q46 Mark Todd:** It is an unusual document, I agree. It has been mentioned how infrequent the visits were to Northern Rock. Has that anything to do with the fact that they are way out of London up in the North East? It is a startling statistic, the relatively low frequency of visits to the company. Has anyone asked why it seemed to be so infrequently visited?

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6 May 2008 Sir Callum McCarthy, Mr Hector Sants and Ms Margaret Cole

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**Sir Callum McCarthy:** We look after a range of institutions and it includes for example HBOS which is headquartered out of London and it includes people who are headquartered around the world. This was not because it involved people getting on a train or an aeroplane; it was because we did not do the job properly, full stop.

**Q47 Chairman:** Sir Callum, we are looking to the future here and you mentioned about regulatory failure but we are the only country where there has been a retail run on a bank. To add to Mark's point here, in terms of your table—and I agree it is a very honest appraisal but we are looking for reassurance for the future—the average number of visits to the major retail banks in the period 1 January to 9 August was 22 and the average number of visits of the FSA to the five largest retail banks was 43; yet for Northern Rock there were seven visits and of those seven visits five were held in the one day, two were by telephone, and none of which had minutes. I suggest to you that if you were the secretary of your local community sports club you would be thrown out on your neck for that. Here we have a high impact firm, one of the 37, with five meetings in one day and no minutes. Can we get reassurance that there is a fundamental culture change taking place in the FSA to ensure that that never happens again?

**Sir Callum McCarthy:** Chairman, we have repeatedly made—

**Q48 Chairman:** In terms of minutes and visits, give us an idea of what is going to happen now?

**Mr Sants:** The answer is, yes, there is a fundamental change. The staff are abundantly clear to the fact that if these standards were repeated those employees would not remain with the FSA. I do not believe that they will be repeated. I am confident they have the message loud and clear. We completely agree with you.

**Q49 Chairman:** Just to assure us that it is not going to be repeated, can you give us a flavour of what you are going to do in the future to effect that change in senior management?

**Mr Sants:** Most certainly, yes, we have a significant programme but at the end of the day I think personally you can have as many programmes as you like; the most important thing is to deliver a message loud and clear. The message is the one that you have just articulated and we have already delivered it. I have delivered it personally, I shall be repeating it, and I shall be holding managers to account and you can hold me to account.<sup>2</sup>

**Q50 Chairman:** There will never be a visit undertaken in the future without minutes?

**Mr Sants:** It would be a rash person who says that there will never be human infallibility of an organisation but what we can say is if we discover such things there will be resolute management action taken.

**Chairman:** You reassure us.

**Q51 Mr Brady:** One of the other issues that was highlighted in the internal audit was the excessive reliance on junior members of staff in regulating Northern Rock. What measures do you propose to deal with that?

**Mr Sants:** From our point of view, as I say, I believe we have set out a comprehensive programme. We do recognise that we need to make changes across the organisation and not just with regard to specific issues identified in Northern Rock. We will be addressing it through improved training, with clear standards and competency levels which will be assessed; through having extra resource; through having far greater focus applied by the senior management with regard to the supervisory process; by clearer accountability to those senior managers to delivering and then, critically, going forward, we are going to set up a unit which will in addition to our internal audit organisation, constantly review that process and ensure that our procedures, as we have just touched on, are being adhered to. That will be a regular, rolling programme with experienced supervisory resource, constantly reviewing the effectiveness of our supervisory regime. We would apply that to all the high impact firms over—and we will work through the details—something of the order of about an 18-month time period, so in addition to internal audit and in addition to increased and determined focus by senior management, there will be a quality assurance group providing regular review as well as regular help and assistance when tricky situations are encountered.

**Q52 Mr Brady:** There is general acceptance that you had a difficulty because of the sector you are regulating that it is difficult to recruit and to retain good people. To what extent, in your view, does that lie behind the problem?

**Mr Sants:** As we said before, it is a challenge obviously to recruit good people, particularly from industry, given the compensation differentials, and that is an established fact that everybody recognises. I would note however two points: (i) industry conditions of late have moved somewhat in our favour; and (ii) I do believe that with thoughtful and imaginative packaging of our employment propositions that we can hire. We have demonstrated of late in particular that you can hire senior people particularly if you offer them a mix of advisory roles, maybe part-time roles. You can bring in senior people with a lot of experience. We have demonstrated that of late by bringing in five or so very experienced and senior individuals to help us in a variety of different roles on the advisory side, so hiring at the top end to bring market experience into the organisation is absolutely doable. I would say in the last six months we have proved and demonstrated that so that we now have a strong team at the senior level. We have a strong and effective graduate programme where we are able to offer an overview of financial services. This is an excellent starting opportunity to market to bright, young graduates. There is an issue in the middle around retention, reflected primarily in the compensation proposition and that will always be a

<sup>2</sup> Ev 60

challenge for us. The expectation that this is an organisation where people come and stay for 20 or 30 years would be the wrong model to be pursuing. What we want to pursue is a model which has fluidity in the interchange between us and the industry and overall gives us a good blend of experience at all times. I think that is achievable and I would say over the last six months there is good evidence that we are on the right track and we have made significant progress already.

**Q53 Mr Brady:** Would you be able to give me any kind of sense of what proportion of the fees that you charge to Northern Rock would actually have been spent on regulating Northern Rock or perhaps more generally for the big, major institutions?

**Mr Sants:** It is an interesting question as to what you mean by “regulating”. What you can say is, including the specialists who support the supervisory process, something of the order of 60% or 65% of the FSA’s people are involved in the supervisory process. Lots of other bits of the FSA are involved in other things such as financial capability and so on and we are not a regulator that only does supervision of individual institutions and, as you rightly point out, we do seek through the fee block mechanism to relate the fees to the amount of supervisory engagement and that is particularly important of course for the smaller firms. However, if you are asking what was the exact cost of regulation for the large firms, or for Northern Rock, over the last 12 months, I would have to do that analysis and come back to you.<sup>3</sup>

**Q54 Mr Brady:** I would be interested to see that, thank you, in particular as a percentage of what the fees coming in from that institution were. If I can just move on to the question of capital requirements, it is also noted that you were aware that Northern Rock was in breach of its capital requirements and yet there was no risk mitigation programme. Why not?

**Mr Sants:** There should have been a risk mitigation programme in my opinion and, back to the analysis shown in the report, I think the failure to fill out the necessary risk data and have a risk mitigation programme were probably two of the most important reasons why we did not do a good job in this case. I do not think the particular issue of the breach of the regulatory capital requirement has at the end of the day had any impact on the events that transpired in the summer because it was a breach of only some 0.2% and it was rectified by the time the summer was reached. I do not think that particular breach has influenced the events that transpired from the end of July onwards. Should there have been a risk mitigation programme? In my opinion, yes, and that was one of the failings that led to an unacceptable performance in supervision.

**Q55 Mr Brady:** On average, how often do firms breach their capital requirements?

**Mr Sants:** If I were to give you a precise answer I would have to come back to you in writing and I am not sure whether we can actually do that for legal reasons. We might be able to give you the aggregate data but we do need to be aware of the confidentiality of individual firms’ data. I think I would have to take an opinion as to whether we could release that information. However it does happen and it is not that unusual an occurrence. The question is how you respond to that and what happens next.

**Sir Callum McCarthy:** Could I make one supplementary point to what Hector has said. A breach should not be thought of as a necessarily irrevocable event. The important thing is if there is a breach what is the action that the bank or insurance company or whatever it may be is going to take to put it right. If you take the instance of Northern Rock there was a programme that put that right, so I am not even sure if the number of breaches quite gives you a flavour of the reality of the situation.

**Mr Sants:** You do not want to confuse breaching a regulatory capital requirement with failing threshold conditions so some idea that just because you breach the regulatory capital requirement you cannot continue as a viable institution would be a serious misunderstanding; they are not the same.<sup>4</sup>

**Q56 Mr Brady:** Why did Northern Rock not have to disclose it to the market then?

**Mr Sants:** In certain circumstances it can be a disclosable event. It depends on the circumstances surrounding the breach. If it was of material importance to shareholders and likely to remain so it would then be a disclosable event.

**Q57 Mr Brady:** So is it your view that this particular breach was too small and insignificant to be disclosable?

**Mr Sants:** It is not necessarily just the quantum, it is also back to the issue around disclosure. If you are likely to be rectifying it within a short period of time then you do not necessarily have to disclose, so it also depends on the existence of a set of mitigating actions. In this particular case, as you know, Northern Rock was able to swiftly mitigate the problem through the disposal of the loan book.

**Q58 Mr Brady:** So there was no need for disclosure in this instance?

**Mr Sants:** I do not believe so but if you would like a more detailed explanation on this I would have to come back to you. These are matters in the past prior to my taking on the Chief Executive role, so if you want a detailed explanation I will come back to you.<sup>5</sup>

**Q59 Ms Keeble:** I wanted to ask a bit more about the overall banking regulation. First of all, do you think that it would be possible for the FSA or the Bank of England to encourage a contra-cyclical break of some sort—this was Charles Goodhart’s approach—so that during the good times if patterns end it did not trigger the next crisis?

<sup>3</sup> Ev 61

<sup>4</sup> Ev 62

<sup>5</sup> Ev 62

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6 May 2008 Sir Callum McCarthy, Mr Hector Sants and Ms Margaret Cole

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**Sir Callum McCarthy:** I think this is one of the questions that we and other regulators around the world absolutely have to develop answers to over the next 12 to 18 months because what one does not want to do is to find that you tighten requirements at the wrong time in the cycle and relax them at the wrong time in the cycle. In some respects, Basel II will help in this. There are other aspects of Basel II where we need to improve aspects of the capital requirements and that is going to be worked on. It is one of the things that the Financial Stability Forum report identified but the wider question that Charles Goodhart was raising is something that we will have to come back to and follow up on.

**Q60 Ms Keeble:** I wanted to ask specifically about some of the issues around liquidity of financial institutions. What have you learned out of the last crisis, the Northern Rock crisis, and will that need international action or do you think there are measures you can take to improve the situation?

**Sir Callum McCarthy:** You know that we have already started the process of taking action on a UK basis. The history of international agreement on liquidity is not a good history. When the Governor gave evidence to you last week, he was pointing out that when the Basel II process began, there was an attempt by the Bank of England to try and make sure that liquidity came higher up the agenda and that attempt failed. One of the things that concerns us is that, because it is likely that there will be slow progress in the Basel Committee in relation to liquidity, it is essential that we take action in the UK. We have already started that with the discussion paper that we published at the end of last year and I think we will be coming forward, indeed we will be coming forward this year, with other proposals on liquidity. It would be ideal if we could get agreement internationally but I am sceptical about the practicality.

**Q61 Ms Keeble:** In the memo you sent to us you said that in your new programme there would be more focus on liquidity particularly in the supervision of high impact firms. Are those some of the changes that you are proposing? One of the key issues here was that Northern Rock did not actually breach the rules so how are you going to improve and sharpen the focus, particularly on the risks factors, and how are you going to assess them given that the rules are quite lax?

**Mr Sants:** We come back here to the point we have made a number of times before. The primary focus, in our view, with regard to liquidity management should be on scenario planning, on stress testing. We do believe that you need to have some prescriptive and detailed rules. As we said before, we do not believe that liquidity regimes should be solely principles-based and, yes, there should be some rules and we will reassess where those rules are pitched and also, critically, the definitions in terms of eligible collateral and definitions of securities which are relevant to those specific rules, but the main focus has to be on ensuring that boards and executives and non-executives are properly focused on giving clear

consideration to the various stress-test scenarios, stress scenarios that could develop and that they properly satisfy themselves that they have adequate liquidity to deal with those types of eventualities. As we said before, that is not what happened here with regard to Northern Rock. It had not properly considered all eventualities with regard to the various scenarios that might develop. It had not made a judgment as to whether it thought those risks were acceptable for its board to bear. We as supervisors, however, had equally not properly engaged with them to ensure that that was happening.

**Q62 Ms Keeble:** Mr Sants, I wondered if I saw some sort of changing of the position around principles-based regulation, because you mention in your memo that you are an outcomes-based regulator. I know we can all sort of dance on a pinhead when it comes to words, but it would seem that outcomes-based regulation, and it is quite specific in your memo, where you look at the results of actions, is different from the principles-based which would look more at the processes that are put in hand, and I wonder if this is a shift. What do you mean by this what seems to be a difference of approach?

**Mr Sants:** I think we have always stated, and certainly when we re-launched our regulatory proposition with our document back June of last year, that we were a more principles-based regulator rather than solely a principles-based regulator, a point I think I have covered with the Committee before. We are not in any way suggesting we could operate solely on 11 principles, there are undoubtedly occasions when rules are necessary, but in that document we also talked about outcomes—judging firms on the outcomes of their actions. I think you are right in saying, however, that in trying to communicate our message in a way that firms and, critically, of course, the management of firms can understand, I do myself find it more helpful to focus on the word “outcome” rather than necessarily that we are more principles-based. More principles-based, if you will, is a framework that we are using and focusing on outcomes is what we want the management of firms to do. I think it is more helpful in the communication process and in the messaging process to stress the point that people have to think about the consequences of what they do. That, surely, is the most important point here. Are people giving proper consideration as to the consequences of what they do? The framework under which we judge whether they are giving proper consideration sits behind that, but I think the main message should be about you, the management of the firms who are the people responsible for running firms, not the regulator, we do not run firms, and you need to think about the consequences of your actions.

**Q63 Ms Keeble:** There has been a lot of critical questioning from colleagues here about the management structures and the reliance on junior staff and the messaging sent out, and so on, and it would seem to me that, if the regulation is to be improved, there has to be clarity of focus, and it

would seem (and again I do not want to dance on a pinhead) that there is a difference in approach between rules-based, principles-based and outcomes-based, and if people are asked to do all three things at once it is a muddle. What is the focus of your regulation, moving forward, given that you need real clarity to deal with financial institutions in a difficult climate?

**Mr Sants:** I would make the point that we would hope that sophisticated banking staff can focus on three things at once, but notwithstanding that, I take the point and, just to be clear, we are asking people to focus on the consequences, the outcomes of what they do. The other comments are about describing the framework that we will use to judge whether those outcomes are reasonable. What we are asking management to do, what we are asking people to do to protect depositors and savers is to focus on outcomes, and I think the message is straightforward and simple and should be easily understandable. It is actually a lot more understandable than, say, adhering to an 8,000-page rule book.

**Q64 Ms Keeble:** What more do you think that financial institutions could have done to overcome the current difficulties?

**Sir Callum McCarthy:** I think that there are a wide range of things that have gone wrong in the risk management within banks and other financial institutions—that is undoubtedly the case—and that is one of the fundamental things. If you look at the origin of the present problems, there have been problems in the origination of mortgages in the US which represent a series of failures, including what I think the US regulatory authorities would recognise as things that they have not appropriately controlled. There are a wide range of things. If you ask what can now be done, I think the particularly important question is to ensure that financial institutions improve their disclosure so that counter parties can make a proper, informed assessment of the position of those institutions, and that is something that we are pursuing.

**Q65 Ms Keeble:** Do you agree with the Governor that the incentive structures in the City of London presently are partly to blame for market turmoil?

**Sir Callum McCarthy:** I think there are some very difficult questions about incentive structures. I think it is a very complex area. I am very mindful of the fact, for example, that if you take Bear Stearns, about a third of the stock of Bear Stearns was actually owned by the employees, but that did not prevent Bear Stearns materialising as an acute problem. I think there are some very interesting and important questions about incentives which are very difficult to deal with.

**Q66 Ms Keeble:** I want to ask one further question, which is about the Special Liquidity Regime. I wondered if you had been consulted on it as one of the tripartite authorities. Given that you think that there should be credible deterrents for financial institutions who do not adopt sound lending

policies, as is also set out in your memo, do you think that the prospect, as the public would see it, of a 50,000 bail-out is a credible deterrent?

**Sir Callum McCarthy:** Yes, indeed. We were involved, extensively involved, in the discussions of the development of the Special Liquidity Regime. Second, I do not believe that the existence of this is going to impede credible deterrence because the essential—

**Q67 Ms Keeble:** It is going to impede it?

**Sir Callum McCarthy:** It is not going to impede it, and the reason why is that the credit risk lies with the banks and remains with the banks, and that is essential to the scheme.

**Q68 Mr Fallon:** The medium-sized and smaller building societies were excluded from the scheme, presumably because they could access funding indirectly. Has that worked? Are you aware that capital liquidity pressures on the smaller building societies have been eased or not?

**Sir Callum McCarthy:** I think the answer is the capital and liquidity pressures on the smaller building societies have eased for a number of reasons. I think it is not principally, at the moment, because of the very early stages of the Special Liquidity Regime. I am confident that there will be a transmission mechanism from those who can access the scheme, which include about half the building societies, to the residual half who cannot.

**Q69 Mr Fallon:** So there are not any smaller societies at risk?

**Sir Callum McCarthy:** Could I just make clear that I do not comment on any institution, but I am very confident that the scheme will work in a way that the smaller building societies will actually get access to it, not directly but indirectly.

**Q70 Chairman:** In fact, there was a radio report last evening as I was coming down talking about Nationwide, which services a number of very small building societies, but that facility had been withdrawn. I am suggesting it is just a radio report, but it highlights the issue of the very small societies having access. Is it something that you can look at and come back to?

**Sir Callum McCarthy:** Chairman, I would simply say that we have been very conscious, as the Bank, of this issue from the very beginning of the scheme, and I remain confident that there will be a transmission mechanism to ensure that the small building societies indirectly get access to it.

**Q71 Chairman:** Mr Sants, in regard to the Special Resolution Regime, you said to me that the role of the FSA was to protect consumers and not shareholders?

**Mr Sants:** As a general point, yes.

**Q72 Chairman:** If you believe so, why do you regard yourselves as the best qualified to close a bank when the best way to protect consumers would be to keep a bank open?

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6 May 2008 Sir Callum McCarthy, Mr Hector Sants and Ms Margaret Cole

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**Mr Sants:** Basically the special regime would not necessarily involve closure. It depends on the circumstances. It depends on the option, the resolution option, then selected as to whether or not that would lead to an orderly wind down or not. Reaching a determination that the current framework under which a given bank was operating was not a sustainable one, or likely not to be a sustainable one, does not also require reaching a determination as to what resolution option would then be selected. Just in passing, however, it would be clearly ill-advisable to reach that determination if you had not already worked out with the person or the organisation who would be responsible for running the resolution regime as to what the likely option was to be selected. That would clearly not be a good idea and that is why a high level of co-ordination is absolutely required between the organisation that runs the special regime and the regulator. There is no suggestion that this should not be a wholly co-ordinated process. I think some of this discussion somehow suggests that we would not be talking to each other. We obviously have to have a wholly co-ordinated approach, but determining that the current business model runs at risk of failure does not also require you to determine what would happen next.

**Q73 Chairman:** But you do not see any conflict of interest between your duty to protect the consumer and the protection of financial institutions?

**Mr Sants:** Undoubtedly, if you give an organisation a task—in our case, as the regulator, our task is to determine whether or not the institutions we supervise meet threshold conditions and we set a set of criteria for so doing—if people stop meeting those threshold conditions, people will hold us accountable to that fact along with the fact that we, of course, would be holding the bank management accountable, but that is the case in all cases. If you give people authority and responsibility, you make people accountable for the event. I do not in itself see it as a conflict, I see it as a natural fact of giving us a job which we would have to do well.

**Q74 Chairman:** Given the fact that the FSA's meeting was not minuted, you can imagine someone like ourselves saying, "Wait a minute, there could be a situation here whereby the potential regulation requirement on the supervisor means that they could hush up what is happening there." That information is not put back to the senior management of the FSA. Indeed, there are no minutes of that. So, at the end of the day, the interests of the consumer are not protected 100% here.

**Mr Sants:** If we do not do a good job, then the interests of the consumer are at risk. There is an obligation on us to do a good job, and Parliament has to believe that we will do our job well, and the purpose of setting out the programme we have set out and all the comments we have been making today and in our earlier appearances is to persuade you, what I truly believe that going forward we will do a good job.

**Q75 Chairman:** So you have got to persuade us that we have absolute trust in you?

**Mr Sants:** You always have to believe that an institution to whom you give responsibility and authority is going to do a good job; otherwise, obviously, you should not do that. We have set out what we believe we have to do, we believe we can do it and we make the point that I think the Chairman has already made that we have gone through a very painful learning process. We will be a better institution for having been brave enough and courageous enough to go through a learning process, lay out what we have to do and acknowledge our mistakes. That is the basis for a really strong institution in the future. Acknowledging your mistakes and learning is, I believe, a key component of a successful organisation.

**Sir Callum McCarthy:** Could I say, Chairman, I have no doubt that this Committee would be properly critical of the FSA, and I mean that, and I also think that that is good for us, but you should be in no doubt about the determination of the Board, the executive team, to actually learn from what has gone wrong and put it right.

**Q76 Chairman:** Sir Callum, but we do not want to be critical of the FSA after the event. We want to make sure that this legislation is fit for purpose, and that is the issue here.

**Sir Callum McCarthy:** Absolutely.

**Q77 Chairman:** I have met quite a number of brave people who just hit their head against the wall. We want bravery combined with intelligence and judgment.

**Mr Sants:** I would ask you not to set it up in a way that we cannot do our job. I am saying I truly believe, if it becomes a complex overlapping process with double supervision, that neither of those supervisors will do a good job and we will be back here with same type of conversation.

**Q78 Chairman:** I do not want to take too much time up, but the report of the Committee in terms of the deputy governor role was made because we need to inject creative tension and grit into the system, and that creative tension, I am suggesting, Sir Callum, was not there. That is why all of you, with equanimity, could come along to the Committee and tell us you did your job.

**Sir Callum McCarthy:** Chairman, I simply repeat what the Governor said. I am all in favour of creative tension so long as it is creative; and the points that Hector has made are ones which seriously worry us in terms of duplication, lack of clarity and lack of responsibility.

**Mr Sants:** We are all in favour of the Bank having a clear mandate with regard to financial stability and the Bank fully involving itself in discharging that mandate, and fully involving itself in discharging that mandate includes being involved in supervision of firms particularly when there is a risk that they

will need to turn to the Bank for liquidity assistance, but being involved in the supervision is not being a parallel supervisor causing confusion.

**Chairman:** I do not think the Governor was suggesting that.

**Q79 John Thurso:** Regarding the legislation, the Government have proposed that it should be enacted during this session. In the consultation document the Government also said it would be consulting with the FSA and other parties. What progress has been made?

**Sir Callum McCarthy:** The initial period for consultation has just closed. There have been very extensive comments, I am glad to say, because I regard this as probably the most important initiative affecting British banking for a decade and is going to shape British banking for decades in terms of the suitability and attractiveness of the UK as a place to do banking business. It is essential that we now digest properly the comments that have been made.

**Q80 John Thurso:** What is the process going to be? I have the same goal that you have, which is that everybody who has been involved in this needs to put what they think they have learned and we need to work through so we get the best outcome for everybody. What I am worried about is that actually, as sometimes happens with legislation, it disappears into the departmental black hole and what comes out is what we are stuck with. What is going to be the process by which you and the other institutions will ensure that best endeavours are made to get the best legislation?

**Sir Callum McCarthy:** There are extensive and intensive discussions going on between the Treasury, who are in the lead of this because it is legislation, the Bank and the FSA on all aspects of the proposed legislation. I think the proposal is that there should be a further consultation paper that will come out some time during the summer and then legislation later in the year.

**Q81 John Thurso:** Would it be worthwhile publishing the legislation in draft or possibly even having pre-legislative scrutiny?

**Sir Callum McCarthy:** It is not my decision. I think these issues are complex and important, and I am all in favour for giving as much clarity as early as possible so that discussion can take place on the detail as well.

**Q82 John Thurso:** So you favour legislation?

**Sir Callum McCarthy:** I favour trying to put out into the public domain the legislative approach. If that is through draft clauses, I think that would be an admirable way of doing that.

**Q83 John Thurso:** That would be something for this committee to have a good look at, would it not? Let us move on. The Governor of the Bank of England when he was with us suggested that there was not much merit in the fact that he sits on your board and you sit on his and that, indeed, it had distracted us

from really understanding the proper relationship that took place at a different level. How useful have you found your membership of the Court?

**Sir Callum McCarthy:** I think that there are benefits in having—. Actually it is the Deputy Governor who sits on the FSA Board. I see very significant advantages in improving the understanding of the FSA's Board about the approach of the Bank and also, I think, if you talk to most of the non-executive members of the Court you would find that they find there is advantage in having a representative of the FSA on the Court.

**Q84 John Thurso:** So you disagree with the Governor on that point?

**Sir Callum McCarthy:** It is possible for reasonable people to have different views.

**Q85 John Thurso:** That is nice to know. If the Bank of England is given a statutory responsibility for financial stability, as opposed to the more generic responsibility that it has at present, how would that interface and where would be the possible points of friction in regard to your responsibilities in this area? Maybe, Hector, you want to have a go at that?

**Sir Callum McCarthy:** Can I make one point before Hector replies. I would not want it thought that at the moment the Bank is, as it were, indifferent to a wide range of issues affecting financial stability. The Bank sits on the Basel Committee and has played a major part in drafting and forming the proposals on capital that are Basel II. The Bank, as the Governor made clear, actually Nigel Jenkinson, an Executive Director of the Bank, chairs the present Basel I committee on liquidity, so in all sorts of ways there is an existing interaction which should not be underestimated.

**Mr Sants:** As I mentioned earlier, I think that being clear about the importance of the Bank focusing on financial stability matters is the way into resolving the question you posed earlier in terms of achieving a degree of four-eyes creative tension, a positive engagement with this important topic from two institutions, and so we support the importance of the Bank having a statutory role with regard to financial stability. As Callum says, I cannot underestimate the point, I think it is important to reiterate the point that we do work well at the working level. We worked well at a working level in the summer of last year, and the Bank was involved right from the beginning, as you are aware from the chronology, in terms of being properly informed of the issues in the market place, including the specifics of Northern Rock. So we do work well together and we should intensify that relationship and a clearer mandate, I think, would help encourage the Bank to be more pro-active in that area, and we would welcome that.

**Q86 John Thurso:** Let me put to you what worries me in this. It is the difference between the duty and responsibility towards the system as a whole as opposed to the specific regulation of an institution. We talked earlier on about the trigger, for example, that might be used with regard to a special resolution system for a bank. It is possible to imagine a

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6 May 2008 Sir Callum McCarthy, Mr Hector Sants and Ms Margaret Cole

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situation where the Bank of England, with its overall new statutory duty with regard to financial stability, took one view with regard to a potentially failing institution, whereas the FSA, as the regulator of the particular institution with, as you have said, high regard for the consumer, might take a different view as to whether or not the trigger should be pulled. Is it possible therefore, if you are the single figure on the trigger, that you might not wish to pull it at a time when the Bank would want to see it pulled and how would that situation be dealt with?

**Mr Sants:** It seems to me difficult to envisage the scenario you are suggesting, I have to say. It is easier when one talks about concrete examples, and I am not sure if I can specifically envisage that. I would go back here to maybe looking at it from a slightly different perspective which may help eliminate this key question, which is that the basic role of a supervisor with regard to institutions—there are other things the FSA does, of course—is already to determine whether or not it meets threshold conditions. That is our job, and I am back to my earlier point. Either we are doing our job or we are not. It is obviously up to this committee and Parliament to determine whether we are not.

**Q87 John Thurso:** May ask you to address this distinction? Banks can fail without having an affect on the system overall. Johnson Matthey, Barings, a variety of institutions have in the past gone bust and it has been judged that the overall system was not at risk. A judgment was made with regard to Northern Rock that the system overall was at risk. So you have a duty to regulate an institution. It is perfectly possible for you either not to or to pull the trigger looking at one institution. The Bank of England have a specific duty to the overall financial system. What I am saying is the two are not always matched. How does that get dealt with?

**Mr Sants:** That would be addressed in a different way. I think that is a different question. There is an interesting question as to whether or not all banks and building societies should be eligible for going into a special regime or not, and if it was chosen that not all banks would be able to enter a special regime but only those who are deemed to be systemically important, then that judgment as to whether or not they were systemically important could well be one reached jointly or in different ways and is a separate determination from the decision as to whether or not they have met thresholds and conditions. The point, we are saying, is it should be a necessary criterion that you have not met our trigger with regard to the deliberation of whether you go into a special regime. There may well be other criteria for going into the special regime which are separate and apart from the determination of whether or not the FSA's trigger has been breached. By the way, in passing, we would take the view that one of the key lessons to be learnt from Northern Rock is the importance of having an effective depositor protection scheme that does protect all depositors. So we certainly would like to see a regime which covers all depositors and does not discriminate between those depositors in smaller institutions and larger institutions, but that is a

separate question and that determination would be addressed separately from the specific of have you met your regulatory threshold and conditions? What we are not wanting to see is somebody who can preempt that initial judgment. The initial judgment should be: have you met your threshold conditions? Subsequently other determinations could be made.

**Sir Callum McCarthy:** Can I make one point. I absolutely follow the line of questioning in terms of institutions versus the system, but to some extent it neglects the fact that there are important things that we do which are aimed at the system. If I can give one example: there has been a rather successful pincer movement between the New York Fed and the FSA designed to ensure that a backlog of credit risk derivative execution was dealt with, and it was something which no individual broker, dealer, bank had an incentive to deal with as it was a collective action problem. That is something which, by action between the FSA and the New York Fed, we substantially improved. That was not about any one institution, but was something which was designed to improve the system as a whole.

**Q88 John Thurso:** My concern is to ensure that going forward the lesson we have learnt is that there is clarity of responsibility?

**Mr Sants:** We would like our clause to be the necessary but not necessarily sufficient i.e. it does not have to be the sole clause.

**Q89 Chairman:** To take up John's point about draft legislation and pre-legislative scrutiny, that is one of the points that I will be including in my letter to the Chancellor as well as market abuse, because this committee has produced a report, Sir Callum, which was unanimous, which reflects the feeling across the whole House, and it is important that this committee is to be assured that we have confidence in this future legislation as the House has, because if we do not, then we are off to a bad start on that issue. So pre-legislative scrutiny is extremely important on a bill which you are saying, with which I agree, is one of the most complex bills that we will have before us in the coming months. Do you agree on that?

**Sir Callum McCarthy:** I think I agree with every word you have said, Chairman.

**Q90 Chairman:** Good. Mr Sants, you mentioned that all depositors should be protected. Do you include wholesale?

**Mr Sants:** No. Thank you, Chairman, for making that point? I just observe that on balance we would favour a regime that did look after all retail depositors.

**Q91 Nick Ainger:** Sir Callum, the Governor told us last week that this crisis, meaning the credit crunch, came right out of the design of instruments traded among the most sophisticated financial institutions where they did not spend enough time thinking deeply enough about the incentive structure of those instruments. Before Northern Rock were you

looking at the risks that all financial institutions were exposing themselves to because of their involvement in the trading of these instruments?

**Sir Callum McCarthy:** Yes. Before Northern Rock, we, the Bank of England and other comparable institutions around the world, had been drawing people's attention to a fundamental mis-pricing of risk which had many aspects associated with it. One aspect of it, and something which I think has had less attention than it should have had, as most of the attention at the moment is on the sale side, i.e. those who originate or distribute products, is I think that one of the central questions arises on the buy side: why did people buy instruments that they did not understand on the basis of a simple rating?

**Q92 Nick Ainger:** Bearing that in mind, if you were giving warnings, as the Bank was as well, about the risks that some of the institutions were exposing themselves to, those warnings were not heeded, and we have now got a situation where banks are still not lending each other money, we have got the credit crunch, people's mortgages are being directly affected and possibly the wider economy. Is it now time to consider a regulatory regime of those financial instruments so it is brought home very clearly and starkly to these financial institutions that they should not expose themselves recklessly, as they clearly have done, to these risks?

**Sir Callum McCarthy:** I very strongly believe that people should not expose themselves recklessly; and one of the points I think I made earlier is that one of the things that absolutely is required is improvement in the risk management practices within firms. I am not in favour of a regulatory regime which actually attempts to regulate individual products—to say you cannot produce this sort of product, you cannot invest in that sort of product—because I think that that has disadvantages which would outweigh the advantages.

**Q93 Nick Ainger:** But if we are all agreed that these financial institutions have, despite warnings, exposed themselves recklessly in the last few years and this has resulted in the first major global banking crisis for many years, and we all accept that, but you are saying that we would carry on with this light touch, while the Governor says that he feels that in the next five or ten years hopefully those managers within the financial institutions will have learnt this particular lesson, but do we not run the risk that new instruments not yet dreamt up by financial whiz-kids will end up doing exactly the same thing that the CDOs, and so on, have done this time? Is there not a risk of that and should we not really be trying to define the exposure of these institutions to the risks that they run rather than leaving it to them to make those decisions, because clearly we left it to them before and this is the mess that we have got ourselves into?

**Sir Callum McCarthy:** I should make clear that I do not believe that either present and certainly not the future should be described as light touch. I do believe that there is a need for a series of changes affecting capital, affecting liquidity, affecting

valuation, affecting aspects of credit rating agencies, affecting aspects of origination where we need specific actions, absolutely, and I think that that complete programme is something that we very badly need. There is determination not only in the UK but in other major capital market centres to implement that.

**Mr Sants:** Also could I make the observation, one of the lessons which we would learn from the last year or so is that market behaviour is not just a function of numbers, it is not amenable solely to arithmetical modelling; one of the key issues here has been a loss in confidence which then affected liquidity. So I think to set ourselves a goal that somehow or other we can create this model which we, the regulator, could then set parameters within which banks would have to operate, I am afraid, whilst it may sound attractive, it just is not possible. Markets are a function of both human behaviour as well as maths, and it is not possible for us to design a model that will anticipate everything that will happen in financial markets.

**Q94 Nick Ainger:** But one of the failings that you have identified in your report on Northern Rock was a lack of intensity by the FSA in ensuring that all available risk information was properly utilised to inform its supervisory actions. Given you have admitted that is a failing, the failure to assess the risk that the institution was under because of its business model, how does that fit in with what you have just said?

**Mr Sants:** Northern Rock's business model, as I have reflected a number of times, was not that complicated, and we do believe in this particular case it was reasonable for the Board, as non-executives, and the supervisor to have better anticipated the risks it was potentially running and to have put in place a better risk mitigation programme than they had. The comment I was making was a reflection of your consideration of the wider issues that have occurred in financial markets over the last 12 months. Northern Rock was, as it were, a victim, in the sense that liquidity disappeared in its main financing instrument, of these wider issues. What I was pointing out was that modelling the entirety of the financial system and all the risks that any individual financial institution is therefore running is not a realistic proposition.

**Q95 Nick Ainger:** So we are back to the position that we were in pre Northern Rock, in that we hope from the culture within these financial institutions that their risk management committees will start performing properly. Would you look at the performance of risk-management committees, for example, within these financial institutions, and what is the difference between what you were doing pre Northern Rock and post Northern Rock?

**Sir Callum McCarthy:** If I may say so, the answer to that is yes and yes. One of the things that we have done, for example, alongside other supervisors, through something called the Senior Supervisors Group, is to look at the experience of the last nine months in relation to those firms which have

succeeded in managing these problems and those firms which have exacerbated the problems to pull out exactly what is the difference in behaviour, to make sure that we ourselves in our supervision, the American supervisors and the German supervisors, and so on, go back to all these firms and say, "Are you actually doing the things that the best firms have done or are you simply doing the things which have led to these problems?" Absolutely, we will do that, and that is the line that we think is going to produce the best results.

**Mr Sants:** We are just trying to tread a balance here between saying, "We can do more" and, "We can do a better job", and also making the point that we are not infallible. We are not a regulator that just comes along and checks, "Are the necessary safety barriers in place", we are a regulator who is trying to make a judgment about the consequences of people's actions, the outcomes of what they are doing. Outcomes occur in the future. It is not possible to predict the future. If we could predict the future, we would not be sitting in these jobs. I am just trying to draw the distinction between what we can do and what we cannot do and encourage the committee to recognise the complexity and challenges in the task, but that should not in any way deflect from the fact that we can do a better job.

**Q96 Mr Dunne:** Just a couple of questions picking up on lessons to be learnt from Northern Rock before I follow up some of the Chairman's questions on market abuse. Now that we have the benefit of not only the hindsight of the way the Northern Rock crisis was handled but also the way the US authorities handled the Bear Stearns crisis, what lessons do you think the authorities here can learn from the way the Bear Stearns crisis was handled in the US?

**Sir Callum McCarthy:** I think that it is clear that Bear Stearns, which I think was a very important set of actions by the US authorities, has had a significant effect on improving confidence. It is clear that the rescue of Bear Stearns would not have occurred without involvement from the US authorities and from the Federal Reserve Board in relation to the £29 billion that they underwrote, and I think that one of the things that one has to recognise is that there are circumstances in which that sort of involvement is necessary.

**Q97 Mr Dunne:** Was there not a very close parallel with the situation with Northern Rock where there was a potential offer, or there was a major domestic bank seeking a central bank funded facility in precisely the same way as JP Morgan were, as you have just acknowledged was required for Bear Stearns? Were those circumstances not parallel to what was potentially available in the UK had the authorities, including yourselves, injected enough energy and speed of activity to encourage a similar situation to that which happened in the space of a weekend in September last year?

**Sir Callum McCarthy:** I think there are not exact parallels, but I do believe there are comparisons between the two, yes.

**Q98 Mr Dunne:** Would you have done it differently in the light of Bear Stearns. Would Bear Stearns provide the excuse or would Northern Rock provide the excuse to engineer a rescue within a weekend today which was not available last autumn?

**Sir Callum McCarthy:** I think one of the things that people were very conscious about in relation to Bear Stearns was how much further through the developing crisis were Bear Stearns versus Northern Rock, and I think that you have to recognise the effect of that, which undoubtedly concentrated minds in the US.

**Q99 Mr Dunne:** Turning to the accounting principles that apply to banks at present, given the difficulties in the securitisation markets of marking books to market, has that exacerbated the problems that there are at present in providing confidence to banks where risks and losses are likely to occur?

**Sir Callum McCarthy:** I think there are very significant problems in valuation of complex instruments in illiquid market. It is because of that that we have been encouraging UK banks and UK institutions to increase their disclosure to enable counter-parties to form an informed view.

**Mr Sants:** It is certainly very important that banks lay out fully all the necessary information that investors would need to reach their own views about the valuations of those positions, and that is something we are very much encouraging banks to do, but I would say, I think the main issue for the market place is not so much the issue of whether they are currently marked to market but rather investors' concerns and lack of knowledge as to what will happen in the future. So the bigger issue for investors has not been knowing what the next mark will be, not necessarily their concern as to whether the last mark was marked to the then market.

**Q100 Mr Dunne:** Do you think there should be greater transparency in identifying bank positions throughout the course of the year rather than simply on balance sheet dates?

**Sir Callum McCarthy:** I find that quite a difficult judgment to make, because I think that the problem in a way is making sure that there is information that is comprehensible and actually usable, and I have some doubts, if these were a daily marking of positions and publication of those positions, whether the amount of data would simply flood the market and be unusable. One of the real problems at the moment is, if you look at the length of annual reports of the major institutions, you get a huge amount of data. It is not clear how much information you manage to extract from all that data, and I think the proposal you make might have that problem.

**Q101 Mr Dunne:** Similarly, do you take the same view over reports by banks of breaches of their capital adequacy positions?

**Sir Callum McCarthy:** I think that it depends very much on the circumstances of any breach, for the reasons that Hector began to discuss in answer to an earlier question.

**Mr Sants:** It would not necessarily be right to say that all such breaches were important. I think you need to give proper consideration to the facts involved and the type of remedial action which would be taken.

**Q102 Mr Dunne:** Because it only transpired that Northern Rock was in breach of its capital adequacy when they published their accounts some nine months later, and it was apparent from your report into your own investigations that the flurry of meetings which suddenly took place with Northern Rock happened about ten days after they had reported that breach to you; so you reacted, obviously, with relatively the appropriate speed at that point; but I note from your report that you did not regard it as sufficiently serious for it to change any of the status of the monitoring of the bank, despite the fact that they were in breach of their capital adequacy regime. Is this a fairly common thing to happen with major banks that they breach capital adequacy, or is it very unusual?

**Mr Sants:** As I mentioned before, I am reluctant to give you precise data. I will give consideration to what we can say to the point. I come back to my earlier remarks, that whatever we do has to be in the best interests of the stability of that institution and if we judge that appropriate remedial action is in place, then it seems to me that that is a reasonable framework under which to operate, but we will come back to it a bit more with whatever we feel appropriate to reveal with regard to how often this occurs.

**Chairman:** I think Margaret Cole, is eager to go on to market abuse questions, Philip.

**Q103 Mr Dunne:** Thank you, Chairman. The Chairman touched on this in his remarks at the beginning. Ms Cole, you have helpfully provided us with a schedule setting out the apparent reduction in informed price movements from regular announcements over recent years of apparently a failure of the systems proportion of informed price movement on the back of takeover activity. Could you elaborate a little bit more on that and, in particular, set that in the context of how that compares with other countries?

**Ms Cole:** Yes. As to the latter question, I think we are the only regulator that publishes a survey of this nature. Indeed, we believe that demonstrates our commitment to transparency and trying to assess the scale of the problem. So I do not think I can give you a direct comparison with other countries. Certainly it is the case that we regard what is shown by these figures as a serious problem.

**Q104 Mr Dunne:** Could you tell us what you are going to do about it?

**Ms Cole:** Yes, I can. We recognise that we need to do more to address the issue of market abuse and insider dealing. We certainly need to bring more cases—that is why we are in the process of preparing cases and why we have carried out a major upgrade to the skills of the staff in the enforcement division. Clearly, what I cannot tell you about is the detail of

cases which are going through the system, but we do have a number of cases which are in the course of being prepared either for criminal prosecutions or for the civil process. We would expect those cases to flow through the system during the course of this year and next year.

**Q105 Mr Dunne:** You have said in your memorandum to us that it is difficult to extrapolate from these figures the idea that all of the price movements reflect insider illegal activity, insider trading, because there are lots of other reasons why movements might have occurred. I think the public perception, however, is that this suggests that roughly 30% of takeovers involve insider dealing and that is the way it has been characterised in some of the media. If that is not the case, I think that is a very unfortunate consequence of this transparency. Are you able to provide any explanation? You have said you are taking action in a number of cases. Can you try and elaborate a little bit more on what proportion of the 28.7% of cases you regard as being suspicious?

**Ms Cole:** I agree with you. I think we have sought to explain why these figures are not necessarily indicative of insider dealing cases because there are many reasons why the price of shares might move ahead of an announcement. We have provided you with some information, I believe, that suggests that we would certainly expect 10% movement without there being any misuse of inside information. That clearly brings the overall figure down to below 20%. We still think that figure is too high.

**Mr Sants:** You should also add into that that the statistic is probably not accurate to more than about 5%, so, effectively, something of the order of magnitude of 15% would be taken out of the equation. You are right, it is unfortunate that despite our best efforts to explain this, the media continue to report it in many cases, not in all cases, in a way which sometimes gives the wrong impression of what this data is designed to do, but we remain of the opinion that it is important to try to have some sort of objective measure here and it is important to enable us to focus on our basic objective, which is improving market quality. It is not the number of cases that matters here, it is improving the quality of the market. It is logically true that if there were no insider dealing you would not have any cases: so you obviously cannot have a case target, you need a target improving market quality.

**Q106 Mr Dunne:** Even if there was no insider dealing, it would be quite possible for a significant price movement in many takeover target companies to occur?

**Mr Sants:** More than possible, it is highly likely probable.

**Q107 Mr Dunne:** Which is why I think some of the comments you have just made about the quantification, perhaps it would be helpful if you could elaborate in future public announcements,

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6 May 2008 Sir Callum McCarthy, Mr Hector Sants and Ms Margaret Cole

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make that point clearer than you have to date, because otherwise it does give potentially quite a misleading impression.

**Ms Cole:** I think we have tried to make that clear in the latest *Market Watch* publication. I will certainly have a look again on that subject.

**Q108 Mr Love:** Sir Callum, does the City of London take market abuse seriously enough?

**Sir Callum McCarthy:** I would say, no, I do not think it does. One of our ambitions is to get it to take it more seriously, and that is why we are determined both to put in the resources within the FSA and to get the additional powers that we believe are going to be necessary to really establish what we are after, which is credible deterrence.

**Q109 Mr Love:** Mr Sants, is the FSA independent enough from its contributing member firms to be able to deal with this problem adequately?

**Mr Sants:** Yes.

**Q110 Mr Love:** Let me go on to talk about the recent controversy over telephone taping, where it would appear, according to *The FT*, which most people consider to be the in-house magazine of the City, they called it “a climb down” that you had moved from three years to six months in terms of telephone taping and that you did not include mobile phones. Does that show the sort of independence and robust action that we need at the present time?

**Mr Sants:** I think that newspaper report was a misrepresentation of the facts with regard to what had happened with regard to our consultation process. Let us just take a look at the facts here. First of all, telephone taping is already common practice in the City, the motivation here being, particularly for the large firms, to deal with trading errors and other related matters. Something in the order of about 80% of all the dealing telephones in the City are already taped. Reflective of our determination to deliver a clearer message with regard to market abuse, we thought it reasonable to take advantage of the introduction of MiFID, though this is not a specific MiFID requirement, to take a look at making a clear rule with regard to telephone taping because of the benefits we believe that brings to our fight against market abuse. Given our regulatory framework, that introducing a rule requires a discussion process and requires a cost-benefit analysis to be done. It is a very difficult issue, doing a cost-benefit analysis with regard to telephone taping, partially because technology is changing all the time and partially because of the difficulty, in fact, of getting accurate information from the firms. We had in our initial process quite a lot of contradictory views as to how expensive this process was. So we put out a proposal to try and flush through that debate and get a clear understanding of the cost of introducing taping. We have now done that and come up with a sensible proposition. Six months is more than adequate for our purposes and we are very happy with where the proposals have ended up. With regard to mobile telephones, it is clearly the case people use mobile telephones and, as

technology improves and, therefore, the cost, potentially, of addressing the taping of mobile telephones comes down, we will return to the point, but at the moment, under our statutory obligations, it was not possible for us to push through that measure and, indeed, technically I think may well have been very difficult in any case.

**Q111 Mr Love:** It was reported to the newspapers that this was a matter of cost, and the institutions have said this was not as expensive as you say on a cost-benefit analysis. Sir Callum, does that send the right message to the City: “Yes, of course we will step down, we are completely independent, we want to send signals to the City of serious market abuse is”? Did that send the right signal?

**Sir Callum McCarthy:** Given the legal requirements that we have to demonstrate that what we are doing is cost-effective, there was no other course of action that we could properly take. I think there is nobody who doubts the determination that we have to actually tackle the problem that has been a long-standing problem over decades. I think that we are tackling it with greater resolution and greater resources than has ever happened before.

**Mr Sants:** To deal with the particular, if we choose to, we can ask people to retain the tapes for longer periods. The obligation this places on us is to act quickly and decisively. If we act quickly and decisively, the change in the time period will have no material affect on our ability to deliver in this area. So it is not that important a point, with due respect. What is important is that the tapes are there for at least a four to six-month period.

**Q112 Mr Love:** Let us talk about quick and decisive. It is accepted, I think, across the City that there is widespread abuse. Whether that is supported in the newspapers, a quarter of all takeovers, or a fifth, or even a lesser figure, it is still very widespread. You have admitted earlier on that there are few prosecutions, even those in the pipeline. Sir Callum has just said this is a system that has been going on, market abuse has been going on, since time immemorial. Why did it take you so long to come back to the Government and say, “We need legislation to improve this situation”? Sir Callum, if you are quick and decisive, why has it taken so long?

**Sir Callum McCarthy:** All I would say is this is something that we have decided to push up our list of priorities. We started doing that, I would say, about three years ago. I think since then we have, as Margaret has said, changed the enforcement team, we have reinforced it, we have spent money heavily on the technology and we are now very clearly asking the Government for further powers. I think that it shows our determination.

**Mr Sants:** Mr Love, you have got a point with regard to the tariffs effect here. What we have learnt in the last year is that civil action alone is not providing sufficient deterrence, which is why we wish and intend to take more criminal prosecutions in the future. So we have learnt something here. We have learnt that our sanctioning needs to be greater to achieve the required deterrent effect.

**Q113 Mr Love:** I will come back to the criminal issue in a second. Can I ask Ms Cole, you were part of a team who went to see how the SEC do it. You indicated earlier on that they do not publish any figures, but did you get any idea from your visit there about the nature of the way they go about dealing with market abuse and are they, in your view, more successful and why are they more successful?

**Ms Cole:** I think there is no doubt that they have had more cases and they have more successful cases. I think one of the major reasons that came across to me from that meeting is that they have more tools with which to build the evidence to bring the cases, and the most significant tool that they have is the ability to enter into plea bargaining arrangements and immunity arrangements with co-operating witnesses, and that is not just a tool, they have a long history of that being accepted within their legal system and it is, as I am sure you know, very commonly the practice that witnesses will come forward when they are aware of an SEC investigation and will offer tangible evidence against other participants in a crime. That is not a power that we have historically had. You mentioned earlier: why has it taken so long for us to ask for it? It is not right that we have only just asked for it. We have been asking for this power for a period now of more than two years.

**Q114 Mr Love:** I accept the issue about the legal powers, but would you accept that there is a difference, a very distinct difference of perception about the robust—I use that word advisedly—and rather tough way that the SEC goes about investigating market abuse in the United States than the more consensual way in which we do it in this country? Is that a contributory factor to whistleblowing and plea bargaining that they achieve in the United States?

**Ms Cole:** I would accept there is a difference in perception and I would accept that that makes a difference to people coming forward, as well as I have explained a long history, a longer history than we have had, in prosecuting cases. I think it is important to note that we have said that we accept that we need to do more in this area and that we publicly said that we need to present a tougher face all round.

**Q115 Mr Love:** What action are you taking? We have heard about the action on resources strengthening the team. We know that you are going to be seeking the legal powers necessary. How do we change the culture in the FSA and, if I may say so, change the culture in the City of London to accept more that this is a criminal offence?

**Ms Cole:** We are certainly taking more steps that we think are bolder investigate steps. We have started a process of early telephone interviews so that we can get on to a case of suspicious movements at a very early stage. We will use all the powers we have available to us. That is both down the criminal and the civil route. We will use and we have used our ability to obtain civil injunctions to restrain the use of the proceeds of potential market abuse, so we

have looked into the various powers that we have and also into the various powers that we need and we do intend to be bolder and more resolute, if I dare use those words, about proceeding with market abuse cases and insider dealing cases.

**Q116 Mr Love:** We will no doubt look at that in the future when you come back. Can I move on to this issue of criminal versus civil, because it is recognised, certainly I think it is recognised by our committee, how difficult it is to achieve prosecutions in this particular area. The test required for a civil prosecution is significantly lower than that required for a criminal prosecution; so at the time when you are saying to us we are having real difficulty in getting prosecutions in this area but we want to move to a situation where we are doing more criminal cases requiring a higher standard of evidence that we simply cannot get, how do we match those two things?

**Ms Cole:** I think the first point here is that we think that we need to do criminal cases because we think they have a significantly greater deterrent effect on the industry than the civil cases. Of course, in civil cases we can impose unlimited penalties and we can prohibit the unregulated from the industry, but in the criminal context, obviously, what people are looking at is, the threat there is of a custodial sentence, and we think that has a significantly greater deterrent effect. So we think we need to move into the space of criminal prosecutions. That is not to say that we will not use our civil powers as well. You are right in saying that, at least theoretically, the burden of proof in a civil action is lower than for a criminal action. I would just say, however, that when we proceed with civil actions, and the process of reviewing our decision there is for the Financial Services and Markets Tribunal, the tribunal have held that there is no meaningful distinction between the burden of proof in a criminal case and the burden of proof in a civil case. That is something which I would say is very different for the SEC, who operate on a true civil burden in civil cases.

**Q117 Mr Love:** Can I ask you, and perhaps others would like to comment, is not the greatest deterrent effect actually achieving prosecutions and should not your first priority be, by whatever means, to prosecute?

**Ms Cole:** We do have a priority to prosecute. Where we can collect the evidence that will justify the bringing of a criminal prosecution in a suitable case, we will bring that prosecution. We have to have evidence that leads to us believe there is a reasonable prospect of conviction and we have to satisfy the public interest test. The important challenge for us is collecting the evidence which will substantiate our cases. We clearly cannot bring cases without the evidence. Insider dealing cases, as you pointed out, are uniquely difficult to bring, largely because the evidence is circumstantial. That is why it is so important to be able to get people to come forward as co-operating witnesses and give us actual direct evidence of the elements of the offence in question.

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6 May 2008 Sir Callum McCarthy, Mr Hector Sants and Ms Margaret Cole

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**Mr Sants:** As you yourself said, some of this is about messaging. You rightly observe that historically people have questioned whether the FSA is taking this issue seriously enough. We are determined to remove that misconception, we are determined to remove the conception that somehow or other we are light touch, and, therefore, one of the key points about bringing criminal cases, where the circumstances and evidence warrant it, is to deliver the right message here that we are determined to address this issue, and any suggestion that the culture of the FSA is not determined I would reject. I have acknowledged in the earlier point on Northern Rock there is more work to do. On market abuse the issue is not the culture of the FSA. I do, however, agree with the observations made by my Chairman and by you. I think there is still a cultural problem in the City in the round, albeit not in the senior management in the larger firms.

**Q118 Mr Love:** One final question if I can, Chairman. Mr Sants, you said earlier on, and I agree very strongly with it, that your role is to look after the consumer. Is it the success of the SEC in the United States that there is a perception there that the authorities look after the little guy against what is happening in some of our city institutions, and should not the FSA be concentrating more on looking after the little guy in order that we achieve more success in this area?

**Mr Sants:** It is absolutely the case that we need to look after everybody. At the end of the day everybody is a beneficiary of fair markets and quality markets, and you are absolutely right, as we said in our Market Watch, insider dealing is cheating and cheating is at the expense of everybody. Everybody who has access to the stock market and every consumer should be worried about this, and we are determined to deal with it.

**Q119 Chairman:** As you are aware, we will be continuing to look at that in our financial stability and transparency inquiry which has unfolded over the past few months. Could I finish on the issue of short selling and its regulation given the controversy there has been in the past? Going long on 3% or over of the total stock in a company must be disclosed to the market. Should there be a requirement for a declaration of interest from going short similar to applying and going long?

**Mr Sants:** Are you specifically referring here to our discussion around CFDs or are you talking about the wider issue of going short in—

**Q120 Chairman:** The wider issue, because I will move on to CFDs in a minute.

**Mr Sants:** I think, to open up on this point, we have in the past looked in some detail about the validity of shorting and I think it remains the case that thoughtful and considered shorting for justifiable investment purposes is a legitimate investment technique, and I do not think we would want to suggest that it is not. Indeed, we think it contributes to the liquidity of markets and, therefore, probably reduces rather than increases volatility. In general,

we do support having a properly transparent market place to enable investors to make informed decisions. The questions around an increase in transparency, both with regard to derivatives and shorts, really focus around whether we can justify that against cost-benefit analyses and the technical difficulties of collecting and delivering data, but the general principle we would agree with; we are always looking for markets to be as transparent as possible without interfering with the reasonable liquidity.

**Q121 Chairman:** But you have seen the havoc that that has caused in the past. We are not arguing here for banning it, but the same level of transparency and disclosure for going short as going long seems a reasonable proposition.

**Mr Sants:** It is a reasonable proposition.

**Sir Callum McCarthy:** Could I just say, if you go back, say 20 years, there was a famous comment once made that insider dealing was a victimless crime. It is absolutely not a view that we have. One of the things that we are particularly concerned about is during the present very fragile market conditions it is something which could cause real economic harm if it is allowed to flourish. We are really determined to try and do all we can on this. We will strain all our powers to deal with it because we absolutely reject any implication at all that this is something that should be an acceptable part of practice.

**Q122 Chairman:** On contracts for difference, on equities, should they be subject to greater trade reporting transparency. The trade reporting disciplines of the cash equity market do not apply to it. Should that discrepancy not be addressed?

**Mr Sants:** On CFDs, we collect data with regard to market abuse, so we are already collecting that data. The issue around CFDs is transparency and visibility with regard to people making informed decisions. It is not hampering our efforts with regard to market abuse because we already have the data input into it. But to my earlier point, in general, the presumption of the FSA is as long as it is not impeding liquidity, and there is an interaction here between transparency and liquidity, we believe full transparency is the right way forward, and that is the backdrop to our current consultation paper with regard to CFDs, but we do need to balance up that presumption of the benefits of transparency against a full understanding of the costs and practicality of delivering it, and, as you will probably know with regard to CFDs, an element of the industry, particularly the investment banks, have raised issues around the practicality of the cost of delivering a more transparent regime, but our presumption is that the regime should be more transparent and we will be coming forward with our proposals for this in due course.

**Q123 Chairman:** Sir Callum, I saw you nodding enthusiastically there. Is your impending liberation making you agree with me even more on that?

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6 May 2008 Sir Callum McCarthy, Mr Hector Sants and Ms Margaret Cole

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*Sir Callum McCarthy:* Chairman, I am very conscious that the last time I appeared before you, you very handsomely thanked me for giving evidence before you. I am rather worried how many final farewell performances I am going to have!

**Q124 Chairman:** Okay. On the short-selling issue, if you take that up and keep in contact, we will be happy. Sir Callum, the remarks I did make the last

time I endorse heartily and I think we are quite sure this time will be your last performance. There is no Frank Sinatra here, is there? Can I thank you for your co-operation with the committee and wish you well in your endeavours in the future, and thanks for everything you have done for the Committee and the FSA.

*Sir Callum McCarthy:* Thank you very much. I am grateful.

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Tuesday 13 May 2008

Members present

John McFall, in the Chair

Mr Graham Brady  
Ms Sally Keeble  
Mr George Mudie

John Thurso  
Mr Mark Todd  
Peter Viggers

*Witness: Mr Jon Moulton, Managing Director, Achemy Partners, gave evidence.*

**Q125 Chairman:** Mr Moulton, good morning and welcome to this session on financial stability and transparency. Your invitation to come here resulted from our report which highlighted the complexity of financial products and posed the question of whether those providing the products and those buying them understand what they are selling and what they are buying. There was a huge question mark over that. We are delighted that you have come along to give us this presentation to explore that further. We will have a few questions on the back of your presentation. Could you identify yourself for the shorthand-writer and then it will be over to you.

**Mr Moulton:** Jon Moulton, Managing Partner at Achemy. Thank you for the opportunity to speak to you. You asked for a presentation<sup>1</sup> and I found it quite difficult to do. The document that this Committee has produced is actually a pretty damn good summary of everything that is out there. I am conscious that I do not really want to repeat things you already know. I have allowed myself a few thoughts to take you through it. There is an ongoing post-mortem into what has happened in the financial world and everybody pretty well knows it. In summary, we had strong economies and people arrived with this new wall of highly structured products that had not been seen before. They provided very, very large quantities of very cheap debt. The only way you can make any money out of cheap debt is to buy assets with it that yield more than the debt. People got very rich finding the assets that would provide enough return and that was sub-prime mortgages, that was leveraged loans in the buyout industry, it was credit card debt, it was consumer debt, it was every kind of debt you can imagine, but, of course, there is a problem; eventually supply runs out and when the good assets ran out people started to buy worse assets. So instead of going at three times salary and 70% loan to value, it was four times salary and 90% loan to value and then that did not work because there was not enough value or enough income, so you stopped checking income, you stopped checking valuations and you stopped worrying about the legals. So integrity went out of the market to try and maintain the flow of assets. At the same time, everybody got more and more complicated scrabbling for the last pennies of return in the business. That was the boom. But, of course, if you buy rubbish eventually the rubbish cannot pay the interest and whether it is US sub-prime or whether it is a company that is

overloaded, eventually they cannot pay the interest and things went bust. That is actually the core of everything that has been going on. There are a lot of things around it. This slide is possibly a little odd to you but it might illustrate what happened. This is a Google earth picture. You might wonder what a Google earth picture had to do with financial stability. This was actually the method used by some of the sub-prime valuers to value houses. They would pick off one of these houses on here, take its Zip Code and then arrive at a value. There is, however, one technical issue which you must give them time for. These pictures were taken at about four in the afternoon. The reason for that is that they could tell from the shadow how many storeys the houses had. That is how silly it all got. That is when the integrity went out of the market. That is valuation. Then you have all the supporting players. You have seen these people, you have interviewed them and in some cases ascertained what it is they have been doing wrong and how they have contributed. There are the rating agencies with this bizarre attitude of, "You don't have to rely on our ratings. They really don't matter. People shouldn't use them to lend money." It is an extraordinary position and one which obviously has its defects because they were central to the whole game. Without the ratings very little of this structured product was even possible. They are a big cause and they are quite difficult to deal with. Then you had the banks. The banks made quite a bit out of this, their profits went up, but actually when the music stopped they were holding so much unsaleable rubbish that they lost an enormous multiple of the profits they had made. We have seen massive erosion of the capital bases of the banks driven by this huge difference between the profits they made and the credit they lost. In the case of Citibank it is something like a factor of ten to one. Then you should look at the bankers. The individual bankers made a lot but they lost little, with big bonuses, huge salaries and big equity packages. This was an extraordinary period of happiness for senior bankers around the world. Then we had the regulators and, as you have found, they were not equipped to deal with the structures that were in front of them and certainly in the UK their organisation was less than perfect. There is still quite substantial disagreement as to what would represent a good organisation. Let me start putting some simple ideas together. What is financial stability? We need to have trustworthy banks. It would be a huge benefit to the UK if the rest of the world believed

<sup>1</sup> Ev 63

that our banks were better than others. At bare minimum we would like them to be as trustworthy as others. It would be a lot better if they were better. The same applies to insurance companies: they really do matter to financial stability. The same is true for asset management and pensions. These are the things that are central. If these work we have financial stability, mostly. We are less concerned about the people that play elsewhere in the jungle. If people want to bet and hazard and try and be very clever in all kinds of exotic things then that is fine, it is good, it is innovative, it makes things liquid, but do we really need them? If the hedge funds were to vanish tomorrow I do not think the UK's financial stability would be that much affected. You could certainly take the view that they do not need control and regulation in the way the other things do. The Governor made this point gently to you but it is an observable fact: bonuses and payments for failing bankers have been at all time peaks. It is quite remarkable how few bankers have left after losing their institutions billions of dollars. It is no coincidence this, it is the real world: people who are given very large incentives to do things will do them; they will do all kinds of things. All that does is it means that the bloke is interested in the current quarter's earnings. He will hazard his institution's money because it is in his interest to do it short term. It is the transaction that matters and not the quality of the investment. The method of payment is absolutely wrong from the viewpoint of ending up with the right economic answer over time. I believe that this ought to be something the regulators should take a lot of interest in because a bank that pays its people 1,000% bonuses on short-term profits is massively more risky than one that pays people out on the basis of five-year performance or of share price performance over a medium term; they generate completely different behavioural patterns. I cannot find much evidence that the regulators take any notice of remuneration schemes when they are assessing the risk of organisations and this is probably the mechanism which actually would drive bonuses and payments for failure back into line, making them a risk factor. If people had to hold more capital because they have got a risky remuneration system it would not be long before they changed their remuneration systems. Let me look at bank capital. Basel 2 is hideously complicated and it is the result of a lot of compromises. It drives in the wrong way; it drives off history and predicts the future. As you get a declining level of failure and default the Basel 2 mechanism drives the capital of the banks down. As things get better the bank needs less capital. It is not a very sensible direction to head in because when things do eventually flip they are left with the least possible amount of capital. That is just the general problem. The more basic point is it is too complicated. It is based on piles of models, all of which have got spurious accuracy attached to them. Many of them have no underlying basis. The complexity of Basel II is a big problem. Northern Rock was fine under Basel II. In the middle of last year they said, "We can increase our dividend and do

a share buy back." Basel II does not work properly, it is not perfect and, despite its almost mystical air, it needs working to make it a lot easier. I cannot understand why the banks are still paying dividends. Many of them are increasing their dividends after announcing diabolical results. The banks clearly need more capital yet somehow they are being allowed, either by the markets or by the regulators, to increase their dividends at the same time. I do not understand that. I think it would be a very good idea to put a simple floor under the bank capital rather than spending some years trying to come up with a Basel III, which I think the Governor was of the opinion would be beyond his lifetime. If we were to say that banks had to have 6% shareholders' funds or some similar statement we would actually give a great deal of confidence to the banking world by putting a floor under it. So you would have to have the greater of the basic floor or the Basel II calculation, that kind of thing. The base rate—another fairly random point but it is a very, very obvious point—is no longer controlling our economy. The bank rate, the LIBOR rate is today 5.8% for 12 months and the base rate is 5%, but gilts for 12 months are 4.3% or so as of this morning. Base rate does not really work very well any more and that has been obvious over recent months. The base rate moves, mortgages do not move, LIBOR does not move. Something needs to be done here and I am certainly not qualified to say what. The principal economic tool that has been used to run the economy is no longer very effective and that is very important towards financial stability. Let me give you some of the things to go wrong that are to come and add a bit of thunder and lightning to give it a background! A lot more can still happen. Things have become terribly interconnected. This is just an example of one horribly complicated game. Let us say you would like to set up a nice new sub-prime CLO or CDO, some horrible little vehicle that is going to lend to very poor credit in poor housing areas in some country or other. Let us call it "Vagrant Loan" just to give the right flavour of the nature of the business. What is the easiest way to get your AAA rating? Of course, you want to get AAA rating on your debt. It was very easy in those days. You would get a bullet proof AAA insurer, a monoline insurer to insure your debt and you are immediately AAA. This became quite routine. This could be done in a matter of a few weeks last year. The CLO could be rapidly raised. This is what you ended up with: a monoline insurer, AAA guarantees the debt of Vagrant Loan. Vagrant Loan itself might be quite a ropey credit but it does not matter because anybody who is buying one of the bonds of Vagrant Loan is relying on the insurance, not on Vagrant Loan. The insurance companies, the pension funds and the rest buy the debt off Vagrant Loan in the belief it is AAA. If this was Northern Rock debt it would have been sold last summer at six one-hundredths of a per cent over Euribor; that was the return for the risk in the deal. Why is Monoline AAA? It sounds like a very simple question. It has got a very simple answer. Because a rating agency says it is, it is a simple as that. Then the problem

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13 May 2008 Mr Jon Moulton

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comes up, how can a monoline insurer underwrite one hundred times its own net worth? Some of them did. I am told that the worst Monoline did 232 times its own net worth. You do not have to have to be of a particularly doubting nature to worry about an insurance company that is covering more than 100 times its assets. What did we come up with? Pass the parcel! Let us introduce a large AAA rated insurance company and let us call it BIG to avoid lawsuits! It sells reinsurance, which is basically a credit default swap. A credit default swap is a piece of paper which says that if the borrower does not pay we will. The mechanics are a bit more complicated than that but that is all it amounts to. It says that if Vagrant Loan is getting into trouble and cannot pay we will pay instead of Vagrant Loan. So the monoline is now bulletproof because it has got a AAA guarantee of itself. Here is how you start to build the kinds of cycles and circles that make this world impossible to handle. You have got guarantees everywhere here. Just look at that for a second. BIG is basically guaranteeing the monoline. Vagrant Loan, which it has got a sort of dotted line relationship to on that credit default swap, is actually going to pay its debt. The insurance company at the bottom is relying on the monoline, which is relying on BIG. The rating agencies have conveniently labelled everything in this circle AAA with a couple of interesting exceptions. Vagrant Loan itself, which has never any kind of source and, perhaps more importantly, the actual source of the asset here, which is the “shack owners” as I call them, the people with the sub-prime mortgages. Look at what happens when the people do not pay. The word “guarantee” becomes “liability”. Liabilities are quite different to guarantees, they hurt. You have to take them through your profit and loss account and write your assets off. So as the mortgages start to go down the CDS, which was just a very large guarantee, becomes a liability and BIG starts to incur very big losses. Its net worth subsides and here is what happens, you lose a bit of rating. Now you have lost a bit of rating. In Monoline, which was an insurance company, it relied on the rating of BIG for itself. What happens next? The Monoline loses a better rating. Think about the people who are in the loans at the bottom. It is no use looking to the sub-prime people, Vagrant Loan has got nothing in it, and you are relying on the Monoline. So what happens to the loan? Those loans are all over America. Every insurance company and pension fund you can imagine will own them and they will just suddenly have suffered a loss in value of the loans because the rating has gone down, and it gets worse. Because the CDS now starts to trade at a terrible price because people realise Vagrant Loans are a real problem you have got more losses, BIG loses more and Monoline loses more. That is the kind of spiral that exists in the market now. These are everywhere. This is the CDS death spiral and there are huge numbers in this game. I am not really here to sell you the pain of this one. There are other problems in the CDS market. There are some remarkable pieces of arithmetic. AIG, which is the biggest writer of these things, has just announced its results. It has got a net worth of

about \$80 billion. It has got a CDS portfolio called “Super Senior”, which is a very reassuring name until you discover that their definition of super senior is that there was no expected loss at inception, which I think means pretty well every asset I have ever possessed as I would not expect to have a loss at inception. Quite worryingly they talk about their super senior CDS portfolio of \$475 billion, which makes me look with some fear for the other portfolio. They have written \$21 billion off this risk-free portfolio so far, \$9 billion of it in the last quarter. What do they do? They raise their dividend and they introduce an improved pay structure for the guys who are operating in the unit that has just lost the \$21 billion. It is interesting times. Then they put out a note which says that the loss is more likely to be \$2 billion and not \$21 billion but they have had to put \$21 billion and, by the way, there is another study which shows it should be \$30 billion. These things are not easily dealt with. The next stuff you could not invent. This is the method they use to value their write-offs on CDSs. They use a model called the BET model. To reinforce the feeling of playing in a casino they use a Monte Carlo simulation to add to the refinement of the calculations. In reality none of us knows whether that write-off should be \$2 billion, \$20 billion or \$40 billion. Part of the CDS portfolio—remember, AIG has a net worth of \$80 billion—is \$192 billion which is used to replace regulatory capital in banks. So a remarkable financial feat seems to have occurred here where \$80 billion is guaranteeing \$192 billion of bank capital. I do not know how that works. I cannot improve on giving you an idea of the fairyland we are in over just showing you the words out of AIG’s own press release. This is about transparency and disclosure. I will read it aloud because it deserves it: “AIG present its operations in the way it believes will be most meaningful and useful, as well as most transparent, to the investing public and others who use AIG’s financial information in evaluating the performance of AIG. That presentation includes the use of certain non-GAAP measures. In addition to the GAAP presentations, in some cases, revenues, net income, operating income and related rates of performance, and out of period adjustments are shown exclusive of realized capital gains (losses)”—so they are excluding either something they add or subtract, we are not really sure—“the effect of FIN 46(R)”—which I am sure I do not need to explain to this audience—“the effect of EITF 04-5, the effect of FAS 133, the effect of trading account losses”—profits before losses are always larger—“the effect of remediation activities, the effect of change in actuarial estimate, the effect of expenses of industry wide reviews and the effect of catastrophe-related losses.” You would not like to think about things like hurricanes and earthquakes affecting the resource of an insurance company. All I am trying to do here is demonstrate to you the incredible complexity of what is going on here. You would not believe that this stuff is out there but it is out there, it is in the fine print and the mountains of paper that these industries produce. Here is what we have got, we have got an interconnected, mind-blowingly

complicated market where losses are not just limited to actual economic losses, there are economic losses arising because of the amplifying effects of the interconnectedness, the loss of confidence and fear. It is very hard indeed to estimate what a \$5 billion loss in sub-prime really means to the financial markets. It might be \$50 billion of losses, the complexity has no limit. However, there is no doubt that both the regulators' and directors' skills in these entities are limited. You have interviewed people who did not know what a CDO was and you have interviewed people who do not understand how this lot fits together at all. I do not think you are ever going to get to a situation where boards of directors and regulators can handle this level of complexity in an effective way. Transparency does not do it. If you look at an HSBC set of accounts, famously 400 and something pages last year and the Royal Mail would not carry it for health and safety reasons, they are unreadable. Northern Rock was a master of disclosure. Everything about Northern Rock is available on its website still. You can find all the details, their off-balance sheets, their guarantees, but how you are supposed to interpret a 400 page document on one of the guarantees, with 11 layers of debt, interest rate swops, currency swops done in three currencies, I do not know. Transparency will not do it. Disclosure does not get you to the answer because nobody understands it or follows it. People piled into the Northern Rock paper at tiny margins. Next we have some ways ahead and some simple ideas. I think if you want to have a UK bank that is worth having you have got to do something which is against pretty well every instinct I have and that means you have got to stop them doing things that are not capable of being regulated. Do not let them go into synthetic CLO squared. We have lost a lot of money in the UK on those and there is not one bank director in ten that could give you a coherent account of one. If you want to have confidence in banking you cannot allow them to play with plague like vehicles and some of these things are. I think that is a really big step but I think it is the right way to go. Limit the banks to that which is realistically capable of being regulated. That will give enormous confidence in the banks. Increasing the banks' capital as the economy recovers is absolutely something that has to happen. There is not enough capital there on any reasonable calculation. They should not be dissipating it in dividends, they should be hoarding it at the moment and building some real capital back up and reducing the risk by getting out of these ludicrous activities that they have lurched into and lost a lot of money at. A clearer capital setup is important. The language of Basel 2 about pillars, levels, layers and models is too complicated. Something much simpler is needed and it may be simple arbitrary percentage floors would be a marked improvement over the apparent sophistication of the current setup. Regulation did not work well in the UK. The multi-headed model simply did not work last year. Each of the heads has a different view on how it should be sorted out. Organisations all have different views. It seems to me very simple: it would be nice to have somebody

clearly in charge, a single soul, somebody who could act across the lot. Why do we need three entities to do it? I do not know. I really cannot understand why we need three entities. It was pathetic that they did not work very well. It was bizarre to read the Governor's evidence to you that it was not helpful to have people on each other's boards, but that would be very straightforward. The FSA deserves a bit of applause for saying it got things wrong. There are things that can be done to sort it out. It is unrealistic to imagine that the FSA can ever handle the complexity of some of these models and markets; they will never do it. Then you have got to have a better bail-out system which is being rushed through at the moment and it needs a little bit of care in the process. If you try and rush through a comprehensive package it will fail. It might be better to live with just extending the emergency powers and doing it properly because they are not going to be needed very often, one hopes. You need to do something similar for insurers. I think that the risks in the insurance industry are something that have been discussed only a little yet, but there are some of the similar risks and some of the same instruments dotted around the insurance world. Finally, you have to allow failure for most non-banking organisations, to make it clear that you would allow that to happen. That is the end of my presentation. Thank you.

**Q126 Chairman:** Thank you for that fascinating presentation. I remember the words of Josef Ackerman of Deutsche Bank when he said, "I no longer believe in the self-healing power of the market." Who is to do these things? Is it nasty politicians and regulators that have got to do something that interferes with a fantastically mobile free market? Are we up against our prejudices here?

**Mr Moulton:** I think you have to have some level of regulation. I do not think there is a requirement for politicians to be nasty, but they do need to be firm and they need to work out what it is they are trying to achieve. I think the basic thing you are after is setting up a stable financial structure. Central to that is having banks that are trusted and trust each other. As of this morning, it is a 1.5% risk premium between taking a piece of paper from a bank for 12 months and a piece of paper linked to gilts. That is the level of distrust there still in the marketplace. People think banks can fail. You need to get the banks in order and that will not happen without some level of regulation. It never has anyway. Yes, you have got to intervene. I would urge you to intervene to the extent of making sure the banks are trustworthy and capable of being understood.

**Q127 Peter Viggers:** Before we recover from where we are we have got to work out just how bad the situation is. Mr Moulton, you did not follow your chilling and very accurate analysis of the banking situation through to its natural conclusion by looking at the housing corporations in the United States and the implied guarantee by the United States Government of the housing umbrella structures.

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13 May 2008 Mr Jon Moulton

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Perhaps you could tell us something about this. I think I am right in saying that there are national housing bodies which give implied guarantees and everyone assumes that the United States Government stands behind those. The chairman of one of the leading housing bodies, when asked about six months ago what would happen if housing prices fell by about 20%, said, "I don't even want to go there." I think we should go there. How bad could it get in terms of the United States' credibility?

**Mr Moulton:** The very strong probability is that US housing prices will descend 20%. I think they will survive the experience. There will be further losses in mortgage banks in the United States. Mortgage vehicles will cease to operate, as they have been doing fairly steadily over the last few months. I do not think that the US Government is threatened by it. They will have to inject liquidity repeatedly into those guaranteeing organisations and those injections will be inflationary in nature, that is the risk they have to take, but that is what will happen. They cannot allow them to go bust. Fannie Mae and Sallie Mae cannot be allowed to cease functioning, so they will pump money into them somehow.

**Q128 Peter Viggers:** And you did not go on to the even more chilling thought that the United States' credibility as a financial entity is threatened by this?

**Mr Moulton:** It is threatened by it. It is threatened now. The dollar has had a terrible time recently. People are much less confident about it. It has been fished out by foreign money and by very energetic efforts in the capital markets. It is a very unstable world. There is as much likelihood of things getting worse as better in the credit markets over the months ahead.

**Q129 Mr Todd:** How has it affected your business?

**Mr Moulton:** I have two businesses with completely different activities in this. We have a distressed debt business which is quite enjoying the current days and a private equity business with a rather larger portfolio which is finding the effects on the businesses quite painful. There is no debt available for the larger buyouts anymore, so I think the activities that you were investigating a year ago have gone away for quite a while. I met a man from one of the larger funds on his way to the office this morning and he said, "Good morning. I don't know why I'm going to the office!" That gives you an idea of the state we are in. There is no large debt available and so it has stopped large buyouts. The further effects are the real ones that are starting to hurt us, retail, house building, construction materials, high end home purchases and anything that is a financial product to the consumer which is finding it very hard to be financed.

**Q130 Mr Todd:** There were two forms of model for private equity: one was leveraged buyout in which you just made your return on the very low debt servicing you carried and the other was injecting proper management skills into a previously rather poorly run sideline business. Presumably the latter model is equally applicable now, is it, if not more so?

**Mr Moulton:** You can either play financial games or you can play operational games. Most private equity firms have fundamentally played both over the years. At the moment there is no financial gain. The financial side of life is a problem. There is a lot more focus on the operations of the companies than there was. The resources have had to divert themselves to it.

**Q131 Mr Todd:** Is this going to produce a shift in this sector with some fallout? There are certainly some businesses which have loaded themselves with debt which presumably is going to come back to haunt them in this exercise.

**Mr Moulton:** For companies that got very heavily laden with debt, particularly over the 18 months to the middle of last year, there will be failures amongst them. I do not know how many failures and I do not know the scale of the failures. Some of those companies are laden with debt at levels that they cannot handle properly. There will be adverse effects on the business; that is happening. There are probably 20 or 30 substantial UK companies that would be in that category. Yes, there is more pain there. Going forward, it is probably quite healthy for private equity because it is going to force people to become managers if they were not so before. The people that are working in the firms are gradually changing towards managers and away from bankers.

**Q132 Mr Todd:** The Government is currently giving some thought to the balance between debt and equity in taxation terms. Is that an area where more could be done? To some extent your previous answer indicates that it is not an issue which will trouble us greatly in the immediate future.

**Mr Moulton:** In the current market the availability of abusive levels of debt is nil; the horse has gone.

**Q133 John Thurso:** I am finding your analysis fascinating, not least because of its strong focus on the banks, which chimes very much with where my own thoughts were going and your way ahead of strong banks. Don Cruickshank, in his famous report ten years ago, I think made the point that banks in good times make excessive profits and in the bad times get protected by the State and the remedy is for them to be one animal or the other. In other words, they are either like a utility, regulated, not very high risk, not very high profit but absolutely trustworthy or we design a regulatory system which protects depositors but allows any and every bank to fail. Is that a reasonable analysis? Do you feel pulled in either direction?

**Mr Moulton:** It is a reasonable analysis. The arguments between the various approaches are quite divided. I think it is really quite desirable that banks have a low probability of failure for any party that deals with them, not just depositors. There is a very clear and obvious danger in making banks guaranteed entities. I think shareholders should be able to lose money and I think people who provide subordinated capital to banks should be able to lose money as otherwise things will just work like the US

13 May 2008 Mr Jon Moulton

S&Ls did in the bad days. You have got to end up with a balance where there is risk. It may be that the kind of situation you want is if a bank gets in trouble typically the government or some fund will bail out the depositors and then the banks should be put into a bankruptcy situation. That would be absolutely right in most circumstances and it would not lead to an erosion of confidence if it was something which happens every 20 years and it is handled properly and quickly.

**Q134 John Thurso:** So your preferred approach, if possible, which I would share, is to ensure strong protection for the depositors, everybody knows where they are, but to say to the banks, and it does not matter how big they are, "If you play fast and lose and you cannot learn to say no then you will go under"?

**Mr Moulton:** Fundamentally, if you make them government guaranteed entities the abuse of that guarantee would undoubtedly occur on a very large scale and you will end up with an absolutely monstrous bailout requirement at some point.

**Q135 John Thurso:** You were talking about the impact on what the Governor called when he was in before us the real economy as opposed to the financial economy. I know that an instruction has been given to the head of RBS business managers in Scotland anyway that they are to get 1% more on every loan coming up for renewal irrespective of whether it is a loaded company. That means that a huge number of businesses which are either family owned or small businesses, which are a big engine of our economy, are all having 1% stuck on their financing costs to pay the bonuses of millions to the Board of RBS basically, which seems to me an incredibly shocking indictment of banking mores as they are at the moment.

**Mr Moulton:** I think there is considerable merit in what you are saying.

**Q136 Chairman:** The issue behind the Financial Services Compensation Scheme is tied to this, that is, we will let the banks go bust. I saw a story at the weekend that said it has got £4 billion at most. That will not cover it at all. We have got the BBA coming in this morning and they are going to say to us, "What you have recommended in your report, a pre-funded scheme, is going to destroy the banks. We do not want that." At the end of the day, if we do not do anything about that it will be all the taxpayers picking up the bill.

**Mr Moulton:** Absolutely. I have noticed that the banks are welcoming the abolition of any risk sharing. If people have got 90% of their retail deposits covered that helps, just the fact that it is 90 and not 100. You cannot have a situation where the Government is an absolute guarantee of these things. People will abuse it, they always do. There will be a concern that there will be loss, but if you make depositors roughly the equivalent of football creditors in the bankruptcy of a football club, where they get out first, then you would probably solve the problem every time. I do not know if you are familiar

with how it works, but in a football club basically the footballers get paid out of any money there is swilling around before anybody else gets paid. If you did the same with banks then that would, in one fell swoop, pretty much guarantee depositors had very little risk ever.

**Q137 Mr Mudie:** I have a lot of sympathy for what you said about banks being trustworthy, capable and understood. It is like Alistair Darling saying he would like old fashioned banking back! I think the consensus is to protect depositors in some way. Let us say that is done and we are in the present situation and we say we are only worried about depositors and we will deal with that. The bank has just \$50 billion. Would you have done that? I am not asking you to pass a judgment on that act. Would you not intervene and just sit back and let them reap the rewards of their own greed? Is that what you are suggesting?

**Mr Moulton:** To a large extent the old moral hazard argument is such a strong one here. There has to be a degree of suffering by the banks.

**Q138 Mr Mudie:** I listened to that argument with the Governor, but I do not see the banks suffering. I see it as the poor sods that are not getting their mortgage extended and the little business that is suddenly getting its money withdrawn suffering. The banks just seem to me to be able to sit it out, recoup slowly and keep paying themselves their salaries.

**Mr Moulton:** It is remarkable how the distribution of the payment has been done. I am a good old fashioned capitalist. To see increases in pay, increases in dividends and a diminution of funds available for small businesses and mortgages is not a particularly graceful sight and that is how it has been worked out.

**Q139 Mr Mudie:** I understand. Nobody in the room would defend the payment of dividends, the payment of bonuses or even some people keeping their jobs. In terms of a politician looking at the general economy and being responsible for the standards of living of people out there, do we not have to intervene to keep this thing intact?

**Mr Moulton:** Yes, you do, there is no alternative, but some central regulation and control, whether it be the very old fashioned fatherly figures of the Bank of England 20 or 30 years ago with a tap on the shoulder and the "Really, you hadn't ought to be doing this" speech, which worked—

**Q140 Mr Mudie:** The Governor says he does that. He showed us some obscure speeches he had made in Bristol and Cardiff and places where he says he warned them.

**Mr Moulton:** I am sure the good bankers of Cardiff were listening to him!

**Q141 Mr Mudie:** I wonder if you place too much responsibility on the regulators in this respect. Ferguson and the Arsenal manager never blame their players, it is always the referee. Their players can kick the hell out of someone and they will say,

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13 May 2008 Mr Jon Moulton

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“Why didn’t you control it?” The banks can behave badly and it is the poor FSA who cop it, they will say, “Why didn’t you stop them?” Why did they do it?

**Mr Moulton:** There is nothing at all that I can disagree with you on. It is the way things are. It can be stopped.

**Q142 Mr Mudie:** As politicians we can put heavy pressure and abuse on the regulators, but what on earth will stop the City continuing with the greed and bad behaviour?

**Mr Moulton:** I would put up one clear suggestion and it is a mechanic, which is that the way people are paid should be part of the way that they are assessed for risk. You put people on 1,000% bonuses and they will do all kinds of things. You can restrict this stuff. Short term they will say, “No, you can’t do that, you will restrict innovation.” We do not want widely innovative major banks.

**Q143 Mr Mudie:** You are suggesting in effect that if you pull it out of the emotional role the regulators should set salaries and bonuses.

**Mr Moulton:** No, I do not think they should do that. Salaries can be very high. It is the incentive payments and so on that really do the damage and it is the structure of the way people are paid which is always a tremendously difficult judgment, but I do not think anybody would say that things had not swung far too far.

**Q144 Mr Mudie:** You would then be advocating that a regulator would interfere with the internal affairs—and I am not criticising it, it is a very interesting thought—of an institution in setting—

**Mr Moulton:** No. What you say is that if you operate with bonuses of no more than 100% as salaries or compensation schemes based on five-year targets that will be fine and you will get the standard capital allocation. If, on the other hand, they want to have 20% of their total remuneration paid out in monstrous bonuses to a small group of people we will add 1% to their capital requirement because we think they have got a lot more risk and then the market will sort it out.

**Q145 Chairman:** George’s point is a very valid one because we can write the script and the script would be that you are going to chase good bankers away to other countries and the UK is going to be a pariah. We have seen it before. Angela Knight said in a speech, after Mervyn King made his comments here, “It is not healthy to argue about the executive compensation in the public eye. This is a financial services industry in which a lot of jobs are hanging.” So the minute the nasty politicians say, “We’d better clean up the market, Jon Moulton and others have told us to clean up the market,” they are going to say, “But you’re going to chase every good executive away from here and the UK is going to be on its own.” How do we argue against that?

**Mr Moulton:** The answer is that at the edges there will be a few. The lad who is determined to get the maximum possible bonus will behave like a traditional salesman does when he does not get a

commission scheme he fancies, he will move to a different sector of the market. He might move to the hedge fund market or overseas. I am not talking about reducing the total level of money or anything, I am talking about the way it is paid. If you pay somebody for doing something terribly short term in a business which is fundamentally medium and long term you have a mismatch of rewards and the needs of the business and the economy. I do not think you would lose very many if you just changed the structure. Three- and five-year plans are much more appropriate for banking than some guy who is paid a fortune for selling a load of rubbish to somebody who does not understand.

**Q146 Ms Keeble:** You were quite critical of the ratings agencies in the early part of your presentation but you did not suggest any recommendations for them in the way forward. I wonder if you have any.

**Mr Moulton:** I have got some. I wish I had got a much clearer good one as then I would have put it in my presentation. I think it is important that they give better information than they do. At the moment they get away with murder. What does AAA mean? Bulletproof is probably about as near as most people imagine to what it is supposed to mean. They ought to be saying it means that you will lose your money X number of times and X shares. They ought to give a lot more information about what losses, rates of loss and so on are associated with their ratings historically. Being more open would be good. I think it would be really quite good for them to be forced to show their own performance, how their ratings are tied to what plays out would be very useful information for the market and it would mean that they would be less inclined to get over-enthusiastic, which I think one would have to say they seem to have been last year when AAA was handed out fairly freely.

**Q147 Ms Keeble:** You have said that people cannot understand the products that they are investing in and you also talked about the “pass the parcel” approach to this as well. Are the people who invest in these not supposed to undertake due diligence? Is that done and, if not, what should happen about that?

**Mr Moulton:** The reality is that in the early days of the growth of structured products probably due diligence was quite well done, integrity was high in the market, but integrity gets squeezed out as you move up the boom. By the time you reached the end of the spring last year large numbers of the people taking pieces of the debt in my market, in the buyout world, were not even bothering to go to the data room to look at the available information.

**Q148 Ms Keeble:** Could you give an example of that so we know what it is?

**Mr Moulton:** Somebody at Goldman’s or CFSB might be syndicating a large loan. They might have 50 people going to participate in that loan. They would fill up either an electronic or a physical, sometimes both, data room with lots of information

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 13 May 2008 Mr Jon Moulton
 

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of variable quality. Half the participants in the loan by the spring of last year would not have visited the data room. That was the routine of what was going on. People had abandoned due diligence. Quite often all they did rely on was a rating or a so-called shadow rating and said, "It's a B something or other and it is two point something over LIBOR, we will take it, done."

**Q149 Ms Keeble:** Is there not an element of culpability in that?

**Mr Moulton:** Yes, there is.

**Q150 Ms Keeble:** Why was it not dealt with or should it have been dealt with? How should it have been dealt with? Who should have done it?

**Mr Moulton:** It varies very much by the segment you are dealing in as to what should have been done or not done. There were boom times. You were rewarded for taking as much as you could of the relevant product. That was the way most people were rewarded. As a result of that they behaved in the way that you would expect, they did stop checking. If you went into the US sub-prime, income checking declined from virtually 100% to January last year when 56% of loans were done on what amounted to self-certification to the call centre. That is what happens in all booms because if you want to grab the asset you are going to have to take poorer quality assets and do less due diligence, it is the market forces. I can tell you now that on deals being done in private equity the level of work being done by the banks now is more than has been done for a decade.

**Q151 Ms Keeble:** You have also mentioned that one of consequences of all of this is that interest rates, which have been a very successful lever for managing the economy here, particularly for innovation, does not work any more, which really spreads the impact from this out to the wider economy into everybody's pockets in a very catastrophic way. Would you say whether you think the genie can be put back into the bottle there or do you think that we then have to look at some other ways of managing the wider economy?

**Mr Moulton:** You have probably got to look at other ways. You cannot put it back in the bottle as long as you have international capital markets and the diversity of animals in those markets we now have. The base rate no longer rules. It is a really difficult area because it has been a successful tool for controlling the economy and it manifestly no longer works very well.

**Q152 Ms Keeble:** Who do you think should be looking at alternative tools and in what directions?

**Mr Moulton:** It should be the Bank of England under the current structure.

**Q153 Mr Brady:** How big a problem is it that the regulators struggle to recruit and retain the best people because they cannot compete with the remuneration?

**Mr Moulton:** It must be quite serious. When you move up to the serious end of complexity it is very complicated—structured products interconnected between different entities sometimes literally going round in a circle, that death spiral I showed you. The loan from Vagrant Loan might have been owned by BIG, in which case it really vanishes of its own in a rather unpleasant manner. I think the regulators cannot reasonably hire the best people in the marketplace because the best people in the marketplace will not work in that kind of environment. They can hope to hire good people and they can hope to train them well, but the very best they cannot, which is why I think you have to limit what they do so that they can reasonably be staffed to perform reliably. Do not forget, one single contract of some of the natures we are talking about here could bring an entire organisation over. You would need to be a brave lad to spot it. I have some sympathy with the regulator. I think the job is currently impossible no matter how much money and people you throw at it.

**Chairman:** With your few clear thoughts in this topsy-turvy world you have enhanced our lack of understanding on this issue. It is a hugely important topic. We are going to come back to this. The points you made this morning we are not going to forget. We are going to be on this subject until the autumn and we will have various people in front of us. As an efficient market participant we take what you have to say very seriously this morning. Thank you for the time you have put into your presentation.

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*Witnesses:* **Ms Angela Knight CBE**, Chief Executive, **Mr Paul Chisnall**, BBA Executive Director, Financial Policy and Operations, and **Mr Alex Merriman**, BBA Executive Director, Wholesale Banking, British Bankers' Association, gave evidence.

**Q154 Chairman:** Good morning and welcome to the Committee's hearing on financial stability and transparency. Could you introduce yourself and your colleagues for the shorthand writer, please?

**Ms Knight:** Good morning. My name is Angela Knight. I am the Chief Executive of the BBA.

**Mr Merriman:** Good morning. I am Alex Merriman. I am the Executive Director responsible for wholesale business in the British Bankers' Association.

**Mr Chisnall:** I am Paul Chisnall, the Executive Director responsible for financial policy and operations.

**Q155 Chairman:** You will all be aware that the Governor of the Bank of England gave us evidence a couple of weeks ago and he spoke about the bonuses and incentives in the City. In a speech

recently you said that it was not helpful to argue about executive compensation in the public eye. Do you think this is legitimate now?

**Ms Knight:** I think it is legitimate to look at executive compensation, yes, but perhaps I could say why I do have concerns. We are looking, and quite rightly so, at the issues that have arisen here in the UK generally as a consequence of the credit crunch. We are doing it in the Anglo-Saxon way in which it tends to be done publicly, predominantly through hearings such as yours, but also more widely as well. Close attention is being paid to what we are saying externally and wherever I go outside the UK there is commentary and that commentary is not particularly favourable. We know problems have risen in other centres as well. What I would prefer to do is for us, at the same time as we look at the issues here in the UK, to be mindful of the face that we are presenting to the external world. We are a big financial centre here and we need to recognise that others want what we have got.

**Q156 Chairman:** We are in the biggest mess we have ever been in in the financial services sector. The public has had to rise to the rescue. The Governor has got real concerns, the regulator has got concerns and Jon Moulton, who is an active participant, came before this Committee this morning and he has got real concerns. Surely you are not saying that the incentive structures have got nothing to do with the current crisis. Richard Lambert has made critical comments as well. Was he wrong to make those comments? Surely we will only get a way forward if there is going to be public pressure in ensuring that banks change their incentive structures. It is wholly inappropriate for you to say we can do this in private, in a monastic way.

**Ms Knight:** Chairman, can I first of all just emphasise again that I do believe that we need to look at a broad range of factors of which executive remuneration is one. In any event, our procedures and processes here in the UK through the involvement of shareholders with remuneration has the effect of putting issues to the vote in a way that is not necessarily replicated elsewhere. I am not arguing with any of the people whom you have just quoted, but I do say again that we need to be mindful of our international reputation. I know that you are also mindful of the international reputation of the UK.

**Q157 Chairman:** I understand, but Mr Moulton has just suggested that banks should be limited to activities that can be regulated. Do you agree with him?

**Ms Knight:** I have not heard what he said and I would have to look to see what he said first. What I do know is the way that banks have developed the broad range of services and the products that they have offered has not only been good for the UK economy but they have been good worldwide. Before we look at trying to restrict overtly or excessively the functions that they undertake, again, we need to look at it in a wider context. The regulation of the industry in any respect is under

review right now through the consultation document of the Tripartite. We are also seeing proposals come out of the international fora, and, if I may say, that is where I do believe that executive pay should be discussed, in the international fora. Because these are international institutions, and we have to be mindful of that as well. So the broad brush of regulatory change is all about the global nature of the industry, the way that regulation takes place on a cross-border basis and the international standards. That is a debate in which we believe we should participate and as an organisation we are certainly participating in it.

**Q158 Chairman:** I can anticipate where Mr Moulton was coming from after listening to him. It was the broader complexity and people not understanding what they are selling or what they are buying, and that has been reinforced by the witnesses who have come before our committee. For example, Edward Corrigan of Goldman Sachs, who came across especially from Wall Street, said to us that there was no question that over recent years the workings of the financial system have become enormously more complicated and complex, and Professor Buiter, who came before the committee, described many securitised structures as ludicrously complex and said it was doubtful that even the sellers and designers of these products knew what they were selling, and in a visit to Europe I heard Alexander Lamfalussy make the point in his speech, "I know of cases where the in-house experts were unable to carry the message to top managers." That culminated in one of the chiefs of the investment banks coming before our committee not being able to explain what a CDO is. We are really in a ludicrous situation and we really need a radical prescription for the way forward. I would like you to be in tune with that rather than deflecting all that and saying, look, things can go on as they did before; they really can.

**Ms Knight:** Chairman, if you look at the written evidence that we gave to this committee—we have given, I think, four lots now, in the first two that we gave right at the start of the inquiry, you will know that we highlighted the needs for transparency, we highlighted the complexity issues, we highlighted aspects relating to credit rating agencies and more. We too believe that there are some very serious issues here which need to not just be looked at but, indeed, addressed as well. We have not run away or hidden from the need for reform or for the need for review. We do believe that that needs to be undertaken. We have continued to engage not just with yourselves but authorities in the UK and in the wider context. We are, yes, representatives of the banking industry, and I can say four-square that the banking industry well recognises that there are issues here which warrant review and reform.

**Q159 Chairman:** The way LIBOR measures interest rates has been called into question. Why do you think that LIBOR remains a relevant measurement?

**Ms Knight:** LIBOR has stood the test of two decades. It is widely used around the world. LIBOR fixes in many currencies. The three main currencies of LIBOR are dollar LIBOR, sterling LIBOR and Euro LIBOR. What LIBOR represents is the rate in the market, and that rate is fixed at 11 o'clock every morning here in the UK. You will have seen that LIBOR has drifted up and is, in sterling and euro terms, significantly higher than the base rates. That does not mean that that is a problem with LIBOR. What that does is say this is what is happening in the market. To go through the technicalities briefly—do you want me to do that because I will do with pleasure, Chairman?

**Q160 Chairman:** If you do, briefly.

**Ms Knight:** I will also send you a letter on the subject.<sup>2</sup>

**Q161 Chairman:** In simple language.

**Ms Knight:** I agree. I can only understand it in simple language too! LIBOR is the rate at which a contributing bank would be prepared to borrow in the market. There are a variety of rates that are contributed by the different banks in advance of the fix. These rates are then looked at and an average is posted as the LIBOR fix. That does not mean that everybody can borrow at that rate. What it does mean is that that is the bench mark and a bench mark that is used worldwide. The questions that have been raised relate to volatility of dollar LIBOR only—not of LIBOR sterling and not of LIBOR euro but dollar LIBOR only—and that is one of volatility. Because of that, we have brought forward the annual review, we have contacted all the banks that are contributors to it and we speak to the Fed on a daily basis. Frankly, we have got a very sticky market out there; it is hardly surprising that you have rates that move in a different fashion than happened in the previous pretty benign conditions.

**Q162 Chairman:** I think we will go further on this but I think we will correspond on that matter.

**Ms Knight:** Yes, if that is all right, and I can let you have the graphs and the details, with pleasure, and also the outcome of the review, which will be available shortly.

**Q163 Mr Brady:** Can I turn to the Special Liquidity Scheme, Angela. You have welcomed the scheme, but what results do you expect to come out of it, both for consumers and for participants in the financial markets?

**Ms Knight:** What the Special Liquidity Scheme has done is it has provided some additional liquidity. To a certain extent you can argue that what it is helping to do is provide the securitisation opportunity because securitisation markets are closed and, extraordinarily, they are closed for first-class assets, and so we have got a particularly peculiar scenario out there. Banks, as you know, not only take a “hair cut” as far as access to the Special Liquidity Scheme is concerned, but they also pay for it as well. That

additional liquidity should help in a number of areas, both in terms of helping on the longer dated LIBOR rates and also helping the banks own liquidity, and so on, to the sorts of lending than they can make.

**Q164 Mr Brady:** Are we seeing any of that changed feeling coming through yet?

**Ms Knight:** I think we are at the start rather than even the middle of that. I think certainly we are starting to see some sort of effect but, frankly, it is a little bit too early to plot, but we ought to be able to see it coming through to a greater extent over the next few weeks.

**Q165 Mr Brady:** So within the next few weeks we should start to see a difference from the consumer perspective as well?

**Ms Knight:** One of the things that the consumer is having difficulty with is the number of lenders who have, in effect, either pulled out of the market for new lending or are severely restricting it. You will have read, as well as I have, the reports of what is happening as far as the building society sector is concerned about the lending restrictions, and of course we all know that the Northern Rock clearly is unwinding its mortgage book. That means that a lot of the lending, particularly mortgage lending, that is taking place out there relates to re-mortgaging not just of the banks' own existing customers but re-mortgaging those customers who are coming off deals with other institutions which for various reasons are not finding the market making it possible for them to lend.

**Q166 Mr Brady:** How do you respond to the suggestion that, given that it is such a large sum of public money involved here, it would have been reasonable for the Government or the Bank of England to put some restrictions, some expectations on banks participating in the scheme?

**Ms Knight:** I understand your question. Perhaps I can answer it both broadly and then narrowly, if I may. Firstly, broadly, you do have to accept, and I am sure you do, that our central bank is acting in a similar way to other central banks around the world. We are not in a unique position here in the UK. Indeed, of course the European Central Bank has been much broader in its lending for some significant time as has the Fed. So we do not have a situation that is just the UK doing something, if you like, particularly differently to other centres, and one of the keys in all this is that major central banks act together. Secondly, as far as the responsibilities are concerned on the banks themselves and others who access the Special Liquidity Scheme, clearly they have to abide by the normal right and proper responsible criteria for the purposes of lending, and they also have to look at the broader portfolio they have and their other considerations, such as their capital requirements. So it is not a direct hypothecation, although, as I said earlier, it should actually help and assist the customers on a broad and general basis.

<sup>2</sup> Ev 77

**Q167 Mr Brady:** What more needs to be done either by the banks or the Government to get the mortgage markets working properly?

**Ms Knight:** I think one of the keys here is, I am afraid, this whole area of securitisation. Is there something that can be done to open up the securitisation market for first-class assets? Unfortunately, it is closed around the world at the moment. This is one more, not of supply, but those who are on the buy side and perhaps reflects a number of things, not least what they already have and are holding in terms of securitisations. If there was a magic bullet, we would have let everybody know. There is not a magic bullet in this area. Some of the things that we are doing in the UK, though, I do think broadly will help. For example, the way in which the banks are declaring exactly what their position is, they are repairing their capital base where that is necessary, and they are making open declarations to the market. That is clearly a confidence builder and something that is important. We heard that all the other centres actually followed suit, but we could argue that only some centres are being as open and transparent in this way, and I do think it is a combination of transparency, it is simplicity, it is being also certain of what else is happening elsewhere in the world as far as the credit crunch is concerned that is of merit and value in freeing up our securitisation market and also, therefore, in assisting on the mortgage front. The wholesale money market, the other part of it, we wait to see what the money market funds do, because they are the absent party from that particular feast that is particularly noticeable.

**Q168 Mr Brady:** Is there more that the Government could or should do?

**Ms Knight:** I think it is quite difficult to say that there is more the Government could do. If we just had a UK securitisation market which was a problem, then I would say, yes, there was something potentially there that could be done. However we are looking at something that is the same in other countries, and that does not make it easy.

**Q169 Mr Brady:** Looking at the wider credit crisis, to what extent do you agree with the Bank of England in its recent Financial Stability Report when it came to the conclusion that the overall extent of the crisis might be being exaggerated by the market?

**Ms Knight:** We see why they say that, and I hope, in fact, that they are correct. It is in the areas of valuation and how you have to value your assets—as you know, the trading book assets are valued on a mark to market basis—when you do not have a market. There are models which banks can use. There are also times when you have a single price out there which is not a market but may be reflective of the price of your instrument. In the US they have had a noticeable spiralling down, which is caused, I think in part anyway, by a combination of their application of the mark to market rules and the way their audit profession is not necessarily allowing banks to make judgment. Inevitably that flows over

a certain extent to the UK, even though here we have adopted international accounting standards and our models are robust. The Governor is right to make the points that he does; that there is a difference between an actual *de facto* loss and a valuation of something where currently the valuation may not be as good as it was but may well come back. These two do get muddled up and we, like him, believe that getting the proper separation out is the right way to go. It is, dare I say it, the involvement of the accounting and the audit professions, and, indeed, not just here in the UK, which will bring that about.

**Q170 Mr Brady:** Are the institutions now being sufficiently transparent to allow proper evaluation of where we stand?

**Ms Knight:** Yes, I think so. What you have seen, and continue to see in the UK, is pretty good transparency. We had, and you have made, criticisms of our market and criticisms of our industry, but, equally so, banks are good at being transparent and the market does bring about some of those declarations and some of those standards which one does not necessarily see elsewhere. In the UK we are all playing to the side of openness, transparency and, ultimately, confidence will return.

**Q171 John Thurso:** I want to ask you some questions about the Special Resolution Regime, but before I do that can I ask you a wider question? Does the BBA membership regard itself as victims or perpetrators in the current financial crisis?

**Ms Knight:** I think the true answer is probably participants actually. We are part of something which is happening around the world. Our members, as you know—many of them—have been involved and are involved with subprime, and you can argue that questions should have been asked, or were not asked as intently as they should have been. Equally, our members are very broad-based banks with a broad-based business model that not only serves them well but, importantly, serves their customer base well and the economy well. So I will still stick with being participants.

**Q172 John Thurso:** I would like to challenge that. You said earlier that your members are good for the UK economy; that their products were wonderful. If you look at the many financial institutions and the impact they have had over a 20-year period, you could make a case to say they have been responsible for some quite phenomenal wealth destruction. If you are out there in the high street at the moment trying to run a business, you do not see your clearing bank as being terribly friendly as your rates go shooting up and you as a businessman are actually having to pay for the incompetence of the board rooms of the big banks. So, why are you so special and why will not anybody in the industry take responsibility for what they have done?

**Ms Knight:** Let us try a few of those points. First of all, does the banking industry take risks? Does the financial services industry take risks? The answer is, yes. Does the engineering industry take risks? Does the pharmaceutical industry take risks? The answer

is, yes. Do politicians take risks? Yes. The reality is that business is about risks and sometimes your judgment is right and sometimes it is not right, sometimes it is wrong, and that is true whatever business you do.

**Q173 John Thurso:** What you try to do, if you are sitting on an audit committee or whatever, is assess risk?

**Ms Knight:** Yes.

**Q174 John Thurso:** And then price it. It seems to me that the banking industry has totally failed to actually assess risk.

**Ms Knight:** I do not think that you can say the banking industry has totally failed. I think that is an exaggeration, if I may say so. What you can say is some banks in some areas did not get that risk right, and that is different. If you want to say to me that risk committees need to look at things more intently, better than they have done in the past, I think we would all agree the answer to that is, yes.

**Q175 John Thurso:** What concerns me is that a sound banking system is absolutely fundamental to a good local economy?

**Ms Knight:** Yes.

**Q176 John Thurso:** And for many years we were never going to go back to Captain Mannering touching you on the shoulder and saying, "Look, old boy, it is time to slow down a little bit", but for many years one dealt with somebody, whether in the City or in the High Street, that had a clear understanding of your business and you had a clear understanding of their business. What you now have is legions of bright young things who have never run diddly-squat creating products that are now termed worldwide as "highly toxic", which board rooms had absolutely no clue about and which risk committees, audit committees could not even conceive of and are so complicated that, even after hours on this committee, I barely begin to understand them. Surely that cannot be right. Surely that is the moment the industry has lost the argument not to be regulated more thoroughly?

**Ms Knight:** First of all, as far as innovation is concerned, I am sure that you are not trying to say that the industry should not be innovative. All industries need to be innovative. If they are not, then they will, first of all, stagnate and then they will decline. So innovation is as much part of the financial service industry, as much a part of banking as anyone else. Do I accept that some of the innovation might be right but may not have been controlled as well as it should? Evidently the answer to that question is, yes, and if you read the recent speeches of a number of US Treasury ministers, you will see that they four-square concentrate on that particular point, including some of the aspects about the rating of the subprime products, which was very unclear, as you well know. As far as industry closeness to its customer, be the customer the individual or be the customer a small business, medium-sized business, man or woman, in the towns

and cities of this country, the industry certainly does not intend to be remote from them in any way. We track some of the statistics through the BBA, not all but some of the statistics through the BBA. For example, the ones which show how people choose to interact with their bank. One of the very noticeable things is that we are in transition at the moment. There are three ways in which people want to significantly interact with their bank: the Internet is the biggest, telephone is the next biggest, branches of course are still there. When you are in that transition period you are trying to satisfy three audiences, if you like, and it is not the easiest thing. The banks are like every other business insofar as they have customers, their customers can go elsewhere. Indeed, in banking it is much easier to change from one supplier to another than it is in many other walks of life. I accept that banking is important for the economy generally. That is one of the reasons why banking is regulated in addition to the other sorts of rules and requirements that hang around industry and commerce generally. Do we think that there needs to be reform of regulation? You will have had our response to the consultation document and, indeed, the responses to the wider issues which we touched on earlier, so the answer is, yes, there are some lacunas there. What we have to be careful about is not throwing out the good, not bringing in regulatory requirements which are either unessential or do not actually fit the right place; they do not meet the spot. As I said at the start—something that is unpopular to the committee—I think we also have to look at the international context, both in terms of the reputation of the industry, but also because the industry operates in multiple jurisdictions and some of the changes need to be done in co-ordination with the more global authorities.

**Q177 John Thurso:** Let me ask you about the Special Resolution Regime. In your submission you note that it should be the Chancellor who decides whether the special regime is triggered. I think that is right, is it not? Why do you want a politician to take a technical decision? Are you hopeful that the constituents' interests will come through?

**Ms Knight:** Not at all. We have a tripartite arrangement right now in which the Treasury is involved, the FSA is involved and the Bank of England is involved; so you have already got that link; you have already got three legs there. It seems to us that where the major emphasis needs to lie with this whole process is in better quality regulation, and that is the regulation itself as well as the regulators. We believe that the entire emphasis ought to be on that particular area. Nobody but nobody wants to have a scenario in which we have a repeat of the Northern Rock, and that, therefore, equates very strongly with better calibre regulation and better calibre regulators. Should an institution start to get into difficulties, then we favour what we call the "heightened regulation approach" where much more interest is paid on that particular organisation. Clearly it has to be done carefully, because one does not want to end up with the result that you are trying to avoid. Should we get to the point at which that

institution cannot be rowed back out by regulation into safe waters, then the question arises as to what happens next. We believe at that point, yes, you have got a tripartite there, the FSA has to give its advice to the Treasury, to the Chancellor, as does Bank of England, but somebody has to take the decision. We believe the Chancellor then, as Chairman of the tripartite, takes the decision and the Bank of England employs the necessary tools to bring about the Special Resolution Regime from a practical operational perspective.

**Q178 John Thurso:** Why not the Governor of the Bank?

**Ms Knight:** We think that there needs to be a clear distinction between the roles and responsibilities of the regulators and of the Bank of England. I think we all can argue that that lack of clarity did not help in the Northern Rock situation. Regulation is for regulators, and that is why we say that that is the part which falls to the FSA, but we do think that the Bank of England has an opinion which needs to be heard at the point at which the SRR is decided. But, can I also say, we think there needs to be a good, high quality formal contact between the tripartite and that they should also operate what we refer to as a “no surprises regime”, so there is information flowing between the bodies. The last thing one wants is somebody to have a surprise, and again it is arguable that surprises did occur with the Northern Rock. So, it is about clearly articulating the responsibilities of each but ensuring that there is a proper, formalised information flow taking place and a no surprises approach as well.

**Q179 John Thurso:** I do not buy that. I do not think that is a good argument at all. One of the most successful things that have happened since 1997 was giving the Bank of England independence. It has added hugely to the general trust and confidence. I think one of the major problems of Northern Rock was the fact that the Chancellor was involved and there was not a clear-cut decision route that was independent of that. It may well be that he misconfirmed it, but it seems to me it should be either the FSA or the Bank that pull that trigger?

**Ms Knight:** That is a fair point. I give you the view as we have discussed it within our community. We feel that it would be enormously surprising if the Chancellor did not feel that he had *locus* on this decision. We note in the consultation document the proposal for a COBRA arrangement, which we do not particularly favour. We certainly favour the Bank of England’s strong role, both in financial stability and also in taking control, should a Special Resolution Regime be implemented. We also believe that the Bank of England clearly has an opinion which we want them to give before that SRR is decided, but for regulation we believe the regulation falls to the regulators and dual regulation is not something that would necessarily be beneficial either for an entity or for the wider community.

**Q180 John Thurso:** We have suggested that, ultimately, it is the Bank of England in that moment that should take charge. Do you disagree or agree with that?

**Ms Knight:** Take charge at what point?

**Q181 John Thurso:** Having charge for financial stability but, basically, when an institution is failing or has come to a point at which its regulation has failed, that is the moment the Bank of England should step in?

**Ms Knight:** We agree with that.

**Q182 John Thurso:** Can I move to depositor protection. You have taken a very strong line against the idea that the banks should build up funds into a deposit protection scheme. Why is that?

**Ms Knight:** We think that the most important thing here is all about making sure that there are funds available, should they be required at the time, and that does not necessarily require, as you know, a build up of funds. We feel to start building up funds now is going to be disadvantageous to customers. Because of the nature of the industry here in the UK, you will either have a fund that is punitive or tokenistic, and we do note, of course, that it has taken about 75 years for the FDIC to get there with its fund and it only looks for small banks, as you know. So we reckon that we need to look at some of the practicalities of how, should failure occur, individuals get their deposits back and get them back speedily. That is the perspective that we have come from.

**Q183 John Thurso:** Let me give you a scenario. The scenario is Bear Stearns came first, Northern Rock came second—in other words, instead of Northern Rock being the sort of *eminence grise* in this little financial crisis, it actually was a small player in one country, which is what it has actually turned out to be—and at that moment the Governor says, “Well, it is not actually that important, it is not systemic, so we will just let it go”, so Northern Rock goes under rather than being saved. Four billion, I believe, is the amount that is held in the protection fund at the moment—clearly not enough—and there is clearly then some knock-on risk, and you might see others. At that point in the cycle, right at the debts, there is going to be no way the banking system can produce sufficient funds. Therefore, it comes straight back to a government bail-out. In the good times there is not a problem; the problems come in the bad times. Is it not the case that, by arguing the banks should not take steps to put some reasonable funds together, in fact what the banks are saying is, “We actually want to be bailed out the by the state when the nasty things happen”?

**Ms Knight:** We are not saying that actually. If Bear Stearns had come first and Northern Rock had come second, then I sincerely hope there would have been early intervention and we would not have the problems that we have got here in the UK right now. However, if I take it on further and take your scenario of an entity that actually is not rowed into good waters by better regulation and where the

Special Resolution Regime also does not resolve the issue via either a bridge bank or a directed sale, or whatever we would like to call it, so you have actually got something that you want to liquidate. At that point, which I think you have got to accept is a very long way down the food chain, how we would anticipate that happening, is that, there would take place as follows. First of all, using the systems of the failed institution. We do not think that it makes sense on any grounds to have a couple of million cheques being written by the Financial Services Compensation Scheme. However, we think that the FSCS should have the ability to borrow and for the banks to pay back whatever the difference is between the amounts that are paid out and the amount that the liquidated institution pays back to the compensation scheme. We note that in the US, of course, in the times that the pre-fund is used by the FDIC, they immediately levy the industry to top it back up. So we think that there is a route, which we are exploring in much greater detail with the Treasury, with the FSA and, indeed, if I may say, with the systems houses as well, because clearly there needs to be some practical resolution. I come back to my earlier point: we need to concentrate upstream of that failure. This is the thing that we need to prevent, and I hope that your committee, as well as the tripartite, will come up with the solutions that ensure that we have a sensible series of preventative measures here in the UK.

**Q184 John Thurso:** I concur with you, we should concentrate on avoiding it and preventing it happening, but it will happen. It may take some time and it may be a long way in the future, but it will happen. The critical point that we have learned is that to avoid a run we need to have strong depositor comfort very quickly, and therefore we need a depositor scheme that depositors really have total confidence in. In order to do that, surely it is correct that, rather than the state funding the banking industry when it gets into trouble, given their profits when they are not in trouble, the banks actually ought to put something aside. It may be a mixture, it may be there is something aside and something comes later, but simply to go on a wing and a prayer, "We will just work it so it does not happen", I think is untenable?

**Ms Knight:** I think the best way to avoid a run is to take early action. The next way to avoid a run is to explain what you are doing when you do something rather than let it leak out into the public domain, frankly. If we get to the point where a deposit protection scheme has to pay out, then we have, we believe, articulated the way in which that can take place that is appropriate, that is timely and, as you say, is paid for by the banks. We do not think that having some sort of pre-fund is a necessary requirement to bring about the correct outcome. Nor do we think that it is going to be particularly advantageous to the customer at this point in time.

**Q185 Chairman:** Angela, four billion at the most is available. If a big bank goes, it is going to have a hell of a lot of money; so at the end of the day it is the

taxpayer that is tiding you over here, is it not? However much it works, at the end of the day the banks do not have the money, they do not want to put the money up front, the taxpayers will only do it with the Government and then you will see if you can pay them back at some time and then your members will probably quip about the interest rate that has been charged by the Government.

**Ms Knight:** Chairman, I know of no country where there is not a back guarantee of their deposit protection scheme. You will know that there is of the FDIC. Let us get that clear.

**Q186 Chairman:** Let me just tell you. I went to see the American Bankers Association.

**Ms Knight:** I know you did.

**Q187 Chairman:** Thinking that they would say, no, but they said a pre-funded scheme is essential for the banks to show their integrity. What I am trying to get out from you here, Angela, is are the banks going to show something in terms of the mess that we are in now that at some future stage the public will be able to see some slither of their integrity and not wait for the Government and the taxpayer to bail them out again? What are the banks going to do to say, "Yes, we are going to have some responsibility here"?

**Ms Knight:** If you want me to say, Chairman, that the way to do that is to put in a pre-funded deposit protection scheme, I am afraid I do not agree with you. I am sorry, I do not agree with you. I cannot agree to something that does not look like it is going to work.

**Q188 Chairman:** I am looking for you to show some commitment that the banks are going to put something in; that the banks are going to be in a position to say, right, the financial services industry in this country is good for the country, but it is good for the industry itself. At the end of the day, if somebody goes down, we should be like any other company where the shareholder takes the hit. In order to develop confidence in the market, we are going to say that, if a situation comes round where a bank feels that, we are going to be upfront somewhere and assist the Government in that; we are not going to wait for the Government to do it 100%. That is where I am looking for you here to build something out.

**Ms Knight:** That is a point taken, and I say to you again, Chairman, we are in discussion right at the moment with both the Treasury and the FSA on some of these issues because, like you, we want to ensure that there is confidence to the customer and confidence in the banking system. Your points are well made. We want to get to the right conclusion.

**Chairman:** If we drag you gently, you will not squeal, will you!

**Q189 Ms Keeble:** You said that regulation is for the regulators?

*Ms Knight:* Yes.

**Q190 Ms Keeble:** But actually the regulated have got an obligation in all this as well. What do you think should be done by the banks to ensure that when warnings are given they are actually heeded and acted on?

*Ms Knight:* I did say regulation is for the regulators. I was talking in the context, of course, of who took what responsibility when moving to and then enacting an SRR. Of course, banks, as indeed every other institution that operates in the financial services industry, have responsibilities to implement the requirements, the rules and the spirit of what is intended. I am not sure of the point behind your question; I am sorry.

**Q191 Ms Keeble:** You have supported our suggestion that there should be a mechanism to ensure that warnings by the authorities are heeded by the banks. How would that work?

*Ms Knight:* We were talking, I think, in that context about early warning systems and we, again, think that that is probably far more international than it is local. I think that there are some issues which, for example, the IMF could, indeed, look at and some trigger mechanisms they could, indeed, look at to make some of the international issues and warnings around them known rather better and clearer. I understand that that is exactly what they are considering doing.

**Q192 Ms Keeble:** You have also said that you would like the Special Liquidity Scheme to become part of a more flexible approach to the banks' future money market operations?

*Ms Knight:* Yes.

**Q193 Ms Keeble:** Again, that comes back to: what are the banks then going to do? It picks up on the other points, but why should the banks be given that type of support unless they are prepared to heed the warnings and apply more due diligence to some of their investments?

*Ms Knight:* Firstly, I do not know of warnings that banks have not heeded, but let us get to your particular point. The question about the money market framework and making it more flexible is this. We have a money market here in the UK, there is one in Eurozone, there is one in the US, there is one in Switzerland—there is one in every other major centre. We have banks operating here in the UK that also operate in those other centres. One of the things that we think is important is that the money market regimes harmonise better than they do at the moment. A point that was most noticeable as we passed through the summer of 2007, when our money market dried up, was that those banks who operated in the other centres where there was a greater flexibility, particularly in terms of collateral and rate, could access money, liquidity, out of other centres, whereas those which were solely UK based could not. So it seems to us that we need to have a look at our money market framework, and, indeed,

the Bank of England is doing that, both in the short-term and also for the longer-term, and bring together, where it is possible to bring together, similar frameworks in other countries. Again, that is something that all the central bankers are looking at. As far as how do central banks work, central banks and how they work was decided when central banks were set up. I do not think you need me to go back to that point, to the beginning. Flexibility is about handling different scenarios and it is about the fact that there are multiple markets out there that need to have, in our view, a greater degree of harmony, where possible, on collateral and on the systems that they operate.

**Q194 Ms Keeble:** Can we go back to the incentives issue again? You rejected that point on the basis of frightening people away, et cetera. It seemed to me that what was being said was perfectly reasonable. It was not that banks could not do it, it was that it had to be assessed and it had to be included as a risk factor, which is just about pricing it properly. What is the problem with that?

*Ms Knight:* In assessing?

**Q195 Ms Keeble:** If you are assessing the risk, then one of the risks is the pay structure for some of the senior staff?

*Ms Knight:* I do not have a problem with that. I keep saying, I do not have a problem with that.

**Q196 Ms Keeble:** You do not have a problem.

*Ms Knight:* I do not have a problem with looking at pay structures. Firstly, looking at pay needs to be done more internationally. Do not forget that 60-70% of the institutions operating in the UK are not UK-based, they are from overseas; so if you are going to look at pay structures for international entities, then you need to look at them internationally. That is the first thing. Secondly, what I did say is that I am mindful of the reputation of our centre, and I do not see any problem with being mindful of it. I do not know if you have looked at the pay for the chief executives of the FTSE 100s, but you will find that the banks are broadly in line with the pay of the FTSE 100 chief executives.

**Q197 Ms Keeble:** We are talking about completely different issues, if you are comparing those issues. What we have heard quite a lot of this morning is what everybody else needs to do, and I think what we are saying is what are banks going to do, in particular, given the consequence is that all of our constituents are paying for what has happened over the Northern Rock debacle where there were clearly failures in what happened around the governance of Northern Rock?

*Ms Knight:* I agree.

**Q198 Ms Keeble:** That has been gone through. There were warning signs that were not heeded. It is always easy to be wise with the benefit of hindsight, but that happened. We have seen the presentation this morning, and you have said a lot about the regulators have to change, they have to look at

international markets, they have to do this and that, and I think what we want to know is, that is fine, but what are the banks going to do?

**Ms Knight:** Northern Rock was, as you rightly say, a real problem. You have looked at that very closely here as a committee. We would support the conclusions that you have come out with. As far as your earlier presentation, I did not see your earlier presentation. What are the banks doing about ensuring that their risks are controlled, that they rebuild their capital if that is necessary, that they continue to lend, because that, of course, is part of their operation. You see that out there, you see that in newspapers, you see that on a daily basis. As far as pay is concerned, which is where you started, board pay in the UK is subject to shareholder vote. We have actually a pretty open process here, and whilst some will quite rightly say, "Ah, but that is only the board", you do also in that shareholder vote and in the annual reports to shareholders in the AGMs set out the structure of pay that operates within the bank on a general basis as well as with individuals. Of course pay is a question, of course pay is one of the things that is being discussed and of course pay is something that is being looked at both here and elsewhere. I think you do need to be careful, though, that you do not just say, "Oh well, the problem is just because a few people got paid too much." We are in a world credit crunch, a problem that started in the US with the unregulated mortgage selling. We are part of a system that is causing difficulty everywhere. In the UK we are being transparent about the issues, transparent about our problems, transparent about our inquiries, and I do hope that that is recognised.

**Q199 Ms Keeble:** You if look at the FSA's discussion paper on liquidity regulation, they have put a number of proposals. What do you think of those and how do you see them as moving forward, particularly as some of them are very vague?

**Ms Knight:** We will have to send you our response to the liquidity discussion paper, because it was actually long and it is detailed. Much of the FSA proposals we support. I cannot actually, off the top of my head, think of anything particular that we had a question mark about other than the need to use Basel to look at liquidity issues. So, I apologise, I cannot remember the detail, but I will let you, as I say, have a copy of our response in full, and to the rest of the committee, Chairman, of course.

**Q200 Chairman:** Angela, we are not talking here about the pay of chief executives, it is the incentive structure for those who deal with the products. It is deeper than that.

**Ms Knight:** Yes, I do agree with you, Chairman, and I appreciate that in my answer I did not go into that point. I do appreciate what you are saying, but I come back to the fact that these whole pay structures, as you know, they operate here and they operate elsewhere. As do the incentivisations. They have been highlighted by a couple of the international fora, of which the IFF is the one that we are more closely linked with than others and is

about to publish some rather more detailed proposals underneath their earlier set of principles, which, again, looks at some of these.

**Q201 Chairman:** Joseph Ackerman is the Chairman?  
**Ms Knight:** Joseph Ackerman.

**Q202 Chairman:** They did a good analysis of it but the prescription was as weak as dishwater.

**Ms Knight:** Yes, but he has got another report coming out and we want to have a look at what he says. I am not going to preclude what he says until I see it, if that is all right.

**Q203 Mr Mudie:** I think the point on salaries that was made that Ms Keeble raised was the business of what Jon had said earlier. It was not so much the level, it was the way they were structured. They were structured in a way that encouraged bad behaviour. You do not find that acceptable, I presume, and that is something that can be done without.

**Ms Knight:** I agree. None of us wants incentives that encourage bad behaviour or, dare I say it, too great risk-taking either. There is something about risk frameworks, there is something about how you incentivise without going over the top, all of which is part of the things that banks are addressing right now, George.

**Q204 Mr Mudie:** Do you regret leaving insurance for banking?

**Ms Knight:** I did not leave insurance; I left the private client stock broking community. It was a lot quieter.

**Q205 Mr Mudie:** You did not regret leaving insurance but you regret leaving the stock brokers.

**Ms Knight:** I see what you mean, when I was involved with Scottish Widows. It all did seem a lot quieter than April Fools Day 2007 when I joined the British Bankers Association. There are many things to do on April Fools Day; that is certainly one of them.

**Q206 Mr Mudie:** Maybe you would have left a better class of people, Angela, but you cannot comment.

**Ms Knight:** I find all jobs that I have ever done interesting. Some can be slightly more challenging than others.

**Q207 Mr Mudie:** Of course, you were at the Treasury at about the time Lamont was there, so you have led an interesting life.

**Ms Knight:** No, I was not, I was there with Ken Clarke.

**Q208 Mr Mudie:** Every time we see the Governor he lectures us on moral hazard. The last time he came I queried why he bailed the banks out with £50-100 billion without getting any assurances from them that they would cut dividends, do something about raising capital and try, above all, as we are trying, to get the banks through this troubled period, trying to get their borrowers through this troubled period, especially people with mortgages.

*Ms Knight:* Yes.

**Q209 Mr Mudie:** Do you think it encourages moral hazard to give this £50 billion facility without asking for those assurances?

*Ms Knight:* You know I am going to say something first, and that is that the £50 billion is not a bail-out, it is liquidity that is there in the market. It starts to match what is happening in other markets, banks pay for it and at some point no doubt that additional money that they have paid for, the cost of that money, will result in an additional dividend to the Treasury. Having said that, let us come to the point.

**Q210 Mr Mudie:** I understand that, but if you are looking for a loan and you are in deep, deep trouble and you get a wonderful facility of £50 billion without any other financial conditions, then I think you have got away with it.

*Ms Knight:* I think that what the banks are doing is nothing to do with getting away with something. It is all about continuing to be able to provide, as you say, mortgages to their customers. One of the problems right now is that there are a very considerable number of other lenders who either have exited the mortgage market or who are nothing like the same participators as they were. When the figures are published we will see a significant increase in the percentage of the mortgage market taken by the banking industry, I am sure, and that is because they are fulfilling, if you like, the commitment to their existing customers and to the customers of others who are no longer prepared to provide that facility.

**Q211 Mr Mudie:** That is really interesting, Angela, because that flies in the face of what the Governor told us. Mervyn said, "I am in no way wanting to encourage you into the housing market." In fact we were critical, I was certainly critical, of the fact that he had not included all the building societies in the facility.

*Ms Knight:* I think I am right in saying there are about ten there, but I am not entirely sure. There are a number of building societies there. What the £50 billion is doing, if you like is it is allowing the banks to continue to do the business that they are doing in a way that is beneficial to their customer base. If you do not want them to keep on lending for mortgages, then say so, but my understanding is that at the same time we are being told that we must continue to provide mortgages. Liquidity, if it is available from the Bank of England, is providing, if you like, an alternative to the securitisation route, which is closed, and they are depositing, therefore, some of the high quality assets in return for liquidity which otherwise would have been sold out into the market. The key is right back at the question which Graham Brady asked, which was: what can we do about the securitisation market? Let us hope the securitisation market does start to open, because that will solve an awful lot of issues.

**Q212 Mr Mudie:** Okay, but that was the behaviour towards the lenders. I disagree with you in terms that you do not expect them to—. I can see a case for not extending new mortgages, but when existing mortgages are two-year mortgages—there is a couple of billion of those—I think it would have been reasonable to ask the industry to ensure that people are kept in their home for at least another two years whilst we get through this period, but they did not do it, and you did not volunteer it, I see.

*Ms Knight:* I was not part of those discussions.

**Q213 Mr Mudie:** No, but you are representing the industry.

*Ms Knight:* So I can tell you what is happening, which is perhaps more important. Perhaps two things. Firstly, re-mortgaging is taking place of existing customers. Re-mortgaging is also taking place of customers of other lenders who, for various reasons, are not providing that re-mortgage; so the banks are picking up part of that system of which the unwinding of the Northern Rock book is clearly a significant factor.

**Q214 Mr Mudie:** Angela, are you sure?

*Ms Knight:* Yes.

**Q215 Mr Mudie:** Because one of the banks, I think it was the Halifax, came into the market and was greeted with amazement and I think very quickly closed their doors because everybody was shoving their business towards them. Are you sure, if I went into a High Street bank now, that facility would be available?

*Ms Knight:* I am afraid I do not know your personal circumstances, so I cannot answer the question in that respect, but if you are asking are the facilities generally available, the answer is, yes. Equally, the point that you have just made, that if there is a particularly attractive offer coming up does everybody pour into that offer, the answer to that is, yes. I had a look on some of the comparison websites before I came out today to see what was available in the way of mortgages and the percentages and proportions that are being offered. There is still a selection out there. I say again, it is predominantly from the banks, and they are doing their part in the re-mortgaging process. The figures will be available in due course. There is a bit that one can see out of the figures we published about three weeks ago. Those ones showed you some of the re-mortgage peaks. I appreciate that all the commentary was about the low level of new mortgages, but if you look at that particular press release, which is compiled from the statistics of the major banking groups, you see a very big peak on the re-mortgaging. That is earlier this year, but that does put some underpinning to what I am saying.

**Q216 Mr Mudie:** I hear what you say, but the figures in terms of repossessions or implied repossessions—and there is a difference—are shooting up.

*Ms Knight:* Yes.

**Q217 Mr Mudie:** Unemployment is not rising, and in fact the library note (and you will understand what I mean) highlighted a couple who were both in work, so there could only be one thing (and this one was the Northern Rock market), that the banks are setting a rate that is causing financial problems to good people who are in work, who are buying their house, raising their families and are being forced out because you do not want their business.

*Ms Knight:* What we are doing in that particular area—and I will have to look at my note, I am afraid—is we have got both a Banking Code set of requirements and requirements in MCOB—that is the mortgage regulation. Clearly I will send you the detail you wish, but it is about dealing fairly with customers in arrears, it is about using reasonable efforts to reach agreements, it is about repossessing only where all else has failed. Clearly, I do not know the specific conditions of the example that you have given, but what I do know is that our members are signed up to a set of policable and enforceable criteria. It is not in their interests to repossess either; it is in the interests of all to find as good a way through as possible.

**Q218 Mr Mudie:** I hear what you say, Angela, but they are repossessing at greater numbers and it is going up alarmingly. What I do not see here is either the authorities or the industry actually operating with the same objectives as are being adhered to in the States, where there is a political will from everybody concerned to keep people in their homes wherever possible. You will never stop every repossession, but it is interesting and alarming that people who are in work are being repossessed. Somebody losing their job can get into trouble and you could understand that they cannot make their payments. So, I suggest they are being forced out, and one of the factors is the rates that are being charged to dissuade them from extending that mortgage.

*Ms Knight:* Your point is well made. As far as the industry is concerned, repossession is a last resort, not a first. It is the place they do not want to go to and the criteria, which are signed up of our own making, as well as the regulation, we hope, will ameliorate very considerably the difficulties that may well result as a consequence of poor economic—

**Q219 Mr Mudie:** I am certainly not getting it from the Bank of England, but I would have welcomed some body being set up to police this and make sure it was happening, because ordinary people are being hurt and they are being hurt because of the behaviour of the banks in the first instance and now they are being hurt by the banks rescuing themselves by divesting them of their business.

*Ms Knight:* Let me take that away, give it some consideration and come back to you.

**Q220 Mr Mudie:** Can you use some of your charm on Mervyn, because he is impervious to my charm, and see if you can get him to take some interest in this?

*Ms Knight:* Can I just make a point about rates. As far as rates are concerned, you know where rates lie. You can see that from both the rates that are given to savers and the wholesale market. That is the lending rate.

**Q221 Mr Mudie:** I can I ask you couple of official questions?

*Ms Knight:* Pity, I thought I had done those!

**Q222 Mr Mudie:** Mr Moulton stated just before you came in that Basel II is too complex; it stems, as we know, from too many compromises because of its nature. Do you agree with that characterisation? He is sitting behind you, so be careful!

*Ms Knight:* I think it certainly is complex, and we have not actually fully brought it in. I think we have just fully implemented it here in the UK, it has been certainly not fully brought in in other places, and the European Commission is about to reopen some aspects of Basel. I certainly think that what these last few months are going to mean is that regulators, authorities of all sorts, need to have a clear, careful look at how Basel II does operate, because so much of that, as, indeed, with some of the regimes we are living with at the moment in other areas, was designed in times which were very benign—a good economic environment—and they were stressed-tested only on a theoretical basis. We are not in those times at all, and we are not in theoretical stress-testing, we are in actual stress-testing, and I think it behoves everybody to just carefully have a look and see what it is that we have got, how it has performed, what is its complexity and what it is that needs to be reviewed, changed, thought through, or whatever.

**Q223 Mr Mudie:** In the first question when the Chairman was asking you about how you were dealing with it in an Anglo Saxon way behind closed doors—

*Ms Knight:* An Anglo Saxon way is in the open actually.

**Q224 Mr Mudie:** —you went on to say it would be better done behind closed doors, by harsh words, dirty linen and all that. The second thing, which I thought was very significant and, I think, right, is that the real reforms have to be dealt with in an international field because so many of the banks are international, but when we asked about reforms in the international field the Governor said, “Not in my lifetime.” I do not know whether he was saying in terms of his lifetime as Governor of the Bank of England, but, in view of that, is this just not the banks stalling for time to get over this crisis and then assume normal practice?

*Ms Knight:* No, it is certainly not us stalling actually. There are some things that absolutely have got to be done on an international basis. Certainly there is some work which we have undertaken ourselves

(and I think it is getting wide acceptance) on cross-border regulation. That might sound a little bit down in the engine room, but it is not in the engine room if you have got a bank that gets into difficulty that is operating in a number of countries. You have to be able to take action and quickly. The transparency stuff: FSF (The Financial Stability Forum) made a statement a couple of weeks ago—three weeks ago, four weeks ago, whatever it was—and they said in 100 days the industry had got to look at its valuations, look at its risk, put things into the public domain, be more open, and so forth. We are actually doing that here in the UK, so I think that it is a bit “where there is a will there is a way”. There are some things that I imagine various countries will die in the ditch on, but I think there is quite a lot which can be done internationally, and I think that there is a role that the industry can very strongly play in that as well.

**Q225 Mr Mudie:** One of the things, I would say, having sat through enumerable hearings since Northern Rock, is that there is a cosy consensus building up that the FSA are totally to blame—the regulator—and the Bank of England have escaped proper scrutiny, and the banks have swung in to support the Bank because, if the FSA can be the scapegoat, it saves real questions being asked of the other participants. How would you react to that?

**Ms Knight:** It certainly appears that if ever I react to anything the Bank of England says I am in permanent trouble. I will give it a whirl. Do I think that the regulators were at fault for the Northern Rock? The answer is, yes. Anybody who has read their report knows that. I think they have been pretty honest, frankly, at the way that they have reviewed themselves and binged it out to the public domain. So I give them congratulations for their honesty, I give them marks for starting to change but I think that what they did was pretty lamentable. Equally, as we were running up through the summer of 2007, there were some pretty strong representations being made about the flexibility requirements of the money market, and the provision of liquidity, in a way that it was being made available certainly in Euroland, because the money market is part of the whole piece. You cannot say we have got the regulators over here, we have got the money market over there and the two are not joined. They are joint and one requires both to work together, and sometimes, if you have a liquidity problem, that is where the money market actually starts to play its part. Some say that if the money market had not seized, if there had been the sort of arrangements that we have got now, that the Northern Rock would still have been in difficulty but it would not have hit the buffers in the way that it did. That may be the case, it may not—we cannot rewrite history—but certainly the performance of the money market is important in all this, as is defining the roles of the regulator and the Bank of England so there is no confusion about who does what. Whether we do it in the way that some want or others want is, to a certain extent, a second order question. The first order

question is that it is clearly defined who does what, that they talk together and interact; and we think that is all part of the process.

**Q226 Mr Mudie:** That just confirms that if you represent the banking industry you are content with just heaping it on to the FSA. Northern Rock happened. It was a bank. It got caught out. It has been dealt with. The credit crunch is beyond Northern Rock, and it was not the FSA that caused this, it was dodgy securities—

**Ms Knight:** Yes.

**Q227 Mr Mudie:**—sold for some considerable time, making a lot of people in your industry very rich and now we are all feeling the pain. The only authority of the three—the Bank of England, the banking industry and the FSA—to be honest and to come before us and say, “Hands up, we made a mistake”, would be the FSA. It has allowed you and your industry and the Bank to carry on without answering any hard questions. The hard question is securitisation and the behaviour of the banks. Jon Moulton said he wanted to see a time when the banks would be trustworthy again and easy to understand and open to understand. What assurances can you give the committee that there is deep-rooted thought going on within the industry that things have got to change, or has the banking industry moved in a way that cannot be rowed back, divided in any suitable way, that depositors’ money is protected and you get on with your financial adventures at your own cost?

**Ms Knight:** I think that the banks, first of all, have taken very seriously these problems. Of course they have. Look at what has happened to share prices. Look at the requirements for rights issues. There are some very strong consequences felt by the industry and by the entities that operate in the industry, and that is a driver for change in a way that I think is arguably stronger than any other. I have been asked already, though, in this session today about innovation, and I say it again. Innovation is part of this industry, as it is part of other industries. There is nothing wrong with securitisation. It is being used widely. What has happened, though—the point that you have made—is that some dodgy stuff has got into the system, it has been rated wrongly, there has been a certain amount of trust given to things in which, frankly, it is a great pity that that trust was given, and the result of that is felt in the system and it is also felt in the industry and, in particular, institutions as well. If that is not a strong driver to change—there is no stronger driver to change than reaping the consequences of mistake. Not everybody made the same mistakes as the Northern Rock and not everybody is exposed in the same way as some of the big banks in the US.

**Q228 Mr Mudie:** Angela, if Mervyn had offered the same facility as he is offering now, Northern Rock would not have gone down.

**Ms Knight:** I said that to you earlier. If the money market had changed at that time, then the Northern Rock may well not have hit the—

**Q229 Mr Mudie:** The bottom line is: are you in the industry going to bring forward proposals beyond better regulation? In other words, if we are going to get the regulator right and avoid this in the future, are the industry going to bring forward radical reforms for consideration that will assure us that we will not go through this again?

**Ms Knight:** We gave you some at the start of your inquiry in which we were looking specifically in the areas of structured products, of securitisation, of credit rating agencies, of assessments that the industry had to make and so on. We have continued in that area. We have made some proposals in market abuse and we are looking internally at more as well. Of course we are engaged, not just in responding to other ideas, but making our own proposals as well. We would be wrong if we were not, frankly.

**Q230 Chairman:** George implies, something I agree with, that in public this is seen as a one-way street for the banks who have got the facility.

**Ms Knight:** I know it is.

**Q231 Chairman:** And there will be a backlash if there is not a real positive, concerted response from the industry, Angela. One of the things that we will be doing in this inquiry is we will be continuing for quite a few months yet and we will have your members in to question them about exactly what is happening: because if repossessions really go up and there are not any alternative proposals by the banks and building societies, then they are surely going to cause a political storm?

**Ms Knight:** Chairman, nobody is more aware than me about what the public at large think of the banking industry. I get it in the neck on a weekly basis in responding to the various questions of the various interviewers, and, indeed, I have got it a fair amount in the neck today in facing you at the Treasury Select Committee. It is important for the industry that there is trust. It is important for the industry to make what changes need to be made in a right and proper way. It is also important for the industry and for the UK that we continue to have this strong international centre quartered here in this country. We have got what others have wanted. Others have lost to us. As we make our move forward we do need to keep our eye on the internationality of the industry; it has got to be kept firmly in front of our face.

**Q232 Chairman:** To take George's point and Jon Moulton earlier, should the regulator only be regulating what they understand?

**Ms Knight:** I do not quite know what you mean. I would hope that the regulators do understand exactly what it is that they are regulating.

**Q233 Chairman:** It is dead easy. Financial products are very complex and we have had a lot of people saying nobody knows what they are buying and nobody knows what they are selling. We have had chief executives in front of us who did not know what CDOs were never mind CDOs squared. That is the type of thing. So should a regulator only regulate what they understand?

**Ms Knight:** Yes.

**Q234 Chairman:** Good.

**Ms Knight:** And that means that the industry has got to try and provide people to the regulator.

**Q235 Chairman:** That is a profound answer, Angela. I am delighted with that answer, because we are not against financial innovation. It is all advantageous, but financial innovation is always one step ahead of potential regulation, and that is where the problem comes in, but that is a good answer for us. Last question, Angela: what difference will plea bargaining make in tackling market abuse?

**Ms Knight:** What I think is that it will send a very strong shot across the bows to those people who do try to abuse our market, as well as, hopefully, enabling the FSA to successfully catch and prosecute, and we have written to the Chancellor accordingly.

**Q236 Chairman:** Good, because we have made that point in our committee. I do not want you to mislead the public, Angela, but this committee is always nice to you, is it not?

**Ms Knight:** You do not want me to mislead the public, John?

**Q237 Chairman:** No.

**Ms Knight:** Then the answer to the question is, no, you are not always nice to me, but please note I always come here!

**Q238 Chairman:** Okay. Thank you, Angela. You always have a very good comment. Can I thank you for your attendance today and for your praetorian guard as well.

**Ms Knight:** Thank you very much.

**Tuesday 20 May 2008**

Members present

John McFall, in the Chair

Jim Cousins  
Mr Michael Fallon  
Ms Sally Keeble  
Mr Andrew Love

John Thurso  
Mr Mark Todd  
Peter Viggers

*Witnesses: Mr Ron Sandler CBE*, Executive Director, and *Ms Ann Godbehere*, Chief Financial Officer, Northern Rock, gave evidence.

**Q239 Chairman:** Mr Sandler, may I welcome you and your colleague to this inquiry into financial stability and transparency, particularly in relation to Northern Rock. Can you introduce yourselves for the shorthand writer, please?

*Mr Sandler:* I am Ron Sandler. I am the Executive Chairman of Northern Rock.

*Ms Godbehere:* I am Ann Godbehere. I am the CFO of Northern Rock.

**Q240 Chairman:** Why did you take the job?

*Mr Sandler:* Because the Government asked me to do it. I felt that this was something that needed to be done. I was asked and I considered that it was my duty to do so. I also thought it would be an interesting thing to do.

**Q241 Chairman:** When they asked you were there any strings attached to that request?

*Mr Sandler:* No strings. I did establish when I was asked certain ground rules about how the company was to be run were it to go into public ownership and those ground rules included the fact that the company would need to be managed at arm's length from the Government. With that as background and with a little bit of conversation with Treasury officials about the company and its particular state at that point, I concluded that it was something that I should do.

**Q242 Chairman:** How high is the risk that the public's money currently invested in Northern Rock will not be repaid in full?

*Mr Sandler:* We have a plan and it is a plan which I believe is deliverable. Assuming the plan is delivered according to schedule, the Government's money will be repaid before the end of 2010. It will take some time longer for the guarantees to be released, so the taxpayer will be exposed for some time further. Equally, I do not want to come here and pretend that this plan is entirely without risk. It is quite a challenging plan in very many respects. I do not think we should take anything for granted at this early stage.

**Q243 Chairman:** Is the main risk at the present time that the company will remain in public hands for longer than expected?

*Mr Sandler:* No. I think the key risks are those that relate to what is happening in the wider economy. If we were to suffer a significant downturn in this

economy and if that were to lead to levels of unemployment which are considerably higher than those at present, I can see that that would place considerable strain on the ability of the company to deliver the plan. There are also a series of operational risks attached to taking a company of the size and shape and structure of Northern Rock, giving it an entirely new strategy and making sure that that is implemented in a way which causes the internal processes to be properly maintained.

**Q244 Chairman:** What is your estimate of the likely extent of house price falls in the UK housing market?

*Mr Sandler:* I do not have any particular insight to offer there. I read the various estimates that more expert commentators provide. As we all know, there is quite a wide range of estimate out there presently as to what the outcomes may be there. We are operating in very uncertain times as far as financial markets are concerned.

**Q245 Chairman:** The reason I ask that is to gauge how it would impinge on your business. To what extent have the recent falls affected the security of your mortgage book?

*Mr Sandler:* The present climate is such that if things were to remain as they are I am confident that that plan can and will be delivered. It is only if we were to see a considerable decline from the status quo that I would start to get concerned.

**Q246 Chairman:** How far would it have to fall before you would have serious concerns about the overall level of collateral available for your present mortgages?

*Mr Sandler:* I do not think there is a simple calculus there. What I would say is that we have stress tested the plan against a number of future scenarios; in particular, we have stress tested it against a decline in the housing market comparable to that which we saw in the early Nineties and the plan is robust to that particular scenario. I do not think we should be talking in generalities about house prices declining. It depends very much on where those declines occur because, as we all know, it is quite a diverse housing market and the sorts of levels of decline that we may be seeing are not consistent across the board.

**Q247 Chairman:** That answer coming from the Chairman of Northern Rock frightens me a little bit because when we asked the previous incumbents of Northern Rock about liquidity they said they had stress tested for liquidity and everything was okay!

**Mr Sandler:** You are right to be concerned. It concerns all of us. We all look anxiously at what is going on in the wider market. There is no question that if house prices were to decline seriously, five, ten, 15 per cent, then that would certainly put a great deal of stress on our ability to deliver the plan. I cannot give you a single figure of house prices decline which would cause the plan to fall over.

**Q248 Chairman:** How geographically concentrated is Northern Rock's mortgage book?

**Mr Sandler:** It is quite widespread.

**Q249 Mr Todd:** I want to ask you some questions about the competitive environment in which you are sitting and the rather unusual circumstance you face of being constrained in your toolset by government aid and the reaction of your competitors to that government aid. You have set out your principles which among them say that you will not sustain a prolonged presence as a market leader in the marketplace in any product category. Has it been easy, particularly in an environment where the products are changing rather rapidly just at the moment, to shift your products around so that that assertion remains sound?

**Mr Sandler:** We put the competitive framework together during the month of March and announced it at the end of March, so we have only been operating for a period of six or seven weeks under the constraints imposed by the competitive framework to which you refer. It has been easy to put our product below that particular threshold and as we operate today we are able to operate comfortably within it, but we will have to see as the market develops in the future just what real constraints it imposes on our operations.

**Q250 Mr Todd:** But it is a pretty counter-intuitive constraint on a business that previously was a market leader in a number of these sectors. So you have a major attitudinal change amongst many of your key staff from being rather aggressive in the marketplace to being deliberately quiescent.

**Mr Sandler:** The change in outlook and attitude amongst our staff extends a lot further than just the pricing of our products. You are absolutely right to point that out. We have a duty as a bank which is temporarily owned by the state not to compete on an unfair basis and not to use the existence of state aid so as to disturb the marketplace in any way. On the other hand, we have a requirement to deliver back to the taxpayer the monies that we have presently borrowed from the taxpayer and there is clearly a balance to be struck here.

**Q251 Mr Todd:** I was going to question you on exactly that balance, which is that the constraints within which you operate, which are understandable in an environment where your competitors would

legitimately complain, are also making it a little harder to accumulate your resources, which would allow an early return to the taxpayer of the payments that are required.

**Mr Sandler:** Indeed, and that is one of the reasons why I said at the outset that this is a challenging plan, because it has to be executed within precisely those constraints. I do believe that we have found the right balance, that what we have put out in our competitive framework strikes a sensible balance between not using government support unfairly and at the same time being sufficiently competitive that we can return our retail deposits back to a sensible level and that we can continue to issue new mortgages at a modest level but keep that side of the balance sheet operating as well.

**Q252 Mr Todd:** The nearest comparison you might have is National Savings in terms of savings product at least in which again there is a desire to compete in the marketplace but not do so in a way which plays on the advantage of state support. Have you had any conversations with them over the way in which they handle that balance?

**Mr Sandler:** No, I have not. I have not looked at precisely how National Savings operate. I and my colleagues have simply looked at the Northern Rock situation and developed this framework considering our own circumstances.

**Q253 Mr Todd:** Is the Northern Rock brand bust?

**Mr Sandler:** I do not believe so. We have conducted a number of exercises to establish attitudes towards the brand and the results of those exercises indicate to me that the brand, whilst damaged, is not damaged irreparably. We are therefore quite happy to continue using the brand. We are finding that the brand is becoming re-established the longer we go on and the more people come to understand our situation. We will have to invigorate it in the years ahead unquestionably, but I am not concerned that we are operating a business with a brand which carries with it such connotations as to make our lives impossible.

**Q254 Mr Todd:** Let us turn to the international dimension of competition. You have shut your Danish office and from the news reports it appears to have been prompted partly by Danish concerns about the competitor position of your Danish operation in their marketplace. Is it reasonable to say that?

**Mr Sandler:** Broadly speaking, yes. It is a peripheral operation. It only provided a few hundred million pounds of funding to the bank, it was not central and as part of the process of returning the bank back to a core focus set of operations we saw that Denmark had no reason to feature. It was also somewhat of a beacon for this whole question of how we should compete and it made sense on all grounds to terminate it accordingly.

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20 May 2008 Mr Ron Sandler CBE and Ms Ann Godbehere

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**Q255 Mr Todd:** There were a small number of other overseas activities as well. Would they be affected by your same desire to focus on the UK or to watch for competitive concerns in some of these marketplaces? I think there was an Irish operation, was there not?

**Mr Sandler:** Yes, and a Guernsey operation as well. They are different in the following respect. They have both been around for somewhat longer and therefore they are more established in their marketplaces, they have better brands and they were not competing as aggressively as the Danish operation, which was a new operation and had to offer very attractive products in order to secure a place in that market. So the competitive dynamic is different in Ireland and Guernsey and we have not seen the same requirement to close those operations. We feel it is valuable to the bank to have diversity in its retail funding base and Guernsey and Ireland help in providing us with that.

**Q256 Mr Todd:** There is a currency issue which you presumably are balancing in the normal way.

**Mr Sandler:** That is easily hedged.

**Q257 Peter Viggers:** You have established a panel to assist maturing mortgage borrowers to find a suitable property to switch to. Who is on this panel and how does it work?

**Mr Sandler:** We have a small number—and by small I mean fewer than five at the moment, although we intend to increase that number—of mortgage intermediaries, firms with whom we have had long-standing intermediary relationships. It works very simply that when our borrowers are approaching the end of their fixed or discounted periods we let them know that they are approaching the end of those periods and we start to alert them to what their choices are. As part of that process in a sense we take them to the panel and introduce them to the panel and we hope that the panel is able—and thus far it is proving to be able—to find them alternative products.

**Q258 Peter Viggers:** How is this different from the role of other mortgage intermediaries? What is distinctive about your programme here?

**Mr Sandler:** Just the proximity with which we work with this particular group of nominated intermediaries. It is just a closer commercial relationship.

**Q259 Peter Viggers:** How do you select the customers that you want to keep and the customers that you want to encourage to leave?

**Mr Sandler:** At the moment anyone whose mortgage is maturing faces a decision as to whether or not to stay with us and move on to the standard variable rate or whether to remortgage or remortgage away specifically. That is the starting set. At the moment we are advising all of those customers about their choices and some are choosing to stay with us and the majority are choosing, with our assistance, to find alternative products elsewhere.

**Q260 Peter Viggers:** Is there not a risk that you will be left with the mortgages that nobody else wants?

**Mr Sandler:** Yes, there is such a risk. We talk of the risk of adverse selection and that is present in what we are doing. There is no question that those customers who represent the better credit risks find it easier to get good alternative products elsewhere and those that are perhaps the poorer risks find it more difficult. We do expect over time that that is going to increase the riskiness of our book but not to a level which we feel will imperil the overall delivery of the plan.

**Q261 Peter Viggers:** Will you need a special category of mortgage to cope with these people with difficulties?

**Mr Sandler:** We may do in extremes. In the main we hope that we will not. There will be certain customers who we may have to make, as we do in any event, special arrangements with if they are struggling to make their payments.

**Q262 Peter Viggers:** How often have you met with the European Commission to address any concerns they have about the trading practices of Northern Rock?

**Mr Sandler:** I personally have not met with anyone from the Commission. The interaction with the Commission has been handled by the Treasury.

**Q263 Peter Viggers:** Are you expecting any further demands from the European Commission to reduce competition?

**Mr Sandler:** I do not really know. I have had no personal dialogue with the Commission so I do not have any first-hand views about how they have reacted to the plans that we have submitted to them via the Government, nor what their response in due course will be. I think we have to allow the process of the state aid investigations, which are being conducted in Brussels, to take their course and in due course we will discover whether or not any modifications to our plans will be forthcoming. When we designed the plans we did so having very careful regard to state aid and how it operates. It is my hope that the plan as presently submitted will prove to be acceptable to the authorities in Brussels.

**Q264 Peter Viggers:** That submission was made on 17 March.

**Mr Sandler:** It was indeed.

**Q265 Peter Viggers:** Have you any indication of when you will hear from them?

**Mr Sandler:** I believe that a communication is expected in the next few weeks and that will signal the start of a period of consultation that they will undertake. I would expect to hear before the end of this year about the final determination of whether or not our plans meet the state aid requirements.

**Q266 Mr Fallon:** Mr Sandler, in your trading statement last week you disclosed that you had discovered some rather inadequate controls on the way in which three-monthly arrears were being

measured. I think it was previously 0.5% of your mortgage book and it now turns out to be 1%. Is that right?

**Mr Sandler:** It is slightly under 1%, 0.95% to be precise. What we discovered is that the policy by which we capitalise arrears was perfectly sound but the controls over the procedures were inadequate in our judgment. More specifically, there is a discretion within our policy. If there is a reason to take a loan which has not completed the full three months of full repayment there is discretion to still capitalise the outstanding arrears. We found that that discretion was being applied rather more widely than we would like.

**Q267 Mr Fallon:** So that discretion had been used artificially to boost the company's position in 2007, had it not?

**Mr Sandler:** I am not sure I would put it in quite those terms. What I would say is that there was a discretion and I believe that most banks operate similar sorts of discretions, but the controls over how that discretion was being applied within Northern Rock really only came to light with the introduction of a new debt management system which was introduced towards the latter part of last year, so we could see more clearly the extent to which the discretion was being applied. We felt that the correct response in that circumstance was to remove the discretion altogether, which is what we have done.

**Q268 Mr Fallon:** You also talk in your business plan about managing credit quality with "more selective credit quality standards". What was going on before?

**Mr Sandler:** There were certain rules, for example, in respect to loan to value ratios which underpinned our whole credit scoring processes. All we are saying is that as we continue to lend in the future we will lend only to risks which we judge to be of the highest quality, for example, our loan to value ratios will now reduce.

**Q269 Mr Fallon:** I understand what you are doing now but I am more concerned to establish what was going on. Presumably some of this lending was not of high quality.

**Mr Sandler:** I am not entirely qualified to answer that because I was not at the bank at the time that that lending was taking place. I look at the loan to value ratios that the bank has lent and the quality of the book and I regard it as quite an acceptable quality when measured by others in the industry. It was a book of prime residential mortgages, leaving aside the buy-to-let and some of the more peripheral activities. Given that we have to be entirely selective going forward and that we are only lending a fraction of what we have lent in the past, it seemed to us to make sense to lend only against the best risks that we could find.

**Q270 Mr Fallon:** How much has been repaid to the Government so far? Anything?

**Ms Godbehere:** Absolutely. At the end of last year the loan was at £26.9 billion and at the end of March it was at £24.1 billion, so we have paid £2.8 billion down since the beginning of the year. In the second quarter we have continued to pay down, which we will disclose as part of the second quarter.

**Q271 Mr Fallon:** How much will be repaid by the end of this year?

**Ms Godbehere:** 25% of the loan will be repaid by the end of 2008, a further 75% by the end of 2009 and fully by the end of 2010.

**Q272 Mr Fallon:** Your Chairman has said that might be affected by the credit crunch.

**Ms Godbehere:** When doing the stress test we stressed it to the 1992 kind of mortgage cycle that we had at that time and the credit cycle and under all scenarios, even with that recession scenario, the loan was repaid with only a short delay from the original timetable of by the end of 2010. What the stress test showed was that what was more likely to happen is that the guarantees, which in our plan we assume will be removed by the end of 2011, may need to stay in place longer.

**Q273 Mr Fallon:** But the repayment is supposed to be by the end of 2009.

**Ms Godbehere:** Of the loan? No, 2010.

**Q274 Mr Fallon:** If you had a 10% fall in house prices over 2008 and 2009 what delay would that cause you?

**Ms Godbehere:** As I said, the stress test goes back to a 1992 scenario and the delay is only about a six month delay in that scenario, which is a real recession stress test scenario of when the ultimate payment date would be.

**Q275 Mr Fallon:** So if we had a 10% fall in house prices the taxpayer would still be repaid in full during 2011, is that right?

**Ms Godbehere:** That is our expectation, yes. That is assuming one pretty critical assumption, which is around the ability for our customers to redeem their mortgages away from us to other lenders. Our plan assumes for a 60% redemption rate. We have assumed that in very difficult circumstances maybe we would only be able to get away with a 50% redemption rate. If redemption rates were to go down further than that then ultimately the taxpayer will get repaid because the cash will come in but it will simply come in more slowly.

**Q276 Mr Fallon:** At what point will the bank move into profit?

**Ms Godbehere:** 2011 is when we believe the bank will get back to breakeven and it will move into profit in the years that follow.

**Q277 Jim Cousins:** You have given us a figure for Government funding of £27 billion but then there is also a separate reference to the Bank of England facilities. Are the Bank of England facilities included in that £27 billion?

**Ms Godbehere:** Yes. The only additional facility which we have from the Bank of England is actually a back-up liquidity facility. This is an undrawn liquidity facility and our plan does not plan to draw on it. It is there strictly as a back-up, as you would normally have with any commercial organisation where you would arrange with banks to have back-up facilities. Over time we would want to replace that back-up facility, undrawn, with just a third party, but we have to get the bank back onto an even keel so we can go back to the commercial markets for that.

**Mr Sandler:** We also have a small open market repo facility as well, which is something that all banks will have. We do not include that within the headline figure in terms of the Bank of England.

**Q278 Jim Cousins:** Does any of the £27 billion have penalty interest rates or is it all at commercial interest rates?

**Ms Godbehere:** The facilities are all at premium rates, yes. We also pay a fee for the guarantee which is on the deposits.

**Q279 Jim Cousins:** The £27 billion is at premium interest rates and there is a fee for the guarantee. Do you not think, after the Bank of England's announcement of a £50 billion facility for the banking sector in general, that those premium rates and special fees are themselves rather anti-competitive?

**Ms Godbehere:** Part of the whole EU state aid process is in fact that there have to be compensatory measures and part of that is the cost which a business that has the benefit of state aid has to pay for that. I believe that in part is actually intended to be anti-competitive.

**Q280 Jim Cousins:** Let me summarise something that is no doubt a great deal more complex. The Treasury's deal with the European Commission over state aid requires premium rates of interest to be levied on Northern Rock.

**Mr Sandler:** Yes, I would say that is a fair summary of the situation. It certainly assists in creating an incentive to repay the Bank of England facilities as quickly as possible.

**Q281 Jim Cousins:** We do not see anywhere in the memorandum a reference to the payment of the bidders' costs that were ultimately set aside by the Government. Has Northern Rock met those bidders' costs or has it been the Treasury that has met them?

**Ms Godbehere:** As part of the arrangements before Ron and I were in situ they were re-billed back to Northern Rock and they were disclosed in the 2007 annual report and accounts, so they were paid at the end of last year.

**Q282 Jim Cousins:** Do you think your repayment policy effectively depends upon reclaiming the money from mortgages because there is nowhere else for it to come from? Do you not see it being slightly illogical and contradictory for the Bank of England

on the one hand to be lending very large sums of money to the banks partly to support the mortgage market, and a state owned bank withdrawing up to £27 billion from that same mortgage market in the same time-frame? That is a bit contradictory.

**Mr Sandler:** I can see the contradiction to which you refer. I am not involved in the manufacture of policy here, but I suspect there are a range of interests which are sought to be accommodated, including overall stability of the financial system and what we are seeing here is an outcome of that in an attempt to balance a series of objectives.

**Q283 Jim Cousins:** The Bank of England is lending large sums of money to the general banking sector partly to support the mortgage market and a state owned bank is recovering £27 billion from that same mortgage market in the same time-frame.

**Mr Sandler:** That is correct.

**Q284 Jim Cousins:** Let us turn to the issue of the staff. Where do you expect these staffing cuts to fall because the staffing cuts are front-end loaded? You are aiming at 2,000 staff cuts this year. Where will they fall?

**Mr Sandler:** It is not 2,000 this year, although I would fully acknowledge that the bulk of the downsizing will occur in 2008 if things go according to plan. We are engaged in consultation with the union at the present time and it would be wrong of me to prejudge the outcome of those consultations, so I cannot be precise on ultimately what the figures will be, but it would be my expectation that something like 2,000 jobs will go from the bank between now and 2011 with the bulk of those taking place later this year. They will largely take place in our processing activities which are located up in the north-east, both in Gosforth and in Doxford.

**Q285 Jim Cousins:** Which site do they predominantly fall in?

**Mr Sandler:** That depends again somewhat on the outcome of the negotiations or the consultation with the union and other employee representatives. I would not want to put a precise figure on that. It is my expectation that they will fall across both sites.

**Q286 Jim Cousins:** You are conducting out-sourcing of some activities in the same time-frame that you are negotiating very large scale redundancies. Is that fair to the staff?

**Mr Sandler:** We are not out-sourcing at the moment, but I think we are intending, if we are able, to find some kind of through lending arrangement. Put very simply the situation is as follows: we have an extremely capable set of staff and processes within the bank which now are scaled to a point which exceeds our own need for those facilities. If we can find an alternative lender who has an interest in employing some of our capability to lend or process mortgages for that bank's book then that would assist in mitigating some of the job losses that we are anticipating and it would also be a productive use of what is an efficient processing capability.

**Q287 Jim Cousins:** You are not proposing to outsource some of your IT services, are you?

**Mr Sandler:** That remains to be seen. We already use quite a large number of sub-contractors so in that sense we already outsource in that way. The IT of Northern Rock is fundamentally insourced. There are no plans at the moment to outsource on any material scale.

**Q288 Jim Cousins:** The qualifications base of the staff is obviously very important for those of the staff who will be entering a wider job market. Why are you withdrawing FSA recognition from members of staff at Northern Rock?

**Mr Sandler:** I am not sure I understand the question.

**Q289 Jim Cousins:** Let me be very specific about this. There are over 100 employees of Northern Rock who have FSA recognition as market operators because of the skills they have. You are pursuing a policy of withdrawing recognition from the FSA in respect of those staff which affects their future job prospects. There were 12 such staff in the north-east six months ago and there are now only two. The numbers are not great but for those individuals it is significant. It also is a pointer to your future modus operandi in the market.

**Mr Sandler:** I am not familiar with the fact that has just been put on the table there, but I am very happy to go back and look more carefully at that and to put some written submission back to this Committee once I understand the facts more clearly.<sup>1</sup>

**Q290 Jim Cousins:** The staff were invited to engage in the purchase of shares in Northern Rock and this was done in three different ways. One of them was a share option plan, another was a so-called share save scheme, but a third category, which has not had enough attention drawn to it, was a so-called share incentive where employees were given shares rather than bonuses. Those shares were part of the reward package that workers were entitled to expect. Those shares are now caught up in the general issue of the share valuation which we do not need to go into. Do you not think that there is a need to recognise the position of those members of staff who were, as a result of the company's policy, inescapably involved in that share incentive arrangement, that third category of share ownership? Do you not think there needs to be some special recompense for those staff?

**Mr Sandler:** What I think we have is a requirement to balance a number of conflicting objectives. We do have a requirement to make sure, particularly as custodians of the public purse for the present, that what comes out at the end of this process is a bank that is viable, that is capable of standing on its own two feet, that is profitable, that meets all the appropriate capital ratios and, therefore, we have to have regard for the economics of the bank going forward. On the other hand, we have as an employer, particularly one in this rather unfortunate set of circumstances, a requirement to treat our staff as generously and as fairly as we possibly can. I am

absolutely committed to ensuring that any redundancy arrangements are as generous as we can make them and ultimately are the product of an effective balance of those conflicting objectives. At the moment we are consulting with the union on precisely these matters and I would hope that we are in a position to reach agreement with the union on the replacement for the job security agreement, which is the agreement that has governed redundancies in the bank in all of the previous years.

**Q291 Jim Cousins:** Can I take that answer as meaning that for those members of staff who were caught up in the share incentive arrangement, which was part of the reward package, it was a bonus that was paid in the form of shares, and who are being made redundant there will be a recognition of their involvement with that special third category of share ownership?

**Mr Sandler:** No, you cannot take it to mean that. All I can say at the moment is that we will seek to be as generous as we feel we can be in terms of any redundancy arrangements which may ultimately arise from the process in which we are presently engaged. At this stage I cannot make any commitment in respect of any group of staff, from directors and senior managers who are governed by the same set of policies in respect of shares all the way through to the lowest ranks in the organisation.

**Q292 Chairman:** You mentioned redemption rates in your previous answer. What is a normal redemption rate?

**Mr Sandler:** I do not know of an industry norm. What I would say is that in the past Northern Rock operated an active retention policy and had a set of policies and procedures in place to attract those borrowers who were coming to the end of their fixed and discounted periods. I think I am right in saying—and this predates my involvement—that there was something in the order of a 40% redemption rate. We are now anticipating that that will rise to something in the order of 60%.

**Q293 Chairman:** Can you expect a 60% redemption rate in a credit squeeze?

**Mr Sandler:** It becomes considerably more challenging if there are not other lenders out there who are prepared to offer acceptable products to those customers who are in that situation.

**Q294 John Thurso:** I would like to ask about the Granite SPEs. The loans to customers are assets in the balance sheet and the securitisation of Granite is a liability?

**Ms Godbehere:** Yes.

**Q295 John Thurso:** When Northern Rock was taken into public ownership there was considerable concern about what may or may not be the actual position with the SPEs and whether or not the loans shown as an asset in fact would end up with Northern Rock or would go with Granite. Have you

<sup>1</sup> Ev 93

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20 May 2008 Mr Ron Sandler CBE and Ms Ann Godbehere

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had an opportunity to investigate those SPEs thoroughly and are you comfortable with what you have discovered?

**Ms Godbehere:** Yes. The way that the structure works is that Northern Rock sells the mortgages into the SPE and those mortgages are then used as the collateral in the SPE, so the SPE can then issue AAA rated paper to investors to invest in. To the extent that the SPEs are over-collateralised and therefore there are more loans in there than the size of the bonds, as the bonds repay the excess simply comes back to the sponsor, in this case Northern Rock. There is no risk that I can think of where any excess over the amount of those Granite bonds that have been issued would not come back to the sponsor.

**Q296 John Thurso:** Is there any risk in the event of defaulting mortgages that are in the Granite vehicle that that comes back to Northern Rock?

**Ms Godbehere:** No. There are relatively standard standards for securities which subsequently get securitised. There are some criteria for which mortgages qualify to go in. If somebody pays down their mortgage, for instance sells their home and moves their mortgage away so that mortgage obviously comes out of a collateral pool, Northern Rock is responsible for replacing that with another mortgage to go into the pool.

**Q297 John Thurso:** What current plans have you for the vehicle? Will you just leave it as it is and let it run?

**Ms Godbehere:** They are sound vehicles. They will run off over time. The total of Granite at the end of 2007 was approximately £43 billion. It fully runs down to zero by 2013. By the end of 2009 it has already gone down to £27 billion. By the end of 2011 it is down to £14 billion and then by 2013 it is zero.

**Q298 John Thurso:** Would you see Northern Rock undertaking any further securitisation over the next year or two?

**Ms Godbehere:** We have assumed in our plan that our main focus is funding through growth of the retail so that we can get to a balance of retail/non-retail funding of about 50/50%. We have assumed that we would do very, very modest levels of non-retail funding through the planning period. The plan actually goes out in a full six-year period that we have thought of but at very modest levels. At the moment the credit markets are still essentially closed so there is no plan. To the extent that there is an opportunity to do some very modest non-retail funding, yes, we would try to do some but not necessarily with the existing Granite trust, it might be a completely new vehicle. We could use covered bonds, of course.

**Q299 John Thurso:** Would you be looking in any way to obtain longer-term funding than Granite traditionally sought in any way?

**Ms Godbehere:** Most likely, yes. That was one of the appeals of covered bonds, they have a longer maturity. As for the existing covered bonds that we have, we had just under £9 billion at the end of last

year, none of the covered bonds are paid down before 2009 but they stretch out to 2017 because they are five, ten and 15-year covered bonds.

**Q300 John Thurso:** I would like to turn to the question of remuneration and congratulate you on your remuneration report. The company had a range of fairly normal incentives. There was an annual bonus, there was an LTIP share save, share matching, et cetera, et cetera. At the end of every section it says "This will not apply in 2008". What incentives will you give your senior managers and also the body of your staff going forward?

**Mr Sandler:** We are in the process of finalising an incentives scheme which is company wide and I think this is an important principle. I do not wish there to be differences in the way the scheme works at any level in the company. I would want everyone in the company to participate in the scheme. The scheme itself is being designed against some very simple parameters. We have a number of very clear objectives, repaying the Government debt, getting those guarantees released and returning the company back to private ownership, and those represent the goals around which the scheme that is being designed is geared. What I will put in place is an incentives scheme which delivers a reward and I hope it will be a suitably incentivising reward simply around the achievement of those objectives.

**Q301 John Thurso:** So it would be fair to say that all of the incentives structures being put in will be specifically linked to the goals of returning the company—

**Mr Sandler:** —ultimately back to private ownership, correct.

**Q302 John Thurso:** Are you using New Bridge Street?

**Mr Sandler:** No. We are not using any outside consultants on this particular exercise. This scheme is sufficiently simple that we are able to design it ourselves. We have obviously sought some external benchmarks, but I do not believe we need the help of high paid consultants to put a scheme such as this together.<sup>2</sup>

**Q303 John Thurso:** You both have £90,000 and £75,000 monthly contracts. Are you on any incentives of any kind or is it just the straight fee and that is it?

**Mr Sandler:** It is just a straight fee. There is no other form of reward other than the one that you have just described.

**Q304 John Thurso:** Do you feel that that is sufficient motivation for you?

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<sup>2</sup> *Witness correction:* I told the Committee that Northern Rock was not taking advice from Hewitt New Bridge Street in relation to the new incentive scheme for the Company. I have subsequently been informed that, in the market benchmarking exercise that followed design of the scheme, Hewitt New Bridge Street provided information to Northern Rock from their proprietary industry remuneration database. They were not involved in any aspect of the scheme design.

**Mr Sandler:** I do not feel at the moment that I need a great deal more motivation than I feel I have to get up in the morning and do what I do up at Northern Rock, which perhaps is the answer to the question. I was asked by the Chairman right at the outset why I was doing this and I can assure you that I am not doing it because of the financial reward that attaches to it. I am doing it—and I am sure that Ann would echo it—because I think it is something that needs to be done and I was asked to do it by a government and there is a degree of public spiritedness, I hope, in my response to that request.

**Q305 Ms Keeble:** I wanted to ask a bit about the interaction with the other authorities. Northern Rock is still regulated by the FSA. I wonder if you could say how many meetings there have been with them and how your contacts with them are structured.

**Mr Sandler:** The contacts with the FSA take place up and down the organisation on a very regular basis. I know there is a weekly telephone conversation with the FSA which reviews a number of matters on a standing agenda. I have had two meetings with the FSA since I have been there and I have a third coming up quite shortly. We and the FSA are trying hard to return the relationship back to one of the FSA acting solely as our regulator and not as part of the tripartite authorities with any ambiguity about the roles of the three members of the tripartite. I view the FSA as my regulator and interact in the normal way.

**Ms Godbehere:** Andy Cope is our lead supervisor. Andy and I have frequent exchanges with each other.

**Q306 Ms Keeble:** Once a week? Once a month?

**Ms Godbehere:** Andy and Joanna Baird, who works closely with him, have both been up to the Rock fairly recently and they will be up again shortly. I am due—I have not got a date set in the diary yet—when I am in London to make sure that I go and visit them as well. If something has come up, if he has decided he wants to write a letter on something, he will ring me first and say, “Ann, this is coming. Hopefully you can respond in a timely fashion,” which of course we do. For instance, when we were reviewing our arrears policy capitalisation that we talked about a little earlier and we determined that, as Ron said, the controls over the use of discretion were not as we would have liked them to have been and we changed it, I phoned up Andy and informed him as a regulator.

**Q307 Ms Keeble:** One of the issues that came out of all this was the failings in the supervision by the FSA previously. I wondered if you had seen from where you sit some real improvements in the way in which they are organising and managing this.

**Mr Sandler:** It is hard to comment on improvements because we have not got the perspective of having seen the previous regime.

**Q308 Ms Keeble:** You have probably seen the report.

**Mr Sandler:** To be honest, I have read an awful lot of material both to do with the FSA’s supervision and other aspects of the bank in the past. I was not there at the time so I have no first-hand judgment to offer. I think that we are operating now with close supervision by the FSA. There seems to be a lot of contact at all levels in the organisation. Based on my experience in the past of working in regulated entities, it does feel to me as if this is a quite normal relationship. It is beginning to operate now, as we put some of the more recent traumas behind us, on a slightly more normalised basis.

**Q309 Ms Keeble:** You mentioned the possible conflict or tensions between the FSA as regulator and the tripartite authorities. Could you just make a couple of comments on that?

**Mr Sandler:** I will give you an example. Up until we introduced the competitive framework we had an arrangement with the FSA that any time we wished to adjust any of our products—and by that I mean any of the terms or conditions or pricing of the products and that happens on almost a day-to-day basis in a bank such as ours—we needed the permission of the FSA to do that, which is slightly unusual. In this case the FSA was acting on behalf of its tripartite colleagues and performing the role almost of an economic regulator. The role they were playing was to ensure that Northern Rock was not competing on a basis which was likely to be deemed unfair by anyone else in the industry. That is a slightly unusual role for the FSA to play. Now that we have the competitive framework in place the FSA has stopped that procedure and we can exercise the controls, as we have set out, without requiring the FSA to play a role which is not the role of a normal supervisor.

**Q310 Ms Keeble:** The relationship with the Treasury is supposed to be arm’s length. Is that in fact the case? How is your relationship with them structured? How does it compare with the FSA?

**Mr Sandler:** It is arm’s length. That was a precondition of my involvement in Northern Rock and it is something that I take very seriously.

**Q311 Ms Keeble:** It was one of your preconditions that they should remain arm’s length?

**Mr Sandler:** Yes. It was not a contentious precondition, but it was established right at the outset that if this bank were to be taken into public ownership—and we are talking about conversations that took place at the end of November, early December now—then it was essential that this bank be run on an arm’s length basis and free from any form of political interference. The Government was keen that that should be the case and I regarded it as essential.

**Q312 Ms Keeble:** Clearly there is an issue about you having your independence to operate but, as is stressed in some of your literature as well, there is obviously the accountability issue. How did you

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20 May 2008 Mr Ron Sandler CBE and Ms Ann Godbehere

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meet that part of the relationship with the Treasury and what kind of discussions or meetings have you had to talk through those issues?

**Mr Sandler:** The Government is our shareholder and our relationship is governed by the shareholder framework and indeed I gave a copy to the Committee so you have that. That calls for a very significant oversight on what we do by the Government that is largely geared towards our progress towards meeting the objectives set out in our plan and our progress towards the outcomes as set out in the plan. That takes expression in a number of ways. We have a monthly meeting set up involving the shareholder and by that I mean a team of people that the shareholder has assembled to ensure that the shareholder's oversight can be properly conducted.

**Q313 Ms Keeble:** Who? At what kind of level?

**Mr Sandler:** It is done through a combination of the Shareholder Executive, which is a branch of the Department for Business, Enterprise and Regulatory Reform coupled with the Treasury. It is about half a dozen people from both the Shareholder Executive and the Treasury at the most senior of levels and from our side it is an equally senior team, I am there, Ann is there, senior colleagues are there and we meet once a month against a formal agenda and we review progress and we explore any matters that are of interest to the shareholder. In addition there is a weekly flow of information. We are still working out precisely how the information will flow because this is a work in progress and we have to ensure that it does not flow in an uncontrolled manner and we have to ensure that the information conduits are not going to be such as to cause disruption in the bank, but all of that is coming into focus. There is a very regular and, I think, very helpful series of conversations all the while between ourselves and the Government.

**Q314 Ms Keeble:** You mentioned at the start that you had a little bit of a conversation with Treasury officials before you took the job on. Presumably the issue about the relationship with the Treasury and the lack of political interference was one of the issues you talked about. What were the other ones?

**Mr Sandler:** The other ones were largely to do with questions of how the Government would exercise its control, for example, board appointments or control over reward structures. It was the series of conversations which ultimately took expression in what you now see as the shareholder framework.

**Q315 Ms Keeble:** Given Northern Rock's status and entity in temporary public ownership, have you had contact with the ONS? How much of the information about the operations of Northern Rock do you expect to appear in the National Accounts?

**Mr Sandler:** I have had no conversation or involvement with the ONS and I have no knowledge of how the ONS is intending to handle the incorporation of Northern Rock within its accounts.

**Ms Godbehere:** We have been told by the Bank of England that the total liabilities of the bank and liquid assets of the bank will be included in the ONS. I believe the intention is to show the statistics with and without those two numbers. It is just about to start this month.

**Q316 Ms Keeble:** Is it going to be an aggregate or will it be separately identified?

**Ms Godbehere:** I am sorry, I do not know. We are feeding the information to the Bank of England, but that is all the information I have been asked to provide.

**Q317 Chairman:** You talk about being at arm's length from the Government, but I notice that Tom Scholar from the Treasury is a non-executive director. In what capacity was he appointed and how active is he in the company? I note that he is a member of the Audit and Risk Committee.

**Mr Sandler:** He and another public servant, Philip Remnant, who is the Chairman of the Shareholder Executive to which I referred a few minutes ago, are both directors of Northern Rock. The Government has the right in the shareholder framework to appoint two directors and those are their two appointees. They sit on the board like any other directors and are involved in the normal governance and oversight of the affairs of the bank for which the board is responsible. Separately they are also members of the Government and have their duties to the Government. I see them in effect in two capacities, I see them as my board members and deal with them accordingly and then at other times in the month I see them as members of my shareholder and I deal with them in the way that is set out in the shareholder framework.

**Q318 Mr Love:** What is your attitude to the decision to continue to fund the foundation to the sum of £50 million for the next three years?

**Ms Godbehere:** It was a commitment made by the Government as part of taking the bank into TPO. It has been allowed for in the plan. The foundation is an important part of the north-east and £15 million per year is consistent with sums which the bank has historically paid to the foundation. It paid about £14.8 million a year ago in 2007.

**Q319 Mr Love:** Do you think it will survive when you go back into the private sector? Will the private sector be interested in continuing to fund a foundation such as the Northern Rock Foundation?

**Mr Sandler:** We have made the commitment for the next three years and it is impossible to speak beyond that about the circumstances of private ownership and how the relationship with the foundation may operate in those circumstances. I have taken the view very strongly that our ability to achieve the objectives of the plan will be considerably enhanced if we can retain the close linkages that the bank has with the region. The regional involvement is an important source of strength and support for the bank and therefore I see the continued interaction

with the foundation as an important element in our ability to deliver what we have to deliver despite the fact that it comes at some considerable cost.

**Q320 Mr Love:** Could I ask you, in terms of the use of public funds, is it not really appropriate that you should be considering how the organisations that receive support from the Foundation could be given, over that three-year period, an opportunity to find alternative sources that would not entail public funding?

**Mr Sandler:** I think the whole question of the application of public funds for these sorts of purposes is a complex question, and it is one that we clearly do need to think carefully about. I could argue that our sports sponsorships are much in the same category. You might ask how can we continue to support Newcastle United when we are a bank that is in temporary public ownership. I think the answer to those questions does come back, in part, to the recognition that we have to run this bank as commercially as possible and as much at arm's length as possible on a day-to-day basis from the Government, so, if one would regard for a normal bank the sponsorship of a football team as being something which is a commercially sensible thing to do, then I think one would have to apply that same thinking to a bank such as our own in the present circumstances.

**Q321 Mr Love:** I do not want to make the pair of you the most unpopular people in the north of the country, but you mentioned Newcastle United and there are other sponsorships that you undertake, and you have given a commercial rationale for that. Is that something you are considering, ending the sponsorship for those organisations, or do you think that the commercial rationale you have outlined outweighs the cost to you?

**Mr Sandler:** We have already ended a number of the sponsorships that I inherited. For example, our sponsorship of Middlesex cricket now either has come to an end or it is coming to an end and the same is true of Durham cricket, but we have chosen to continue the sponsorship of Newcastle United and Newcastle Falcons partly because of commitments we have entered into there, and sometimes sponsorships continue until they come to a contractual end, but partly because I believe that it is in the commercial interests of the bank that we should continue with both of those.

**Q322 Mr Love:** You mentioned back at the beginning when we were talking about the risks to the business that one risk, that is the housing market, is completely outside your control. The other main risk that you mentioned was how you move the strategy of the organisation from where it was before to where it is now. Now, we have been looking at the membership of your Board of Directors and we see that only two of the Board have a long experience of Northern Rock. Is that appropriate considering that the risk that is within your control requires an understanding of the organisation and how you move it in that direction?

**Mr Sandler:** Well, I think you will find that only one of my board members has longstanding experience of Northern Rock. It is only Andy Kuipers who was on the Board in the middle part of 2007, for example, so the Board is effectively a new board which is not ideal in many circumstances, I readily concede that point, but I think, given the particular traumas that the bank has gone through and the particular events which were overseen by the previous Board, that it is better that we have a fresh board, a well-equipped board, I hasten to add, but nonetheless a fresh board that is able to guide this bank through the very difficult waters that it still faces.

**Q323 Mr Love:** I have down here that Michael Queen was also a board member going back, but perhaps not as far as that?

**Mr Sandler:** No, forgive me, Michael has been a board member for some considerable time. He was in situ when I arrived on 22 February. He was Chair at the time of both the Risk and the Audit Committees and the accounts had not yet been finalised. I asked Michael to stay on to oversee the publication of the report and accounts in his capacity as Chair of the Audit Committee on the understanding that he would then leave the Board in May, and indeed on 1 May Michael resigned from the Board of Northern Rock, so he is no longer a board member.

**Q324 Mr Love:** I do apologise, we should have been up-to-date with that. You mentioned earlier on the challenge to the brand that Northern Rock represents and you have talked a lot about the connections with the particular part of the world that it is in. Are you giving consideration to a change of name of the organisation, recognising the balance between those two?

**Mr Sandler:** I arrived at Northern Rock, as you would expect, with an open mind on that issue, as indeed on all issues. I very quickly formed a judgment, having spoken to people and having read some of the research that had been conducted, that the brand was well-equipped to sustain the bank going forward and I now am giving no consideration whatsoever to changing the name.

**Q325 Mr Love:** If you are considering that it is important that the connections you have with the North are important to the future of the bank, does that extend to considerations of who will continue in employment? Are you intending that the employment be focused primarily, as it already continues to be, in the North and what about your branch network because clearly, since most of your funds will be retail, there will be the continuation of the branch network? Are there any changes that you are proposing there?

**Mr Sandler:** We have 76 branches at the moment and those are quite widespread around the country. It is wrong to think of Northern Rock as a retail bank which derives its funding from the North East. The branches themselves are widespread and it is also important to understand that the bulk of our retail funding does not come through the branches,

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20 May 2008 Mr Ron Sandler CBE and Ms Ann Godbehere

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it comes through the Internet, it comes through the telephone, it comes through postal accounts, and it is truly spread around the country. What we do have, however, is an employment base which is traditionally rooted in the North East and I think it is essential that we should continue to view ourselves as a principal employer in the North East and that we retain, from an employment perspective, the roots and connections with the region that have historically existed.

**Q326 Mr Love:** But you do not see any change in your branch network, so you are not going to shift the balance more to the Internet, as a modern way of saving, if I can put it that way, rather than the more traditional way in the high street?

**Mr Sandler:** I can see that expanding the branch network might be something which the bank should consider. State aid considerations would make that a very difficult thing to do at the present time, so for the duration of the plan we have merely committed to retaining the branch network at our level of 76 and in the fullness of time, when state aid considerations no longer apply, then I think it is up to the management of the bank, in those circumstances, to consider further whether they wish to expand the branch network.

**Q327 Mr Love:** Since you consider the link with the North an important consideration in all the decisions you are taking at the present time, do you see any merit in returning to a mutual structure when the bank is privatised because it is on the basis of that mutual structure that the very firm connections first existed between Northern Rock and the North East?

**Mr Sandler:** I can honestly say that I have not considered that. I have had my plate full of a number of other things in the last few months and I have not had time to think about whether there may be other corporate structures that may apply.

**Q328 Chairman:** I think you mentioned sport sponsorship. Kevin Keegan's aspiration, when he took over Newcastle United, was to take it back to mid-table security. Is that the same aspiration that you have?

**Mr Sandler:** I certainly wish to see it and I doubt whether we will ever be top of the Premier Division, but I would hope that we are well-established within the leading pack.

**Jim Cousins:** Chairman, you may wish to have my interest declared as a season ticket-holder of Newcastle United.

**Mr Love:** He is an optimist!

**Q329 Chairman:** And Jim's aspirations are for Europe! Now, going back to a previous question, the state of the economy presents large risks, and I asked about stress tests you have done before, but could you elaborate on the stress tests that you have undertaken in your business plan in the light of the economic risk?

**Ms Godbehere:** Yes. I think I mentioned earlier that we have stressed to say that, if we cannot achieve a 60% redemption rate, what it would look like with a

50% redemption rate. We have stressed it with the 1992 recession scenario, so we have stressed it to see if we cannot get the guarantees off by the end of 2011, and some of the criteria for getting the guarantees off include achieving at least an A-minus stand-alone credit rating to have sufficient stand-alone funding, so those are the kinds of stresses that we have applied to what we call the 'base case'.

**Mr Sandler:** But I would additionally want to make the point that we are operating in extremely hard-to-predict economic circumstances at the present time and, whereas we have tried to accommodate all reasonable scenarios as we look ahead, it is just not possible to understand the full range of what we might be exposed to and we may come to discover that the plan has not fully accounted at the moment for things that we cannot yet understand or know of. What we have undertaken to do is review the plan again in the third quarter of this year based on the developments between now and then and look afresh at whether or not it remains robust to the world as we see it.

**Q330 John Thurso:** I just have a couple of quick questions, one on corporate governance. When the last Board of Northern Rock came before us, I was a little taken aback at what I thought was a rather lackadaisical box-ticking attitude of the Risk Committee. You have got a brand-new Board and the company has been through the mangle, so obviously you have an opportunity to inculcate a new culture. What have you done to ensure that the Board committees' culture will be one of robust thinking rather than corporate box-ticking?

**Mr Sandler:** The whole subject of risk is still very much a work-in-progress at Northern Rock. We do have outside consultants, and I am now, in a sense, going back on something I said earlier, not resiling from it, but we are using outside consultants to look at all of our risk structures and the control mechanisms that exist within the bank. That work is going on as we speak and, by some time in July, we would expect to see the full output of that work, and that will allow us to think afresh about some of the structures and control mechanisms within the bank. At the same time, we also have a new board and I believe that we have a very able board and it is a board which, I am sure, will also be strengthened over time with the addition of further non-executive directors who can come to understand the needs better, but I will ensure that the new Board and the newly formed committees are well-served by a revised risk structure within the bank, and we are recruiting already for a variety of positions within the bank which will serve to strengthen the oversight and controls that we have operating.

**Ms Godbehere:** The board members themselves have asked for induction training which we are going to arrange for, in particular, the Risk Committee to make sure that they get as deep an understanding as non-exec directors can of the workings of the bank from a risk management perspective.

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 20 May 2008 Mr Ron Sandler CBE and Ms Ann Godbehere
 

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**Q331 John Thurso:** No doubt you will appear before this Committee again in the future. It is a matter I would like to follow up because I think you may have lessons as you are in a situation where you will be actually probably doing things which could have a read-across to other companies. My other quick question is that, when you come to the happy moment of an exit, which do you think is more likely for a return to the private sector, a float or a takeover, or is it too early?

**Mr Sandler:** It is too early to say. I am concerned that we should exit and that we return the bank to private ownership, and the precise mechanism for doing that will depend on the circumstances at the time.

**Q332 John Thurso:** Has the Government put any criteria forward at this point, ie, they want money out of it and they just want it off their books?

**Mr Sandler:** No, the Government has not imposed any of those criteria. We have spent quite a bit of time trying to establish just how profitable we need to be and what ratings we will need from which agencies and what our capital ratios will need to be so that we have a picture in our minds of what the minimum thresholds of viability will need to be in order for us to comfortably return to private ownership, but no one has imposed any particular conditions on that.

**Q333 John Thurso:** Given that you have to pay the Treasury or the tripartite authorities £12 million and other people £5 million, so you have actually borne all the cost of what went on, there is nothing on the public purse for all of this and the Treasury Solicitor got the shares for not a great deal of money, at the end of the day it would be awkward if the Treasury walked off with a great deal of money on your privatisation.

**Mr Sandler:** That is a matter for the Treasury. My job is to get it back into private hands.

**Q334 Jim Cousins:** Could I just ask about your own exit strategy. What are your own intentions about how long you intend to stay with this situation? Will it be to see the whole plan through to its conclusion? Is that your intention?

**Mr Sandler:** My first intention is to get the bank stabilised and to make sure there is a clear plan and the bank is working well towards that plan and I agreed to come on as Executive Chairman to oversee that part of the process. What I have said right from the outset is that I do not intend to be Executive

Chairman for the duration, that I will relinquish my executive responsibilities as soon as I feel able to do so and return to a non-executive chairmanship, and I would very much hope that that will continue for as long as it makes sense to be there. I have no horizon established for the tenure of my non-executive chairmanship.

**Q335 Jim Cousins:** Does your tenure now depend upon your fellow board members or does it depend upon being appointed by the Government?

**Mr Sandler:** Well, I think originally I was appointed by the Government and I have not really considered the governance arrangements of my future tenure. I suppose logically the Government is the sole shareholder and the Government retains all the rights ultimately in terms of who sits on the Board of the company, but whether that comes to a mechanism of board recommendation or directly from the Government, I would have to go back into the detail of the shareholder framework to explore that.

**Q336 Jim Cousins:** One always has to remember the immortal phrase that occurs in *The Wizard of Oz*, that “people come and go so quickly”, but you have no intention, if it is left to you, of coming and going quickly?

**Mr Sandler:** I intend to get out of the executive chairman role when it is right for me to do so, but I have absolutely no intentions whatsoever of giving up on the non-executive chairman role that will follow.

**Q337 Chairman:** What will Northern Rock look like when it is returned to the private sector?

**Mr Sandler:** It will look like a bank with a balance sheet of around £50 billion with a balance of funding which is roughly 50% retail and 50% non-retail. It will be profitable, not to the level that it has seen in the past, but profitable and growing, it will be efficient and will have a cost:income ratio which is towards the upper end of the pack, the better end of the pack, it will have capital ratios which comfortably exceed the regulatory minima, and I hope it will be a bank which senses itself to be proud and thriving and capable of standing on its own two feet.

**Chairman:** Well, can I end by congratulating both of you on your appointments and commend you on the quality and the precision of your evidence, and wish you well with your tenure of Northern Rock. Thank you very much.

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# Written evidence

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## Memorandum from the Financial Services Authority (FSA)

### INTRODUCTION

1. We are submitting this Memorandum ahead of our appearance before the Treasury Committee on 6 May. The Memorandum covers:

- (a) our regulatory philosophy;
- (b) lessons learned from Northern Rock;
- (c) Banking Reform;
- (d) regulation of a nationalised Northern Rock; and
- (e) market abuse and insider dealing.

### (a) OUR REGULATORY PHILOSOPHY

#### *Our approach to regulation*

2. We are a regulator which seeks, wherever possible, to base our approach on principles rather than detailed prescriptive rules; an approach termed by us More Principles-Based Regulation (MPBR). We believe that the best means of encouraging the behaviour we seek in firms, and consequently our judgements of compliance, should focus on the consequences of firms' actions rather than rigid adherence to specific rules. We are therefore an outcomes-based regulator. We recognise that a successful financial marketplace requires innovation, the capacity for risk taking, and competition: an approach which has served the UK economy and its financial markets well. A consequence of this philosophy is that we cannot guarantee there will not be failures. The inherent certainty that there will be failures within our framework results not just from this requirement to recognise that risks are unavoidable, but also since outcome-based judgements are essentially predictive and thus our judgements necessarily reflect the inherent uncertainty of forecasts.

3. Our supervisory priorities arise from the key risks that we identify through our risk framework and the necessity of working with finite resources. As the environment changes and new risks emerge we reassess and adjust these priorities and the resources we allocate to them. We consequently term ourselves a risk based regulator. At all times, however, we emphasise that managing a firm is first and foremost the responsibility of banks' senior management.

4. We are not a "light-touch" regulator. We believe in credible deterrence. Wrongdoers must not only realise that they face a real and tangible risk of being held to account; they must also expect a significant penalty. Deterrence can, however, be achieved through a variety of actions other than direct enforcement, notably disclosure and supervisory action.

#### *Our priorities for 2008–09*

5. Our statutory scope, and consequently our activities are wide. In 2008–09 our most important aims can be summarised as follows:

- deliver effective supervision;
- take forward our financial capability agenda;
- take forward our key policy initiatives;
- achieve "credible deterrence";
- implement our "Supervisory Enhancement Programme" and related lessons from Northern Rock; and
- continue our drive to improve the efficiency and quality of our staff, and ensure they work within the right organisational culture.

6. A successful regulator needs to have the confidence of its community—its firms and consumers. A vital component of success is achieving the support and trust of firms' management along with savers and borrowers. This trust has been eroded by last year's events. We are working to restore it in 2008–09.

#### *Our people*

7. Key to our success is our people. As an organisation whose success rests on judgements, we depend on having the right people in the right roles. We believe we have made significant progress in the last nine months. Our senior team consists of 36 managing directors, directors and senior advisors. Of the nine new recent additions, seven of these appointees have relevant external business experience. In particular, we have hired four with significant capital markets and risk management expertise. Among these is the former Chief

Financial Officer of Barclays, Naguib Kheraj, to advise our Supervisory Enhancement Programme; and Colin Lawrence, who has over 20 years' experience in senior risk management roles at UBS and Barclays, as the director responsible for our Prudential Risk Division.

(b) LESSONS LEARNED FROM NORTHERN ROCK

*Our Supervisory Enhancement Programme, following our Internal Audit Review on our supervision of Northern Rock*

8. As the Committee is aware, our Internal Audit report (redacted version published on 28 April) identified four key failings in our supervision of Northern Rock: a lack of sufficient supervisory engagement with the firm, in particular the failure of the supervisory team to follow up rigorously with the management of the firm on the business model vulnerability arising from changing market conditions; a lack of adequate oversight and review by FSA line management of the quality, intensity and rigour of the firm's supervision; inadequate specific resource directly supervising the firm; and a lack of intensity by the FSA in ensuring that all available risk information was properly utilised to inform its supervisory actions.

9. To address the failings identified in our Northern Rock Internal Audit Review, we have put in place a Supervisory Enhancement Programme to ensure that our standards of supervision are improved across all firms we consider to be high-impact institutions.

10. The main features announced in the programme were:

- a new group of supervisory specialists will regularly review the supervision of all high-impact firms to ensure that our procedures are being rigorously adhered to;
- the number of supervisory staff engaged with high-impact firms will be increased, with a mandated minimum number of staff per firm;
- the existing FSA specialist prudential risk department will be expanded following its upgrading to divisional status, as will resources of the relevant sector teams;
- the current supervisory training and competency framework for FSA staff will be upgraded;
- the degree of senior management involvement in direct supervision and contact with high-impact firms will be increased;
- there will be more focus on liquidity, particularly in the supervision of high-impact firms; and
- there will be increased emphasis on assessment of the competency of firms' senior management.

11. A small core team is now in place to ensure the overall coordination, oversight and delivery of the Supervisory Enhancement Programme. We expect to complete the programme by the end of 2008. However, we have already progressed a number of points. In particular, we have both strengthened our senior management team and increased their involvement in supervision. Additionally we have increased the number of staff involved in day-to-day supervision, both through recruitment and reallocation of our existing resource. We have raised the profile we give in our supervisory work to assessing the business model of firms and assessing how they manage their liquidity and capital.

12. This detailed programme complements the overall drive of the FSA, as set out in our three-year plan to 2010–11, to significantly improve the quality of our staff and infrastructure to create a more effective working culture.

*Further measures relating from recent market turbulence*

13. During this period of continued market turbulence, we continue to supervise all wholesale and retail banks and deposit-taking institutions at a much increased level of intensity. The Tripartite Authorities continue to operate together closely and we have increased our working-level interaction with the Bank of England. We welcome the measures announced by the Bank of England on 21 April 2008, to introduce a "Special Liquidity Scheme" which allows banks to swap temporarily their high-quality mortgage-backed and other securities for UK Treasury Bills.

14. With the combination of increased supervisory action and the Special Liquidity Scheme, we should expect to see signs of improved conditions in the market and participants successfully managing their liquidity needs. However, it should be noted that, while improved conditions will no doubt facilitate improved credit facilities to consumers, we would not expect a return to conditions that have prevailed in previous years, in particular with regards to the volume and terms of lending.

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(c) BANKING REFORM

15. The Government, in conjunction with the FSA and the Bank of England, and working with the Financial Services Compensation Scheme (FSCS), has just concluded a consultation process begun in January 2008, on “Financial Stability and Depositor Protection: Strengthening the Framework”. As the consultation document made clear, strengthening the existing framework for financial stability and depositor protection is necessary in order to reduce the likelihood of failure of banks, and to ensure that any failures are managed with minimum disruption and costs to the economy and to individuals.

16. The Reform proposals cover five key objectives: strengthening the stability and resilience of the financial system; reducing the likelihood of individual banks facing difficulties; reducing the impact if, nevertheless, a bank gets into difficulties; providing effective compensation arrangements in which consumers have confidence; and strengthening the Bank of England and improving coordination between the authorities, both in the UK and internationally.

17. The Government has made it clear that it firmly believes that the tripartite structure is appropriate for the UK but does need some changes. The Government proposes strengthening the statutory role for the Bank of England in relation to financial stability and making changes to the Court of the Bank of England.

18. The reform proposals as a whole are far-reaching changes and need to be considered and planned very carefully. During the consultation process the Tripartite Authorities and the FSCS met a wide range of stakeholders, including firms, consumer bodies and trade associations, to explain the proposals and hear their views. The consultation document has prompted a very full response and the Tripartite Authorities are carefully working through these to ensure all the feedback we received is carefully and fully considered. As the Chancellor made clear to the House in his statement on 21 April, further engagement with stakeholders will be important to ensure that the final legislative proposals are fully appropriate. We understand that it is intended that legislation will be introduced into the House during this session.

19. Meanwhile, the FSA is taking forward work on improving depositor protection for consumers. We plan to publish consultation papers on compensation limits and on a number of other issues, as set out in the Tripartite consultation document. On the key issue of whether deposit protection should be pre- or post-funded, we recognise this is a major issue for the industry and that the final decision should not be reached until the consultation process is concluded. From our perspective, the key issue is that the FSCS has access to the necessary liquidity to pay claims; the source of that funding is a secondary consideration.

20. The Tripartite consultation document proposed that the decision that a bank should be resolved should be taken by the FSA.<sup>1</sup> We believe this is the correct allocation of responsibility. Such a decision is—at its heart—a supervisory decision that the FSA, as the authority with sole responsibility for the supervision of individual institutions, should take. We think that the approach set out in the consultation document<sup>2</sup>—namely that this decision should be based on an assessment of the bank’s compliance with its threshold conditions (which would enable us to consider a range of quantitative and qualitative factors)—remains appropriate. We support the importance of the Bank of England in its role as a liquidity provider working closely with us as the supervisor on individual banks when there is a prospect that emergency liquidity may have to be provided to that institution, but at all times it is important to avoid the potential of overlap and confusion in decision making and thus the supervisor must retain the lead role.

21. The consultation document leaves open the question of which authority should oversee, or run, the delivery of the resolution tools once implemented. We will be interested to see the responses to the consultation on this question. We believe there is an inherent conflict of interest in carrying out this role while at the same time supervising the bank in question, and for this reason do not believe it appropriate for the FSA to both manage and regulate a bank subject to that special regime.

22. Coordination amongst the authorities involved will be essential for the resolution framework to function effectively. A decision to put a bank into resolution cannot, in reality, sensibly be taken without knowing which of the resolution tools is to be applied. We will need, as the consultation document makes clear, enhanced cooperation and coordination between the authorities to ensure that this is achieved. Clarity in the roles of the authorities will be essential. There must be no duplication of effort; there are limited resources available to the authorities and limited expertise in these areas: we must make best use of them.

23. Lastly on the Banking Reform proposals, we think it is useful to note that we believe that, if the toolkit proposed in the consultation document had been in place, we would have been able to deal much more effectively with the situation in which Northern Rock put itself.

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<sup>1</sup> Paragraph 4.9.

<sup>2</sup> Paragraph 4.10.

(d) THE REGULATION OF A NATIONALISED NORTHERN ROCK

24. Following the Government's legislation to take Northern Rock into temporary public ownership, we approved a change of control application submitted by the Treasury for the Treasury Solicitor on behalf of the Treasury to become the new controller of Northern Rock.

25. Northern Rock continues to be an authorised firm and continues to be subject to FSMA, our Handbook and our normal supervisory processes. As far as possible and practicable in the circumstances, we intend to supervise it in the same way as any other authorised bank of similar size and impact. The ownership of Northern Rock has changed, but the company's business continues as before and, as an authorised firm, it has an obligation to meet our principles and rules as to capital and liquidity as they apply to its particular circumstances. Taking these circumstances into account we are focusing on the importance of ensuring its business model is credible and sustainable.

26. As required by the Transfer Order, and after following similar due diligence processes as apply in the case of approved persons, we determined that Ron Sandler and Ann Godbehere were fit and proper to manage the bank. Below Board level, the Approved Persons regime continues to apply in the normal way so that, for example, other senior managers are approved to perform their particular roles.

(e) MARKET ABUSE AND INSIDER DEALING

*Market abuse is a key priority*

27. Our work to combat market abuse is one of our key priorities, addressing our statutory objectives to maintain market confidence and reduce financial crime. We aim to maintain fair, efficient and orderly markets; clean markets are vital to the continuing success of London as an international financial centre. Market misconduct, particularly in the form of insider dealing and market manipulation is, put simply, cheating and reduces investor confidence in the UK markets. Our aim is to have a regime which achieves "credible deterrence" and ensures a level of market quality we can all be proud of.

28. On 29 April we published our Market Watch update, setting out in detail our key strategy and objectives in this area—with a particular focus on insider dealing. A copy of Market Watch is attached and the key elements of our strategy summarised below.

29. Our strategy is to prevent abuse occurring, detect it where it does occur, and take appropriate enforcement action against those who perpetrate it. We focus on serious cases, including insider dealing by City or business professionals who abuse positions of trust by misusing information legitimately passed to them to perform their jobs, for example, brokers, accountants and lawyers; repeat offenders—where we suspect systematic trading on inside information; and cases where there is a significant profit made or loss avoided. We consider these cases pose the biggest risk to our objectives. Tackling market abuse is a long-term challenge and our strategy involves making use of all the tools we have available as well as seeking new powers (such as the power to grant statutory immunities) where we think these are needed. We have reviewed our existing tools and taken steps to make fuller use of these, including deploying them at earlier stages in our inquiries. We are determined to continue to improve our capabilities to meet the challenges we face.

*Prevention and detection*

30. We aim to make it as difficult as possible for individuals to commit market abuse. One way of doing this is by promoting effective anti-market abuse systems and controls, including training and managing conflicts of interest. To do this, our Market Conduct teams identify current or emerging risk areas, undertake thematic visits to firms to assess their systems and controls, publish details of weaknesses and good practice points and work with market participants to enhance controls. Examples of the work we have pursued with the industry in the last two years include reviewing the quality of suspicious transaction reports, reviewing controls over inside information relating to public takeovers and reviewing anti-market abuse systems and controls operated by hedge fund managers. Through all of this we have championed the concept of working in partnership with the industry to ensure that combating market abuse is not seen as a job for the regulator alone. Following extensive consultation with the industry, we have enacted rules which will from March 2009 require firms to record all telephone conversations and electronic communications relating to client orders and the conclusion of transactions in the equity, bond and derivatives markets, and to keep those recordings for six months. We firmly believe that access to such records provides high-quality evidence when investigating and prosecuting market abuse.

*Measurement of market abuse*

31. It is difficult to measure the actual level of insider dealing. As part of our general commitment to openness and transparency, we have led the way among regulators in developing and publishing a statistical analysis of market cleanliness, which seeks to help inform our understanding of the extent of the problem. The methodology measures market cleanliness by looking at the extent to which share prices move in the two days ahead of the regulatory announcements that companies make to the market. An "informed price

movement” (IPM) indicates that the share price movement for that stock is abnormal compared to how it behaves in a non announcement period.<sup>3</sup> The latest figures, showing the results for 2006 and 2007, are set out below.

#### FTSE 350 ANNOUNCEMENTS

<i>Time Period</i>	<i>Announcements</i>	<i>Significant Announcements</i>	<i>IPMs</i>	<i>Percentage (IPMs/Significant Announcements)</i>
1998–2000	487	51	10	<b>19.6</b>
2002–03	734	54	6	<b>11.1</b>
2004–05	927	49	1	<b>2.0</b>
(2006–07)	1085	78	6	<b>7.7</b>

#### PUBLIC TAKEOVER ANNOUNCEMENTS

<i>Time Period</i>	<i>Announcements</i>	<i>IPMs</i>	<i>Percentage (IPMs/Announcements)</i>
2000	183	44	<b>24.0</b>
2002	147	37	<b>25.1</b>
2003	160	22	<b>13.8</b>
2004	102	33	<b>32.4</b>
2005	177	42	<b>23.7</b>
2006	199	57	<b>28.6</b>
2007	167	48	<b>28.7</b>

32. It can be easy to misinterpret what the market cleanliness statistics show. The statistics have often been reported as suggesting that the level of IPMs is a direct match for the level of insider dealing—with an IPM of 25% in a year equating to insider dealing before 25% of announcements in that year. This interpretation is wrong. Examples of where IPMs could be caused by actions other than insider trading would be price movements triggered by trading due to financial analysts doing a good job at assessing which companies are likely takeover targets, and non-abusive trades, for which there is a perfectly rational explanation, that just happen to fall before an announcement. This level of non-abusive informed trading is unlikely to remain constant over time. Finally, price movements relating to takeovers can be triggered by a deliberate “strategic” leak of information by a company or its advisers to help position an important deal in the marketplace. The leakage of such information, while clearly improper, may not actually give rise to any opportunity for insider dealing.

33. Due to the statistical thresholds we use when computing IPMs, even if there is no insider or other (legitimate) abnormal trading, we would not expect the results to be zero but on average, around 3% for the FTSE 350 data set and 10% for takeovers. These may represent either insider dealing or legitimate informed trading, the split of which is difficult to determine. It is also important to note that, in takeover announcements, for reasons of statistical significance a movement of 5% in either direction is needed before it is safe to conclude that the level of informed trading has changed at all. Given these complexities, establishing specific targets is not realistic.

34. For the FTSE 350 corporate announcements, the level of informed price movements has decreased since FSMA came into force and now stands at a low level.

35. Although establishing a specific target is not feasible in our view, we clearly consider that the level of IPMs relative to takeovers is too high and is not reducing as we would wish. In 2006–07 we conducted a review of the systems and controls at a wide range of firms, both regulated and unregulated, involved in takeovers. This highlighted a number of weaknesses in controls that we believe are contributing to the leakage of inside information and will need to be addressed before we will see a significant improvement in the market cleanliness statistics. In particular, we highlighted a general complacency by individual firms that leaks came from other market participants and were not therefore a significant problem requiring action by them. We also observed that the number of insiders on deals was often very high, IT controls were sometimes weak and training could be improved. We have been working with authorised firms to improve controls, have stepped up our efforts to work with firms once leaks are identified and have facilitated an industry working group to draft a voluntary paper called “Principles of Good Practice for the Handling of Inside Information”. It is aimed at non-regulated firms to help them to develop and demonstrate robust controls for handling inside information and we plan to publish it later this quarter.

<sup>3</sup> More detail on the methodology and interpretation can be found in FSA Occasional Paper 25 published March 2007 (<http://www.fsa.gov.uk/pubs/occpapers/op25.pdf>)

36. Identifying potential market abuse quickly is key to successful investigation and enforcement action. Suspicious transaction reports from authorised firms have proved to be a valuable source of leads about possible market abuse. Since they become mandatory in July 2005 we have received over 700 suspicious transaction reports.

37. We are also upgrading our transaction monitoring system known as SABRE. This is the database for all reports of securities and securities derivatives transactions carried out by UK firms and other EU firms trading on UK markets. The first phase of the system went live in November 2007, with full functionality to come on stream in 2009. It is a major investment, with a development budget of £17 million for the core programme. When the system is fully upgraded we will have enhanced monitoring capability including:

- alerts concerning unusual price movements or dealing; and
- advanced analytical functions to enable us to examine patterns of transactions (useful for identifying and tracking possible insider dealing rings).

#### *Investigation/Enforcement*

38. We can prosecute insider dealing as a criminal offence or deal with it as civil misconduct in contravention of the FSMA market abuse regime. The criminal regime provides for imprisonment for up to seven years and/or a fine; under the FSMA regime, we can impose a financial penalty (on which there is no limit), or, in the case of FSA Approved Persons, we can prohibit them. (It is worth noting that there is nothing we can do to stop individuals banned from the London market from setting up business in a new jurisdiction, if they receive authorisation in that jurisdiction). We can also take action against FSA-authorised firms or Approved Persons for breaches of our Principles for Businesses, especially the principles relating to the need to act with integrity, with due skill care and diligence and to observe proper standards of market conduct. We are using, and expect to exercise further, our powers as a criminal prosecutor. This is driven by the belief that criminal prosecution where a custodial sentence is a real risk will act as a stronger deterrent than a civil or administrative market abuse action under FSMA. It is a significant shift of emphasis for the FSA. We currently have one criminal case awaiting trial and others under investigation. We expect to commence two further prosecutions in the near future.

39. Last year we reviewed the skills and experience that we needed in the Enforcement Division and carried out a major change programme. This involved the redundancy of 72 staff out of a headcount of 227, and the recruitment to date of 75 new staff from a range of backgrounds including senior criminal barristers, solicitors from top city law firms and staff formerly with the Serious Fraud Office. We are building a team of lawyers and investigators with the depth of skills, knowledge and experience to tackle the difficult challenges we face in our work. That recruitment programme is now largely complete.

#### *Number of cases*

40. We have concluded six civil cases in the last two years with the highest penalty imposed on a firm being Deutsche Bank (£6,363,643, April 2006) and the highest penalty imposed on an individual being Philippe Jabre (£750,000, August 2006). We bring civil cases under the market abuse provisions of FSMA, and we also bring cases where our Principles for Businesses (which apply to authorised firms and approved persons) are contravened. Our Markets Division receives around 700 case referrals each year (781 in 2007), from Exchanges, overseas regulators, firms or individuals where there are initial suspicions or indications of potential market abuse. At any one time there may be around 200 open enquiries (206 as at 28 April 2008). The Markets Division undertakes a risk based assessment of each referral. Many of the cases will be closed quite quickly following identification of reasons to mitigate the trading. Cases that are identified as higher priority cases, of which there are usually around 15 at any time, are subject to close early discussions between Markets and Enforcement regarding the appropriate actions to take; some of these will result in formal referrals to Enforcement for investigation. There are currently 29 Enforcement investigations into market abuse.

#### *Financial Services and Markets Tribunal*

41. Those subject to FSA disciplinary action have the right to refer their case to the Financial Services and Markets Tribunal. We have recently taken the opportunity afforded by the invitation to respond to the consultation paper by the Tribunals Service, “CP30/07 Transforming Tribunals”, to suggest some possible improvements.

42. In our response to the consultation paper we said we would welcome High Court judges sitting in the tribunal. Their judicial experience in the handling of complex cases will aid the efficiency and speed with which cases are resolved. We feel that this is particularly important given that many FSA cases involve

matters where witness evidence is key. High Court judges have invaluable experience in dealing with such cases, and in particular, assessing the veracity of witness evidence. In this regard, we understand that the sitting of High Court judges in the Competition Appeals Tribunal has been implemented with great success.

43. Following on from this suggestion, we believe that in cases where the expertise of High Court judges is called for it would not normally be necessary also to have non-legal members sitting.

#### *Tougher criminal stance*

44. We expect to bring more criminal prosecutions than in the past, as well as using our internal administrative and tribunal processes to bring market abuse cases under the FSMA. Following the Code for Crown Prosecutors where we bring criminal proceedings, we must be satisfied that there is sufficient evidence to secure a “reasonable prospect of conviction” and, if that hurdle is achieved, that it is in the public interest for us to prosecute the particular offence.

45. Serious harm is caused to the UK economy, and to individual investors and companies, by people who abuse positions of trust by disclosing inside information, trade on the basis of such information, or spread false rumours with a view to profit. We have stated publicly for some time that there are very real difficulties in proving and then prosecuting insider dealing or other market misconduct and that we need extra powers to deal with insider dealing successfully.

46. In this context we welcome the Government’s recent announcement of its plan to give us the statutory power to enter into “immunity agreements” and to recognise other forms of cooperation from suspects in criminal cases, under the Serious Organised Crime and Police Act 2005 (SOCPA). The timing of a legislative change is a matter for the Government and we have yet to receive a firm timetable for legislative change. This power is already available to the Crown Prosecution Service and to the Serious Fraud Office, and will be a valuable addition to our existing powers. We are determined to achieve our goal of credible deterrence and a resultant improvement in the quality of markets in the UK and this new power should send a clear message to those contemplating insider dealing about the FSA’s and Government’s commitment to bring them to book.

6 May 2008

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### **Supplementary memorandum from the Financial Services Authority (FSA)**

#### **FOLLOW UP TO QUESTIONS FROM 6 MAY SESSION ON FINANCIAL STABILITY AND TRANSPARENCY**

This note provides further information on five issues raised in the course of the FSA’s oral evidence session on 6 May.

#### *1. How many senior managers received bonuses in 2007–08 and how does that compare with the previous year?*

At Q25, the Committee asked about bonuses. As Hector Sants said in his evidence to the Committee on 6 May, the FSA paid the same percentage bonus to the employees of the FSA in the 2007/08 pay and bonus round as in the previous year.

Bonuses totalled £13.9 million in 2007–08—12.3% of the total salaries bill (in 2006–07 bonuses totalled £14.4 million, also 12.3% of the total salaries bill). All employees (including the Chairman and Executive Directors) are eligible for an award between 0%–35%, with some employees receiving nothing.

Each year we set objectives for the annual pay and bonus round. This year’s objectives were to:

- reward people who consistently demonstrate successful delivery of their objectives, consistently make a significant contribution to the FSA’s overall success and regulatory goals, and who demonstrate the behaviours we value;
- help to ensure that we are able to retain the talent we need to meet our objectives, with particular emphasis placed on targeting reward funds at our “at risk” areas;
- ensure that the FSA’s pay decisions comply with equality laws and best practice, ensuring that we record why an award has been made or not;
- continue to recognise the differences in the overall remuneration of staff on different pension arrangements through our total reward approach; and
- continue to emphasise the FSA’s reward strategy, which aims to match FSA base salaries against the market median within the relevant part of the financial services sector.

We have many highly competent and experienced people whom we need to retain—in particular, we need effective managers to lead and direct the organisation. It should be recognised that in many areas we are below the relevant market compensation benchmark. In this pay round we have rewarded our staff for their hard work and success on many fronts. Overall, the FSA met 96 of the 100 milestones set out in our 2007–08 Business Plan. This year and last year are as follows:

#### BONUSES AS A PERCENTAGE OF SALARY

	<i>Directors</i>	<i>Heads of Department</i>	<i>Overall staff average</i>
2007–08	17.6%	15.9%	11.5%
2006–07	16.7%	14.8%	12.0%

These are average figures.

#### 2. *The steps being taken to make sure that the FSA implements the necessary changes, post Northern Rock*

At Q49 the Committee asked how the FSA leadership team would make sure that the necessary changes in FSA practices are implemented. As we made clear in our evidence to the Committee on 6 May, we have put rectifying the shortcomings identified in our Internal Audit report on our supervision of Northern Rock at the top of our agenda.

The Board and the FSA's senior management team have agreed on the action that needs to be taken to address these shortcomings, under three main headings:

- The Supervisory Enhancement Programme (SEP).
- Better people management across the FSA.
- Expanding the team of FSA's senior advisers with recent market experience.

This change programme is being led personally by the Chief Executive, who has spoken directly to all staff to set out his expectations. He will hold the senior management to account for delivering their part of this programme.

#### A. SUPERVISORY ENHANCEMENT PROGRAMME (SEP)

We have put in place a Supervisory Enhancement Programme to improve our implementation of our supervisory framework and practices. We have a core team of nine in place to develop and implement this programme by the end of 2008.

The main features of the SEP are:

- a new group of supervisory specialists will regularly review the supervision of all high-impact firms to ensure that our procedures are being rigorously adhered to;
- the number of supervisory staff engaged with high-impact firms will be increased, with a mandated minimum number of staff per firm. Recruitment of the additional staff has now begun;
- the existing FSA specialist prudential risk department will be expanded following its upgrading to divisional status, as will the resources of the relevant sector teams;
- the current supervisory training and competency framework for FSA staff will be upgraded. Staff with supervisory responsibilities will be required to pass a competence test;
- the degree of FSA senior management involvement in direct supervision and contact with high-impact firms will be increased;
- there will be more focus on liquidity, particularly in the supervision of high-impact firms; and
- there will be increased emphasis on assessment of the competency of firms' senior management.

In our supervision of high-impact firms since last autumn we have been implementing a number of aspects of this new approach.

#### B. BETTER PEOPLE MANAGEMENT

The Chief Executive has implemented a compulsory executive leadership programme for all members of senior management.<sup>4</sup> All participants have a development plan as a result and a number will be reassessed at the beginning of 2009 where significant development gaps were identified. This programme places a stronger emphasis on managing people and talent. The performance assessment framework for the business has been reworked to hold the senior management more clearly accountable for demonstrating leadership and accountability for the FSA's overall performance. In the new framework 40% of staff directors' bonus

<sup>4</sup> Managing directors, directors and heads of department.

will be based on an assessment of their leadership skills, 40% on delivery of personal objectives and 20% on the FSA's overall performance. For supervisors, the training framework is being reworked to ensure that the required level of competency is visibly achieved.

In addition, the CEO is engaging directly with all FSA staff to ensure that key messages about staff conduct reach every level of employee. He has given a series of presentations to all staff members where he said explicitly that the failings on our supervision of Northern Rock were completely unacceptable. He has made it clear to all staff that he expects consistent delivery of professional standards across the organisation, starting now. A series of measures are being developed to track progress.

### C. EXPANDING THE TEAM OF FSA SENIOR ADVISORS

The FSA have a team of six Senior Advisors (with three more to join shortly) who fulfil a critical role in providing authoritative views and comment on industry developments, ensuring that the respective FSA departments and divisions remain current on trends in the market place and on the respective firms under supervision. The Senior Advisors:

- Continue to keep the Retail and Wholesale Institutional Markets Business Unit abreast of relevant industry developments.
- Assist and support teams at all levels, transferring their expert knowledge, providing detailed insight and understanding of the market place and commercial drivers in their area(s) of expertise.
- Challenge on emerging issues and provide coaching on specific regulatory ones.
- Act as an expert in training sessions for FSA staff on behavioural skills (such as interviewing and relationship management)—these would include training and support for ARROW II training throughout 2006 and beyond.
- Support senior management on a range of matters from technical industry knowledge to management issues (including in the regular series of risk committee meetings).

### 3. *Regulatory fees paid by Northern Rock*

At Q54, the Committee asked about the regulatory fees paid by Northern Rock and how that relates to the work which the FSA carries out in regulating that firm. By way of background, we first of all explain the way in which the FSA funds its activities overall and recovers its costs from the institutions it regulates.

The FSA is funded entirely by the firms and markets it regulates, the companies it lists and the societies it registers. Each year we consult on and set fees sufficient to meet our Annual Funding Requirement ("AFR")—the amount of money we expect to need to cover our budgeted operating costs, and we publish the AFR in our Business Plan and Fees Consultation Paper. Those costs relate both to our work directly regulating individual institutions, and to other FSA work. This second category represents in fact the bulk of the FSA's work and cost base and covers a broad range of consumer and industry-wide activities, such as financial capability, policy work, financial crime work, consumer communications, international co-operation, as well as our general overheads. For this reason, only a small proportion of the regulatory fee paid by an individual firm relates to the FSA's direct work in regulating it.

In order to allocate our AFR across all the institutions we regulate, we have identified a total of 21 different activities which the FSA regulates—for example, accepting deposits, dealing as principal in investments, general insurance intermediation. We allocate our total AFR across those categories, which we call 'fee-blocks'. An individual firm may belong to a number of fee-blocks, if it carries out a wide range of regulated activities. In order to decide how much individual firms pay within a fee-block, we apply a formula (on which we consult publicly each year) reflecting the number of firms in the fee block and an agreed measure of the volume of business carried out by the individual firm. For example, the agreed measure for the activity "accepting deposits" is modified eligible liabilities.

Northern Rock carries out a range of regulated activities, which fall within six fee-blocks in total:

- A001—Deposit acceptors.
- A002—Home Finance Providers and Administration.
- A010—Firms dealing as principal in investments.
- A013—Advisory only firms and advisory, arrangers, dealers, or brokers (not holding client money).
- A018—Home Finance Providers/Advisers/Arrangers.
- A019—General insurance intermediaries.

In 2007–08 Northern Rock's total regulatory fee was £1.5 million. For the reason explained above, as with all regulated firms, only a small proportion of this sum related directly to the FSA's direct regulation of the firm. As we have explained to the Committee in earlier evidence, since August 2007 the FSA has devoted significantly more effort to direct supervision of Northern Rock and to related activities.

4. *Aggregate data on breaches of capital requirements by regulated institutions*

At Q55 the Committee asked for details of aggregate capital breaches by regulated firms. Since 1998 there have been a significant number of capital breaches in all sectors (over 2,000) and the majority of these (86%) occurred in small firms after 2004; this reflects the scope of the FSA, (in particular, taking on mortgage and general insurance firms) and the enhanced reporting that we introduced. Of the remaining capital breaches between 1998 and 2008, the majority (62%) occurred in the insurance sector.

Less than 0.5% of the breaches in the last decade occurred in high impact groups—ie those of similar status to Northern Rock. The vast majority of these cases were considered to be technical transgressions that were soon corrected, rather than being significant breaches.

5. *Considerations affecting whether such breaches, and Northern Rock's breach in particular, are/was disclosed*

At Q58, the Committee asked about the need for disclosure of Northern Rock's capital breach. As the Committee are aware, our internal audit review makes it clear that Northern Rock breached their capital in March 2007, and this was rectified by June that year. Should Northern Rock or another firm breach their capital requirements, these are the considerations they would take into account in considering disclosure.

Regulatory disclosure

Part of the FSA's capital adequacy framework under Basel I involved setting an individual capital ratio (ICR) for each bank. The FSA gave each bank guidance as to the minimum individual capital ratio which the FSA considered it should maintain.

As set out in the FSA's handbook, banks were requested to advise the FSA if they breached, or were likely to breach, their individual capital ratio. Northern Rock advised the FSA of its breach and the reasons for it. The FSA responded promptly by requiring the bank to take immediate action to remedy the breach.

Disclosure to the market

Whether a bank is required to disclose a breach of its capital guidance to the market is a question which has to be assessed in each individual case in light of the particular facts and circumstances applying at the time.

Under the FSA's Disclosure and Transparency Rules, Northern Rock (and any other listed bank) would have been required to disclose a breach of its individual capital ratio to the market only if that information was inside information. "Inside information" is information which is precise, not generally available, relates to the issuer's financial instruments and, if generally known, would be likely to have a significant effect on the price of the financial instruments.

In the case of Northern Rock's breach of its individual capital ratio, Northern Rock would have had to take into account a number of matters to decide whether this information was inside information (and so should be disclosed), including the content of previous statements made by the bank to the market about its capital. It was also relevant that compliance with an individual capital ratio was a matter of guidance, not a regulatory requirement and that Northern Rock was taking appropriate steps to remedy the breach. As the Committee is aware, Northern Rock did not decide to disclose the information to the market.

21 May 2008

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**Presentation by Jon Moulton  
13 May 2008**

**Financial Stability  
- A Few Clear Thoughts**



**House of Commons Treasury Committee**

**THE ONGOING POST MORTEM**

- The causes are now pretty well known.
  - In good economies there arose a new wall of structured debt instruments providing cheap debt in great volume.
  - People got very rich finding assets to take advantage of this financing.
  - When the good assets ran out, people acquired worse and worse assets at higher and higher prices. Integrity declined. Complexity burgeoned. Boom.
  - Eventually the poor assets (sub-prime especially) could not generate enough income to pay the interest. Bust.
- 
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- Eventually the poor assets (sub-prime especially) could not generate enough income to pay the interest. Bust.
- Supporting players
  - Rating Agencies “Don’t use our ratings ....”
  - Banks – made a little, lost a lot
  - Bankers – made a lot, lost little
  - Regulators – unequipped and disorganised

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### FINANCIAL STABILITY – WHAT DOES IT MEAN?

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- The UK needs world-leading major financial institutions.
  - Trustworthy Banks.
  - Solid Insurance Companies.
  - Highly credible asset management and pensions.
  - Hedge funds – should we care?
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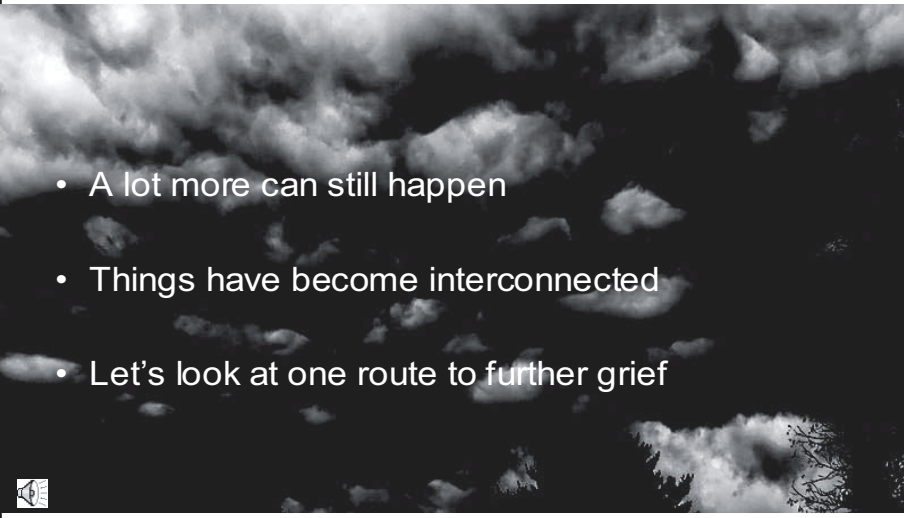

### SOME ISSUES

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- Bonuses and payment for failure
    - Both at historic peaks – no coincidence and why there is no interest in anything but the current “deal”
    - Should be a critical risk factor for Regulators
  - Bank Capital
    - Basle II is clearly imperfect. Complexity makes much of its calculation unclear. Northern Rock was fine.....
    - Dividends – why still being paid and increased?
    - Could be a very good idea to put a simple floor under Bank Capital
  - Base Rate
    - Toothless control?
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## OUTLOOK FOR THE FINANCIAL WORLD!

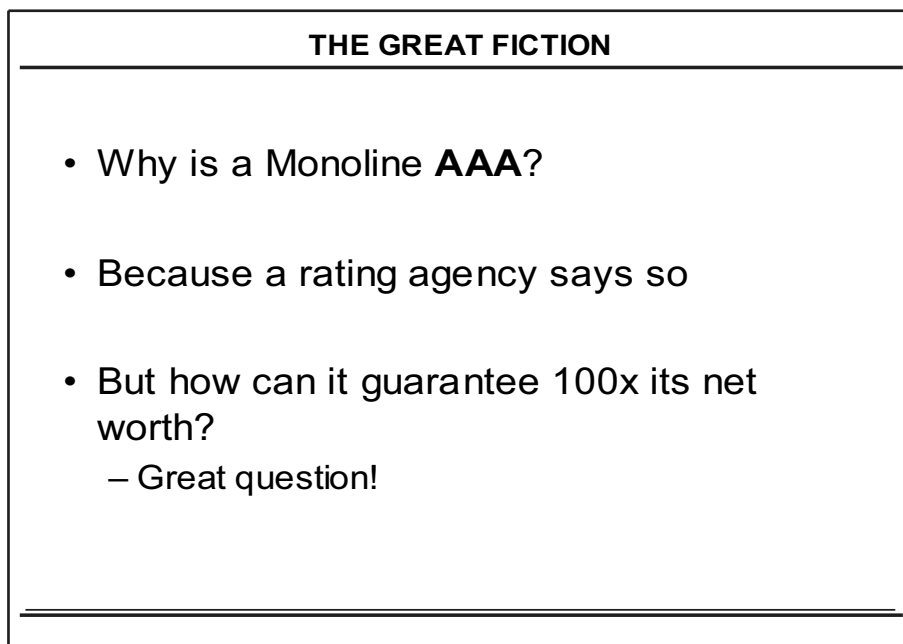
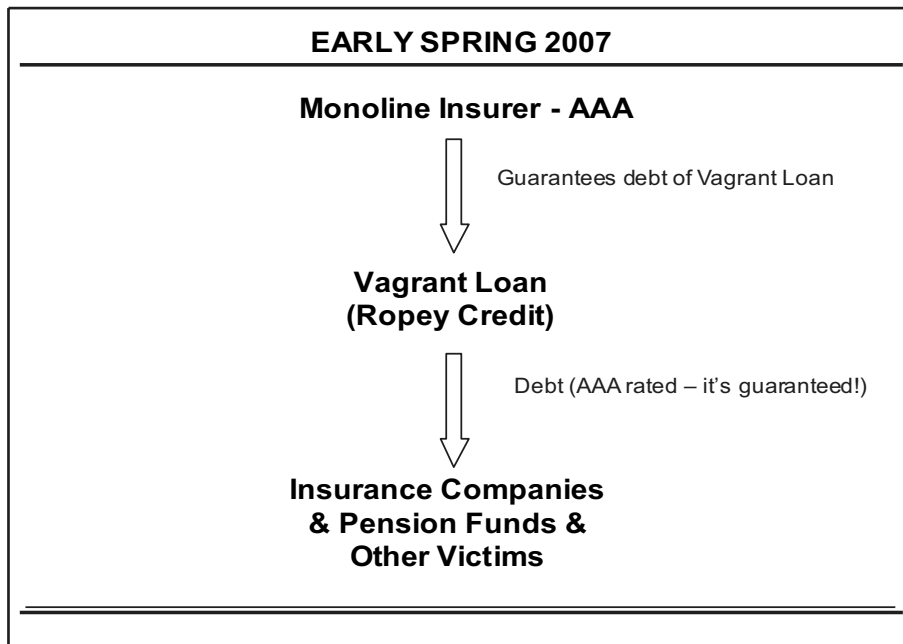
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- A lot more can still happen
  - Things have become interconnected
  - Let's look at one route to further grief
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## EARLY SPRING 2007

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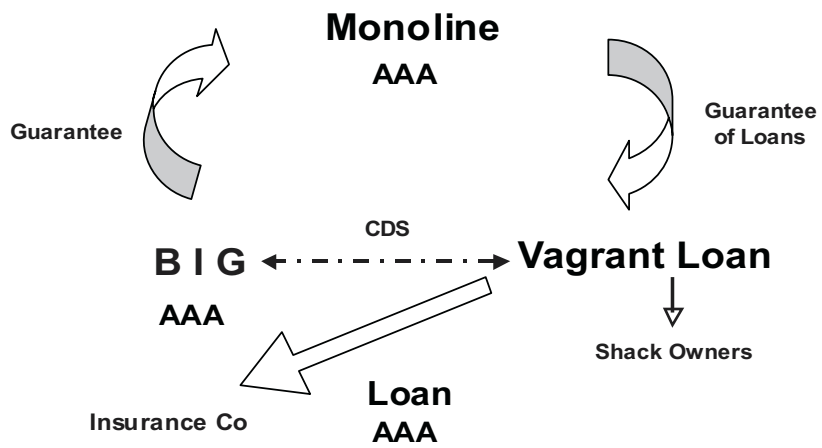
- You would like to set up a nice shiny new sub-prime mortgage CLO (or CDO)
    - Call it Vagrant Loan
  - What's the easiest way to get your AAA rating?
  - Get a bulletproof AAA insurer, a monoline insurer, to insure your debt
- 
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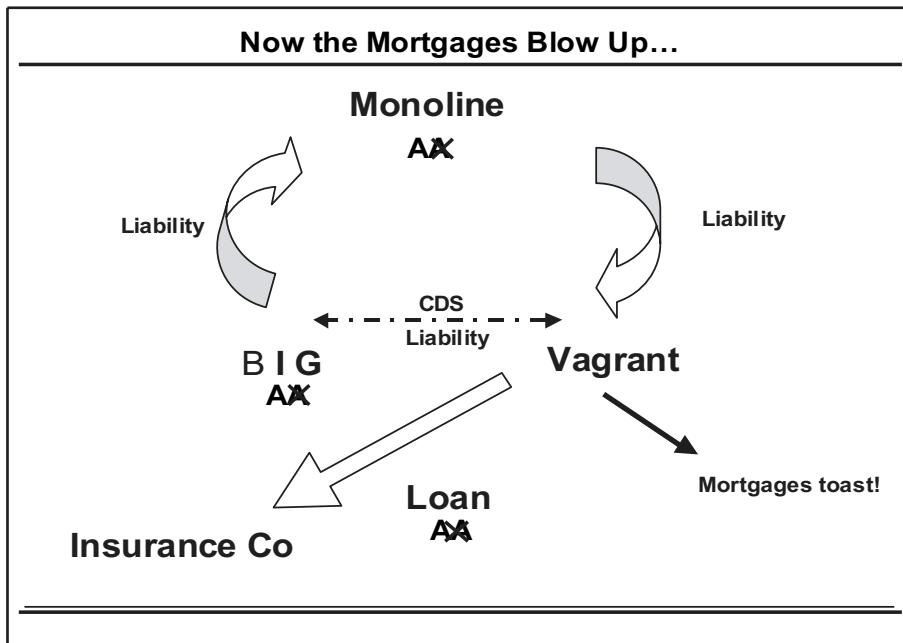
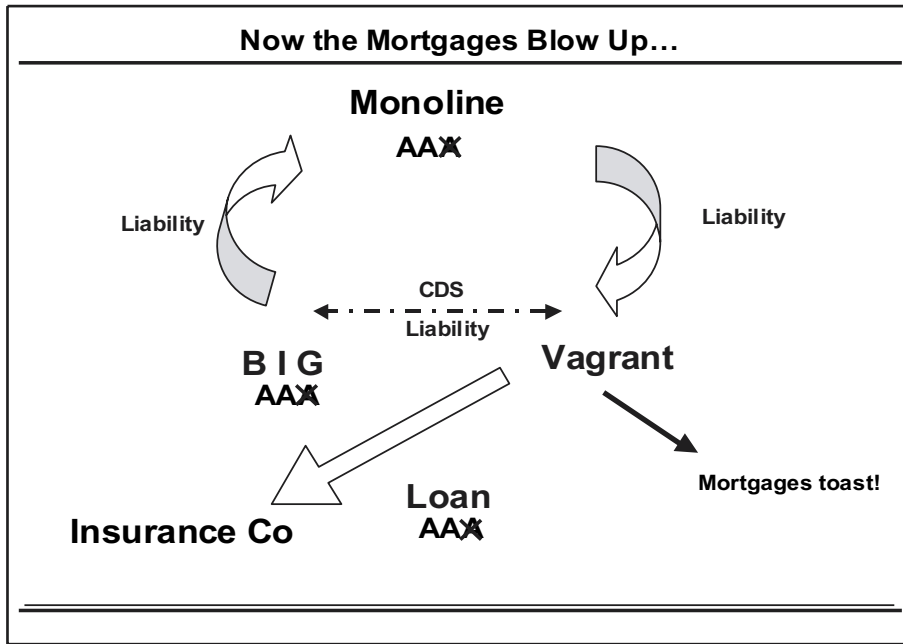


**PASS THE PARCEL...**

- Introduce large AAA rated insurance Co
- Call it BIG
- It sells reinsurance
  - CDS – “Credit Default Swap” to Monoline
- Monoline now bullet proof??

**THE NETWORK**





### CDS LOSSES

- AIG has just announced its Q1 2008 results. Net worth \$80bn. CDS portfolio of \$475bn (called "Super Senior" as there was "no expected loss at inception" – oops.)
- \$21 bn written off so far. \$9bn in last quarter.
- AIG raise dividend and introduces improved pay for its structured finance group in Q1 2008.
- AIG says actual loss likely to be c\$2bn not \$21 bn.
- Binomial Expansion Technique ("BET") model with Monte Carlo simulations used to value portfolio.
- "AIG presents its operations in the way it believes will be most meaningful and useful, as well as most transparent, to the investing public and others who use AIG's financial information in evaluating the performance of AIG. That presentation includes the use of certain non-GAAP measures. In addition to the GAAP presentations, in some cases, revenues, net income, operating income and related rates of performance, and out of period adjustments are shown exclusive of realized capital gains (losses), the effect of FIN 46(R), the effect of EITF 04-5, the effect of FAS 133, the effect of trading account losses, the effect of remediation activities, the effect of change in actuarial estimate, the effect of expenses of industrywide reviews and the effect of catastrophe-related losses AIG excludes the effects of FIN 46(R) and EITF 04-5, and the effect of hedging activities that did not qualify for hedge accounting treatment under FAS..."

### REGULATE THE REGULATABLE?

- Interconnected, complicated markets are here to stay.
- Losses can be a big multiple of "actual loss" – mark to market and fear are not hard numbers!
- Complexity has no limit. Regulators' and directors' skills are limited.
- Transparency does NOT do it. Hardly anyone can understand a current set of Bank Accounts. Disclosure works if you understand it!

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**SOME WAYS AHEAD**

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- Strong Banks
    - Limit Banks to activities that are regulatable
    - Increase capital as economy recovers
    - Clearer capital set-up
    - Sort out Regulatory hydra and improve regulation
    - Better bail-out system
  - Similar for Insurers
  - Allow failure for most non-banks
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**Financial Stability  
- A Few Clear Thoughts**

**Jon Moulton  
13<sup>th</sup> May 2008**



House of Commons Treasury Committee

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## Memorandum submitted by the British Bankers' Association

### FINANCIAL STABILITY AND TRANSPARENCY

#### INTRODUCTION

1. The British Bankers' Association is the leading association for the UK banking and financial services sector, speaking for 223 banking members from 60 countries on the full range of UK or international banking issues and engaging with 37 associated professional firms. Collectively providing the full range of services, our member banks make up the world's largest international banking centre, operating some 150 million accounts and contributing £50 billion annually to the UK economy.

2. The Treasury Select Committee has indicated that it is particularly interested in receiving written evidence on:

- Lessons learnt by the regulators on the regulation of Northern Rock.
- Potential reforms to banking regulation.
- Market abuse.

3. While this written submission focuses exclusively on these elements of the Committee's inquiry we have enclosed, for information, the BBA's formal submission in response to the tripartite authorities' consultation document "Financial Stability and Depositor Protection: Strengthening the Framework".

#### LESSONS LEANT BY THE REGULATORS ON THE SUPERVISION OF NORTHERN ROCK

4. We believe that the critical lessons to be learnt by the regulators are that they must utilise their regulatory powers to the full and that when issues concerning potential institutional failure—or systemic threat—arise they should act decisively and with confidence. It is clear to all concerned for example that the tripartite arrangements did not work particularly well in the case of Northern Rock and that, while responsibility for its failure rests principally with management and line supervision, the subsequent dithering contributed significantly to the loss of confidence and the run on the bank.

5. We do not, however, believe that the tripartite system is fundamentally broken; rather we believe that it can—and must—operate more efficiently. The essential ingredients are: an approach that identifies emerging risks in a timely and robust way; a clear assignment of roles and responsibilities; improved communication between the authorities and the outside world; and a better process for crisis management. We therefore agree that the Memorandum of Understanding underpinning the tripartite arrangements needs revision, but are unsure whether this necessitates a COBR mechanism.

6. We support the FSA's continued role as the sole UK financial regulator. But, as recognised in the refreshingly candid internal report, in the case of Northern Rock the FSA clearly displayed shortcomings in regulatory execution and a key aspect of strengthening financial regulation must be ensuring that it is in a position to ensure that line supervisors have the resource and capability to exercise the regulatory powers in their hands. We are encouraged that steps have already been undertaken to begin the design and execution of a new supervisory enhancement programme. This will necessarily involve a review of the quantum and calibre of staff involved in line supervision and ideally should involve drawing more on private sector expertise and a more interactive approach with industry.

7. We also believe that conditions of market stress can be significantly calmed through a more flexible application of the Bank of England's money market operations and have observed that this requires the Bank to embrace more radical change as part of its Sterling Money Market Review. We welcome the proposals included in the recent Financial Stability Forum report on enhancing market and institutional resilience<sup>5</sup> particularly its comments on destigmatisation, widening the types of eligible collateral and the need for central banks to work together in an internationally coordinated way. We expect that these recommendations will flow down into a changed sterling money market regime.

8. Our members welcome the introduction of the £50 billion Special Liquidity Scheme by the Bank of England during April, and particularly the ability for institutions to swap mortgage-backed securities for periods of up to three years, and the Bank's confirmation that it would be willing to increase the amount of the facility should this prove necessary. We believe that such a facility could become part of a more flexible approach to the Bank's future money market operations, in tandem with concerted action by leading central banks, including a more common and interchangeable collateral pool.

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<sup>5</sup> [http://www.fsforum.org/publications/FSF\\_Report\\_to\\_G7\\_11\\_April.pdf](http://www.fsforum.org/publications/FSF_Report_to_G7_11_April.pdf)

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POTENTIAL REFORMS TO BANKING REGULATION

9. The tripartite authorities published their consultation document “Financial Stability and Depositor Protection: Strengthening the Framework” on 30 January setting out a far reaching package of banking reform in response to the sustained turbulence and instability in global financial markets. The proposals for reform are aimed at five objectives summarised as follows:

- Strengthening the stability and resilience of the financial system—in the UK and internationally.
- Reducing the likelihood of individual banks facing difficulties—including regulatory interventions and liquidity assistance.
- Reducing the impact if, nevertheless, a bank gets in to difficulties—including a new “special resolution regime”.
- Providing effective compensation arrangements in which customers have confidence.
- Strengthening the Bank of England, and ensuring effective coordinated actions by authorities, both in the UK—including through reforms to the tripartite arrangements—and internationally.

10. The pursuit of these objectives involves a comprehensive and wide-ranging set of initiatives that collectively represent the most significant banking reform in the past 30 years. They include:

- Plans to strengthen key aspects of regulatory arrangements placed on banks by international regulatory bodies and international cooperation by the Bank for International Settlements, the International Monetary Fund and the Financial Stability Forum.
- Improvements in the transparency with which markets operate through the provision of better information about complex transactions and improved best practice on the part of credit reference agencies and hedge funds.
- Plans to strengthen regulatory execution on the part of the FSA, including the introduction of a clearer path to heightened supervision on the part of the FSA in the event of the financial position of an institution giving serious cause for concern.
- Plans to develop the money market tools at the disposal of the Bank of England, within an approach that seeks greater convergence internationally in the money market operations of key central banks.
- The introduction of a special resolution regime (SRR) and bank-specific insolvency arrangements that would help resolve an ailing institution in the rare event that heightened supervision had not succeeded.
- Measures aimed at enhancing the terms of the Financial Services Compensation Scheme and the confidence in which consumers hold the scheme and the prospect of efficient and orderly payout in the event of bank failure.
- Improvements to the basis on which the tripartite arrangements work and further measures aimed at strengthening the Bank of England’s role in overseeing financial stability.

11. In responding formally to the tripartite consultation document, the BBA, on behalf of the banking industry, expressed support for the reform package in concept and committed to working with the tripartite authorities and other interested parties to ensure that each of the measures is developed with the full engagement of the industry.

12. We nevertheless found it appropriate to explain that the industry has significant concerns about various aspects of the proposals. While we remain optimistic that constructive dialogue can resolve our concerns satisfactorily, they are summarised below for the committee’s information.

*Use of the FSA’s existing powers*

13. We are not convinced that sufficient weight has been placed on the benefit of improving the FSA’s execution of its existing regulatory powers. The FSA’s internal audit report on the supervision of Northern Rock and the supervisory enhancement programme outlined in the high level recommendations illustrate the extent to which the poor execution of existing regulatory powers was a factor in to the downfall of Northern Rock. The high level recommendations and the proposed supervisory enhancement programme will contribute significantly to the execution of the FSA’s extensive regulatory powers and in themselves will greatly strengthen banking supervision in the UK. Any proposals to introduce additional regulatory powers should be scrutinised critically in light of what can be achieved by exercising existing powers.

14. We believe that heightened supervision can play a significant part in the turning around of an ailing institution and would propose to engage constructively in discussion with the FSA on this. We support such arrangements resting on banks or building societies breaching threshold conditions based on key regulatory ratios but would underline the need for there to be sufficient scope within the heightened supervision arrangements to find the best means of working with management to secure the future of the institution in question.

15. The aim of heightened supervision should be to return the bank or building society to a state of normality, with varying degrees of strategic refocusing, depending on need. This should be the primary objective of heightened supervision and the triggering of the SRR arrangements should only be undertaken when it becomes clear that there really is no viable alternative. Entering heightened supervision should be based on quantitative and qualitative factors and should involve threshold criteria based on key regulatory ratios. We should ensure however that heightened supervision in itself does not become self-fulfilling as a result of a loss of market confidence following institutions being made subject to such arrangements.

16. A decision that heightened supervision will not work, and that there is no alternative to utilising the SRR arrangements, should be taken by the Chancellor of the Exchequer on the advice of the tripartite authorities and should involve responsibility passing from the FSA to the Bank of England; any engagement on the part of the Bank in advance of this should be limited in scope to the Bank assessing which of the SRR tools is likely to be most appropriate. Should this not prove possible then we would wish to think again about the best process for ensuring appropriate oversight for the introduction of SRR arrangements and may wish to reconsider whether or not transfer of responsibility to the Bank is necessarily the right way to proceed.

17. We further noted that the Treasury Committee report “Financial Stability and Transparency” recommends the establishment of a mechanism whereby warning of deteriorating market conditions from the Bank of England or the FSA would need to be formally acknowledged by financial institutions and discussed at Board level. This strikes us as being a highly practical suggestion in keeping with the UK principles-based regime.

#### *Special resolution regime and bank-specific insolvency arrangements*

18. The BBA can see the reasons why the tripartite authorities would want a special resolution regime and possibly bank-specific insolvency arrangements as part of the “toolkit” for dealing with the consequences of an ailing institution in extreme circumstances. While we would hope that the answer lies in the better execution of the FSA’s regulatory powers, including through a process of heightened supervision, and better liquidity support to the market by the Bank of England, we cannot rule out the need for a more extreme approach and these measures are aimed at providing the statutory powers to enable a more efficient and orderly resolution of a failed bank’s affairs.

19. In common with many other commentators, however, we are extremely concerned about the aggressive legislative timetable that the Government is proposing to follow in respect of these reforms since the changes in question impact on property rights central to the principles of English law. As matters stand, we are unclear, for example, about how a partial transfer to a bridge bank would work: would this subdivide creditors into “haves” and “have nots” depending on whether their interests were transferred to the surrogate institution or left behind in the residual company? We are also concerned about the potential effect on commercial practices that form the backbone of the UK’s financial markets. What will the effect be on set-off and netting arrangements; how will the arrangements affect the ability to close out contracts against a defaulting counterparty in derivative and securities trades? What will be the effect on the ability of counterparties to realise collateral held by way of title transfer against the bank or to enforce security interests? There are then issues concerning the impact on the rights of employees.

20. We believe that the complexities involved are such that changes of this nature could usually be expected to be the subject of an extended and multi-stage process of consultation and research. We understand however that the Government has placed absolute priority on the primary legislation at least being in place before the temporary powers provided by the Banking (Special Provisions) Act 2008 run out. In recognising the severe constraint that this places on the timetable we have recommended that as a minimum the Government:

- Ensures that the legislation is drawn up in such a way that the broad legal framework provides scope for time to be taken to get the detailed arrangements right.
- Engages openly with interested parties in the development of the Bill so as to ensure that there is an opportunity to take on board concerns; this should involve a further consultation on the draft legislation before it is introduced into Parliament.
- Commits in clear and unambiguous terms to a full consultative process in respect of the secondary legislation that will subsequently be brought forward; and ensures that Parliamentary debate on this also takes place.

21. We should further add that we believe that one of the arguments in favour of pre-funding arrangements for the FSCS is that it would create a pot to pay for SRR arrangements. If this is the case, then we would negate this by saying that we believe that the cost of invoking the SRR arrangements should fall to the estate of the failed institution. Other than within the confines of the deposit protection scheme, we can see no case for the banking industry generally bearing the cost of failure.

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*Deposit protection and consumer confidence*

22. Perhaps the first point that we should make is that the deposit protection scheme is only necessary as a last resort when the regulatory system has not prevented the failure of a deposit-taking institution. Thus the best protection for depositors will come from well run, appropriately capitalised and profitable banks, operating in effectively regulated and stable markets.

23. Within this context, we fully support the objective of providing effective compensation arrangements in which consumers have confidence. We supported the removal of the co-insurance element of the depositor compensation scheme within the £35,000 limit and regard this as a highly significant improvement in the terms of the scheme; the industry has also agreed to a revised funding structure for the FSCS involving ex-post levy contributions of up to £4 billion per year. We further believe that there may be a case for moving to gross payments.

24. But in the highly concentrated UK market we cannot see a role for pre-funding as such arrangements would be either punitive or tokenistic and neither is advisable. It would take several years to build up an adequate fund and in the interim we fail to see how the admittance of a partial fund could enhance consumer confidence. Pre-funding would also constitute a drag on bank liquidity and would tie up capital that could otherwise be better utilised. We regard the key to consumer confidence as being a guarantee of payment and in this regard see no substitute for a guarantee from the Bank of England.

25. We also believe that the Government has massively underestimated the consequences of permitting an institution to fail operationally and that as a result its expectation of 7 day payout by the FSCS is unrealistic other than in the case of a very small institution. While this is an area on which the BBA is undertaking further work, we believe the only possible outcome is that all concerned agree that it is imperative that all be done to ensure that business can continue to be conducted using the existing infrastructure of the failed institution.

26. In the case of using one of the pre-insolvency arrangements, this would enable a continuum in the provision of banking services precluding the need for resort to the compensation arrangements. Customers would in essence have access to their account monies and banking services with only minimal disruption. While no doubt there may be a process of account normalisation that would necessarily follow to all intents and purposes they would experience a seamless—or near seamless—service delivery. This by far is the optimal outcome in terms of how to deal operationally with the consequence of an institution failing financially.

27. Even in the case of the FSCS being called upon, it remains the case that utilisation of the infrastructure of the failed institution provides the most efficient means of dealing with the consequence of failure. What is at issue here is not only the payment of compensation, but the recreation of banking services that enable customers to re-establish their full range of banking facilities, including money deposit, the payment of direct debits and standing orders and the receipt of regular and ad hoc payments.

28. Only in extreme cases—circumstances that we believe are highly unlikely to arise in the case of a large or medium-sized financial institution—would the FSCS need to proceed without being able to rely on the use of the existing infrastructure. Financial failure need not be synonymous with operational failure, though we naturally accept that the two can go hand-in-hand and the maintenance of operational capacity in the event of financial failure requires careful planning. In view of this, we consider the consultation document to fall short in terms of setting out a realistic plan in terms of how payout could work in the event of the complete failure of anything other than the smallest of institutions.

29. We are concerned in particular that there is a lack of appreciation of the scale of the IT changes that would be involved in delivering the single customer view as proposed in the consultation document and an unreal expectation of what could be achieved in terms of delivery through the FSCS. Paragraphs A.206 to A.213 relate to the proposal for a single customer view enabling the FSCS to obtain information from banks and building societies at an earlier stage. Paragraph A.210 states: “There are no significant ongoing or one-off direct costs associated with this measure. This is because the amount of information being required is the same; its just the timing that is different”. The cost quantification is given as negligible.

30. Our initial assessment shows that it would take a large bank with significant legacy systems to cope with at least three years to design and implement the necessary changes and cost in the region of £25 million to £50 million per institution. The cost of this measure across the industry would therefore be in the region of several hundred million pounds. It would involve further ongoing cost and add significantly to the scale of any future IT projects involving customer-facing systems since any change to the IT platform would need to be tested across the SCV data capability.

31. We are therefore undertaking further work on understanding the practical impediments to seven day payout in order that we can better understand the issues involved and whether there are shortcuts that would enable these to be overcome; we are also looking at whether we can establish a better process overall through a better understanding of the difficulties involved. In addressing this we are taking the view that the issue is not only one of compensation payout, but account maintenance or opening.

*Effective coordination*

32. As explained above, we support the proposed strengthening of the tripartite arrangements but in the UK context see the answer as lying more in the assignment of clear roles and responsibilities for each of the three parties and view this as being the key to improving coordination.

33. As observed in the Treasury Committee report “Financial Stability and Transparency”, the international nature of the recent instability in the global financial markets and the instantaneous nature of world communications “make national borders largely irrelevant to the transmission of some shocks”. The strengthening of cross-border cooperation under the aegis of the Financial Stability Forum and the International Monetary Fund is therefore of central importance given the global marketplace and international transfer of risk. The contribution that these bodies have to make has been amply illustrated by the report published by the Financial Stability Forum on 12th April and the action plan that it sets out for improvements to international regulatory requirements and market transparency. The measures set out in the report are comprehensive and their combined effect should be to strengthen regulation and market transparency in areas where existing arrangements are deficient.

34. In a global banking market practical cross-border supervisory cooperation is also critical in terms of more effective supervision. This is arguably where the greatest systemic risks lie. While we are highly dubious of proposals for a unified European regulator, we are firm advocates of the use of supervisory colleges and believe that these can significantly strengthen cross-border cooperation in support of home country regulation. This keeps the regulatory function closer to the principal marketplace and is preferable to an approach that would distance the regulator from the regulated institution in geographical and possibly cultural terms.

*Market abuse*

35. Our members are the FSA’s strongest partners in tackling market abuse and engendering clean markets in the UK. This, we believe, is evidenced in the strong self reporting and early resolution culture of financial services firms in the UK. Both the industry and FSA’s goal are clean markets.

36. In regard to Halifax Bank of Scotland (HBoS) share price movements the committee should bear in mind that in extreme circumstances markets can react very quickly and severely. Especially with automated trading, stoploss trades and the general level of concern. In a highly automated and integrated market as exists in the UK it is not surprising to see extensive volatility in times of stress. However volatility does not mean there has been market manipulation.

37. Following the FSA’s failure on Northern Rock, the ensuing run on the bank, the collapse of Bear Stearns, the several days of turmoil on world stock markets it is unsurprising that the market reacted very sharply to any suggestion of weakness at HBoS.

38. The BBA and its members are supportive of the FSA’s use of plea bargaining in market abuse cases. Judicious use of plea bargaining will allow the FSA to tackle more effectively insider trading rings. However it should not be seen as a panacea and excessive use of these powers will likely be unhelpful. For plea bargaining to be fully effective a change to the current legislation to provide full legal immunity is required. Specifically, protection from: third party civil suits; other European Regulators; and the SEC.

39. The Treasury is currently reviewing FSA keeping super-equivalent powers to the Market Abuse Directive (2005).<sup>6</sup> These powers exist very much at the fringes of the regime and firms find them both confusing and costly. These extra rules undermine the European Single Market and encourage other EU regulators to bring in their own super-equivalent rules. The FSA has wide powers in the FSA handbook under principles (PRIN) to address market abuse cases. These extra powers are therefore unnecessary.

40. The FSA is concentrating excessively on these marginal and confusing powers when the real issues are in the transaction reporting of derivatives. This information feeds into their database, “Sabre II”. It is this that puts a spotlight on individual actions and it is in derivatives where large amounts of leverage can be obtained. Over the past 18 months the BBA and its members have been working closely with the FSA on complex derivatives and how they should be reported so that the FSA can see the true economic position of trades in the market. We therefore believe that in response to the current consultation the Treasury should conclude that it need NOT renew these superequivalent powers. We are in the process of finalizing our response to the consultation paper and will forward on completion.

*May 2008*

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<sup>6</sup> HMT consultation paper “FSMA Market Abuse Regime: A Review of the Sunset Clauses”.

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## Supplementary memorandum from the British Bankers' Association

### BBA LIBOR—AN INTRODUCTION

BBA LIBOR stands for London InterBank Offered Rate. It is produced for 10 currencies with 15 maturities quoted for each, ranging from overnight to 12 months producing 150 rates each business day. BBA LIBOR is a benchmark; giving an indication of the average rate a leading bank, for a given currency, can obtain unsecured funding for a given period in a given currency. It therefore represents the lowest real-world cost of unsecured funding in the London market.

Individual BBA LIBOR rates are the end product of a calculation based upon submissions from a panel, made up of the largest, most active banks in each currency BBA LIBOR is quoted for.

The key concept is that BBA LIBOR is based upon the offered rate, and not the bid rate. Every contributor bank is asked to base their LIBOR submissions on the following question; "At what rate could you borrow funds, were you to do so by asking for and then accepting inter-bank offers in a reasonable market size just prior to 11.00 am?" Therefore submissions are based upon the lowest perceived rate that a bank on a certain currency panel could go into the inter-bank money market and obtain sizable funding, for a given maturity.

The rates are not based on actual transaction, indeed it would not be possible to create the suite of LIBOR rates if this was a requirement, as not all banks will require funds in marketable size each day in each of the currencies and maturities they quote. However, this does not mean the rates are inaccurate. A bank will know what its credit and liquidity risk profile is from rates at which it has dealt, and can construct a curve to predict accurately the correct rate for currencies or maturities in which it has not been active.

"Reasonable market size" is intentionally left undefined. This is because it would have to be constantly monitored, and in the current conditions it would have to be changed almost daily, certainly every week, and would vary between currencies, maturities and even contributors. This would lead to a great deal of confusion.

The current definition became the standard after a review in 1998 where previous submissions from panel members were based upon the following: "At what rate do you think interbank term deposits will be offered by one prime bank to another prime bank for a in a reasonable market size today at 11.00 am?" The new definition enables accountability for the rates.

### WHAT IS BBA LIBOR USED FOR?

BBA LIBOR is the primary benchmark for short term interest rates globally. It is used as a barometer to measure strain in money markets and often as a gauge of the market's expectation of future central bank interest rates. Independent research indicates that around \$350 trillion of swaps and \$10 trillion of loans are indexed to BBA LIBOR. It is the basis for settlement of interest rate contracts on many of the world's major futures and options exchanges. It is written into standard derivative and loan documentation such as the ISDA terms. It is also used for an increasing range of retail products, such as mortgages and college loans.

### SELECTION OF CONTRIBUTORS

Contributor banks are selected for currency panels with the aim of reflecting the balance of the market for a given currency based upon three guiding principles:

- (1) scale of market activity;
- (2) credit rating; and
- (3) perceived expertise in the currency concerned.

Each Panel for the 10 currencies, ranging from 8 to 16 contributors, is chosen by the independent Foreign Exchange and Money Markets Committee (FX & MM Committee) to give the best representation of activity within the London money market for a particular currency. A full list is included as Appendix I. Therefore, with all due to consideration to current economic situations, the LIBOR submissions from panel members will be on average the lowest interbank unsecured loan offers within the money market that are on offer.

Every year the FX & MM Committee undertakes an assessment of each panel, based upon a review by the BBA of the contributors. The review re-evaluates each bank by ranking them according to their total money market and swaps activity over the previous year. The review is not limited to contributors as any Banks can submit themselves to the evaluation process for any currency.

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CALCULATION

Reuters are our designated calculation agent. They audit data submitted by panel banks and create the rates using the definitions provided by the FX & MM Committee, and they do so under the supervision of BBA.

Each cash desk in a contributor bank has a Reuters application installed. Each morning between 11.00 and 11.20 an individual at each bank, typically the currency dealer, takes their own rates for the day and inputs them into this, which links directly to the fixings team at Reuters. Banks cannot see each others' rates as they submit, only after final publication. Reuters run a barrage of automated and manual tests on the submitted rates before they are sent to the calculation engine. After calculation the data is released to the market, via Reuters and nine other data vendors.

Every BBA LIBOR rate produced by Reuters is calculated by the same method, using a trimmed arithmetic mean. Once Reuters receive each contributor submissions they rank them in descending order and then drop the top and bottom quartiles—this is the trimming. The middle two quartiles reflecting 50% of the quotes are then averaged to create a BBA LIBOR quote. This is repeated for every currency and maturity resulting in 150 rates produced every business day.

Please see the below example for a US dollar quote for one maturity.

<b>WESTLB</b>	2.85000	
<b>ROYAL BANK OF SCOTLAND</b>	2.75000	
<b>HBOS</b>	2.70000	
<b>BARCLAYS</b>	2.70000	
<hr/>		
<b>BANK OF AMERICA</b>	2.70000 }	
<b>J P MORGAN</b>	2.68000	
<b>ROYAL BANK OF CANADA</b>	2.67000	
<b>UBS</b>	2.65000	<b>LIBOR RATE</b>
<b>RABOBANK</b>	2.65000	<b><u>2,66250</u></b>
<b>NORINCHUKIN</b>	2.65000	
<b>LLOYDS</b>	2.65000	
<b>H S B C</b>	2.65000	
<hr/>		
<b>CREDIT SUISSE FIRST BOSTON</b>	2.65000	
<b>CITIGROUP</b>	2.65000	
<b>BANK OF TOKYO MITSUBISHI UFJ</b>	2.65000	
<b>DEUTSCHE BANK</b>	2.63000	

The decision to drop the bottom and top quartiles in the calculation was taken to increase the accuracy of BBA LIBOR quotes. As previously described, BBA LIBOR is a benchmark and including outliers for any given reason will not reflect a market rate. By dropping outliers it is out of the control of any individual panel contributor to influence the calculation and affect the BBA LIBOR quote. For a complete list of all Historic BBA LIBOR data please refer to BBA Website (<http://www.bba.org.uk/bba/jsp/polopoly.jsp?d=141&a=627>)

## INCEPTION OF BBA LIBOR

BBA LIBOR was first developed in the 1980s as demand grew for an accurate measure of the real rate at which banks would lend money to each other. This became increasingly important as London's status grew as an international financial centre. More than 20% of all international bank lending and more than 30% of all foreign exchange transactions now take place in London.

In 1984 UK banks asked the BBA to develop a calculation that could be used as an impartial basis for calculating interest on syndicated loans. This led to the creation of "BBAIRS"—the BBA Interest Rate Settlement in 1985, which in 1986 became BBA LIBOR. The objectivity and accuracy of the rates allowed derivatives to be created based on the data as a reference, and this has flourished to become an enormously successful cornerstone of business transacted in the City and worldwide.

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**APPENDIX I****CONTRIBUTOR PANEL BANKS****AUSTRALIAN DOLLAR (AUD)—8 BANKS**

Barclays Bank plc  
Commonwealth Bank of Australia  
Deutsche Bank AG  
HBOS  
Lloyds TSB Bank plc  
National Australia Bank Ltd  
The Royal Bank of Scotland Group  
UBS AG

**CANADIAN DOLLAR (CAD)—12 BANKS**

Bank of Montreal  
Barclays Bank plc  
Canadian Imperial Bank of Commerce  
Deutsche Bank AG  
HSBC  
HBOS  
JP Morgan Chase  
Lloyds TSB Bank plc  
National Bank of Canada  
Rabobank  
Royal Bank of Canada  
The Royal Bank of Scotland Group

**SWISS FRANC (CHF)—12 BANKS**

Barclays Bank plc  
Bank of Tokyo—Mitsubishi UFJ  
Citibank NA  
Credit Suisse  
Deutsche Bank AG  
HSBC  
JP Morgan Chase  
Lloyds TSB Bank plc  
Société Générale  
The Royal Bank of Scotland Group  
UBS AG  
West LB AG

**DANISH KRONE (DKK)—8 BANKS**

Barclays Bank plc  
Deutsche Bank AG  
HSBC  
JP Morgan Chase  
Lloyds TSB Bank plc  
Rabobank  
The Royal Bank of Scotland Group  
UBS AG

**EURO (EUR)—16 BANKS**

Bank of America  
Barclays Bank plc  
Bank of Tokyo—Mitsubishi UFJ  
Citibank NA  
Credit Suisse  
Deutsche Bank AG  
HBOS  
HSBC

JP Morgan Chase  
Lloyds TSB Bank plc  
Rabobank  
Royal Bank of Canada  
Société Générale  
The Royal Bank of Scotland Group  
UBS AG  
West LB AG

STERLING (GBP)—16 BANKS

Abbey National plc  
Bank of America  
Bank of Tokyo—Mitsubishi UFJ  
BNP Paribas  
Barclays Bank plc  
Citibank NA  
Deutsche Bank AG  
HBOS  
HSBC  
JP Morgan Chase  
Lloyds TSB Bank plc  
Rabobank  
Royal Bank of Canada  
The Royal Bank of Scotland Group  
UBS AG  
West LB AG

JAPANESE YEN (JPY)—16 BANKS

Bank of America  
Bank of Tokyo—Mitsubishi UFJ  
Barclays Bank plc  
Citibank NA  
Deutsche Bank AG  
HSBC  
JP Morgan Chase  
Lloyds TSB Bank plc  
Mizuho Corporate Bank  
Rabobank  
Société Générale  
Sumitomo Mitsui Banking Corporation Europe Ltd (SMBCE)  
The Norinchukin Bank  
The Royal Bank of Scotland Group  
UBS AG  
West LB AG

NEW ZEALAND DOLLAR (NZD)—8 BANKS

Commonwealth Bank of Australia  
Barclays Bank plc  
Deutsche Bank AG  
HSBC  
JP Morgan Chase  
Lloyds TSB Bank plc  
National Australia Bank  
The Royal Bank of Scotland Group

SWEDISH KRONA (SEK)—8 BANKS

Barclays Bank  
Deutsche Bank  
HSBC  
JP Morgan Chase  
Lloyds TSB Bank plc

Rabobank  
The Royal Bank of Scotland Group  
UBS

US DOLLAR (USD)—16 BANKS

Bank of America  
Bank of Tokyo—Mitsubishi UFJ  
Barclays Bank plc  
Citibank NA  
Credit Suisse  
Deutsche Bank AG  
HBOS  
HSBC  
JP Morgan Chase  
Lloyds TSB Bank plc  
Rabobank  
Royal Bank of Canada  
The Norinchukin Bank  
The Royal Bank of Scotland Group  
UBS AG  
West LB AG

22 May 2008

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**Memorandum from Northern Rock**

INTRODUCTION

1. Northern Rock welcomes the opportunity to inform the Committee of the key steps it has taken, since being taken into temporary public ownership on 22 February 2008, to rebuild the business. Since the events leading to the requirement to take the Company into temporary public ownership have already been extensively reviewed by the Committee, the focus of this submission will be on the current and future activities of the bank.

2. The material included in Appendix A and Appendix B has already been published on Northern Rock's website. It is re-presented in this memo, together with certain supplemental information, to assist the Committee and form a foundation for the oral evidence session scheduled with Northern Rock for 20 May 2008, by providing an outline of the future governance structures of the Company, and its approach to accountability and transparency whilst in temporary public ownership.

EXECUTIVE SUMMARY

3. Northern Rock, whilst still in a consolidation and review stage, is planning for its future as a financially viable mortgage and savings bank that can be returned, in due course, to the private sector. The publication of the Accounts for 2007 (available on Northern Rock's website) concludes our financial analysis of the past.

4. The Tripartite Authorities have set out their objectives for Northern Rock during the period of temporary public ownership: to protect taxpayers, to promote financial stability and to protect consumers.

5. Key building blocks to deliver these objectives have already been put in place with the agreement of the Tripartite Authorities, which includes HM Treasury (the Shareholder). The principal elements of these building blocks are:

- A Provisional Restructuring Plan.
- A Competitive Framework.
- A Shareholder Relationship Framework.

6. The Provisional Restructuring Plan (the Plan) provides details of Northern Rock's strategic priorities and the actions the Company proposes to deliver these. The Plan's strategic priorities include:

- repayment of the Bank of England facilities, principally by contracting the business to become smaller and more sustainable;
- enhanced risk control;
- resizing the organisation; and
- building a standalone capital and funding position

7. The Plan also recognises that Northern Rock cannot take advantage of the support it receives from Government to compete on a basis that is unfair or that introduces competitive distortions into the markets in which it operates. The basis on which the Company intends to operate will therefore be constrained by adherence to a set of principles and commitments (the Competitive Framework) while in receipt of State aid. These will be kept under review and remain subject to the requirements of the European Commission.

8. The Shareholder Relationship Framework sets out the structure of how the day-to-day shareholder relationship between the Company and HM Treasury (the Shareholder) will work in practice.

9. This written submission gives added focus to the issues of governance and accountability, under the following headings:

- **Governance:** How the formal governance arrangements for Northern Rock operate.
- **Accountability:** How Northern Rock will be held to account for its performance against the objectives set out for the period of temporary public ownership.
- **Transparency:** How Northern Rock's performance will be communicated to external stakeholders.

#### GOVERNANCE

10. While under temporary public ownership, Northern Rock intends to continue working under the governance arrangements similar to those for a listed UK public limited company, with appropriate modifications as set out in the Shareholder Relationship Framework. The principal oversight responsibility for Northern Rock's activities and performance lies with the Board of Directors.

11. The Board composes the Executive Chairman (Ron Sandler), Chief Financial Officer (Ann Godbehere), Deputy Chairman and Senior Independent Director (Stephen Hester), Chief Executive (Andy Kuipers) and five other non-executive Directors. The Board composition has been substantially changed since August 2007. Of the current Board, only Andy Kuipers was serving in August 2007.

12. The Executive Chairman, Chief Financial Officer and Chief Executive have executive responsibility for delivery of the Plan that has been agreed by the Board and Shareholder subject to employee consultations and EC State aid approval.

13. The Board meets at least monthly (with the exception of August) to conduct its various duties, and has designated four committees to perform specific governance roles:

- Audit committee—Chaired by Simon Laffin.
- Risk committee—Chaired by Laurie Adams.
- Remuneration committee—Chaired by Stephen Hester.
- Nominations committee—Chaired by Ron Sandler.

14. Northern Rock's risk strategy and policies are being revised to meet the new Plan objectives and strengthen the risk and control environment. In addition, monitoring and reporting processes are being strengthened and will be aligned to an enhanced risk function. The risk and control review, details of which are set out in the Provisional Restructuring Plan Executive Summary (Appendix A), is presently underway.

#### ACCOUNTABILITY

15. The Board of Northern Rock recognises the high standards of accountability to which it is being held in pursuance of the objectives of temporary public ownership set out in paragraph 6 above, alongside the normal accountability of a UK regulated bank and public limited company.

16. Northern Rock's primary accountability is to achieve the objectives determined by the Tripartite Authorities, and specified in the memorandum of association, namely: to protect tax payers, promote financial stability and protect depositors. While meeting these objectives Northern Rock must operate within the requirements of Financial Services regulation and European State aid legislation. The strategic priorities and related actions set out in the Plan (Appendix A) are intended to achieve these objectives.

17. Beyond the requirements of company law and financial services regulation, Northern Rock's Board will adhere to the principles outlined in the Shareholder Relationship Framework (Appendix B), which requires a high level of accountability to the Shareholder (HM Treasury).

18. The Shareholder Relationship Framework establishes the basis for regular meetings and dialogue with the Shareholder to review in-depth progress against the Plan and agree any material changes to the Plan.

19. In addition, Northern Rock is subject to the oversight of the Office of Fair Trading (OFT), for those aspects of the business that are subject to the Consumer Credit Act. The OFT has also committed to publish a report annually on the competitive impact of Northern Rock under temporary public ownership.

20. To address concerns that the Government's involvement with Northern Rock could cause competitive distortions, a self-imposed Competitive Framework has been developed. The Framework balances principles and rules that govern how the Company competes, and makes firm input- and output-based commitments to minimise market distortions. The Competitive Framework is outlined in the Provisional Restructuring Plan Executive Summary (Appendix A).

#### TRANSPARENCY

21. Northern Rock recognises the considerable desire for transparency of its performance. The company will go beyond the normal reporting requirements for a limited company and those requirements it is obliged to meet, and will report in a similar manner to a publicly listed company, with appropriate modifications.

22. This will consist of several elements of public disclosure and communication including:

- **Annual reports and accounts**—containing Chairman's statement, remuneration report, corporate governance report, community and environmental report, Directors' report, auditor's report, operating and financial review and annual financial statements.
- **Interim report and accounts**—containing management commentary and interim financial accounts.
- **Quarterly trading statements**—containing an update on Northern Rock's performance and outlook.

23. In addition, Northern Rock provides significant disclosure to third party holders of debt, through its SEC filings and other mechanisms. This includes disclosure on the company's website of monthly investor reports related to the Granite securitisation programme and Northern Rock's covered bond programme, which provide current financial information, the current position of the mortgage portfolio underlying the programmes and any significant changes therein.

24. In these very challenging times for the banking community, it is believed that the arrangements outlined in these documents, facilitated by supporting plans and review results, will give confidence to the Treasury Select Committee that the public interest will be appropriately discharged while Northern Rock is within temporary public ownership. It is further believed that the ongoing support of the Treasury Select Committee is important in assisting us deliver the overall objectives set for us.

### APPENDIX A

#### PROVISIONAL NORTHERN ROCK RESTRUCTURING PLAN: EXECUTIVE SUMMARY

##### A. BACKGROUND TO TEMPORARY PUBLIC OWNERSHIP AND THE RESTRUCTURING PLAN

The core business of Northern Rock plc (the "Bank") is secured residential mortgage lending.

During the first half of 2007, Northern Rock's operational performance was in line with previously stated strategic targets, with asset growth of 12.4% over the six months to 30 June 2007. However, financial performance was impacted by margin pressure experienced in the first half of 2007, due in large part to the prevailing interest rate environment as well as the Bank's timing of transacting hedges for fixed rate mortgages. This resulted in a downward revision to profit guidance in June 2007.

Northern Rock raised £12.1 billion in aggregate in the first half of 2007 to support growth through the four funding channels of wholesale funding, securitisation, covered bond issues and retail deposits. The Bank also sold a tranche of commercial secured loans in June 2007 with further tranches sold in the second half of the year. These transactions provided additional funding for secured residential lending amounting to £1.46 billion. As at 30 June 2007 around 75% of Northern Rock's total funding was sourced from the non-retail money markets with £53.8 billion of total non-retail funding balances of £80.5 billion, ie two thirds, raised from securitisations and covered bonds.

Concerns about credit exposure in financial markets began to surface in the summer of 2007 and credit spreads (the cost of credit) increased. The announcement by a major US investment bank of difficulties in one of its investment conduits and subsequent similar announcements by other banks led to a serious disruption in the medium term funding markets on 9 August 2007. This quickly led to severe restrictions in the liquidity of the short term wholesale markets. In the week commencing 10 September 2007 it was necessary to arrange a facility to provide liquidity for Northern Rock in the event that medium term and securitisation markets failed to reopen. This facility was provided by the Bank of England at a premium rate of interest.

In the days that followed the grant of the Bank of England facility, there were significant withdrawals by Northern Rock's retail depositors reflecting customers' concerns as to the security of their savings. The substantial amount of retail deposits withdrawn following the grant of the loan facility, together with the impact of maturing wholesale funding, contributed to Northern Rock having to draw on the Bank of England facility.

On 17 September 2007, the Chancellor of the Exchequer announced that, should it be necessary, arrangements would be put in place to guarantee all existing deposits in Northern Rock during the current instability in the financial markets, which significantly slowed the level of customer withdrawals. The guarantee arrangements were clarified and extended by HM Treasury on 20 and 21 September, 9 October and 18 December 2007 to include all unsecured retail products, all uncollateralised derivative transactions and all obligations of the Company to make payments on the repurchase of mortgages under the documentation for the Granite securitisation programme. In order to minimise any unfair commercial advantage to the company, Northern Rock has agreed to pay a fee to HM Treasury for the guarantee arrangements. Consent was obtained from the European Commission for the provision of support for the six months from 17 September, in accordance with European law.

Following a strategic review with its advisers Northern Rock, having consulted with the Tripartite Authorities (HM Treasury, the Bank of England and Financial Services Authority) acting in their respective capacities, explored a range of options for the business; these included proposals put forward by both management and third parties. On 17 February 2008, the Chancellor of the Exchequer announced that this process had failed to reach a solution that adequately safeguarded taxpayers' interests and that the Government had decided to take Northern Rock into a period of Temporary Public Ownership. A further submission to the European Commission in relation to the longer term restructuring proposals was made 17 March 2008 and the existing arrangements may be maintained while this submission is considered.

The Tripartite Authorities have set out their objectives for Northern Rock during the period of Temporary Public Ownership: to protect taxpayers, to maintain wider financial stability and to protect consumers. Northern Rock's Provisional Restructuring Plan (the "Plan") has been developed to achieve these objectives in a way that complies with State aid requirements. It sets out the basis for the removal of financial support provided by HM Treasury and the Bank of England through the creation of a smaller, more focused and financially viable mortgage and savings bank that will be returned in due course to the private sector.

Those elements of the Plan which are likely to impact on Northern Rock's workforce remain subject to consultation with representatives of Unite and other employee representatives before any final decisions are taken.

## B. NORTHERN ROCK'S OBJECTIVES AND STRATEGIC PRIORITIES

Northern Rock's prime objectives are the repayment of the Bank of England debt, the release of HM Treasury guarantee arrangements and a successful return to the private sector.

The Bank will pursue four strategic priorities in order to achieve these objectives by creating a smaller, more financially viable mortgage and savings bank. These are to:

- **Repay the facilities provided by the Bank of England**, principally by contracting the business to become smaller and more sustainable—reducing the balance sheet from around £107 billion in 2007 to about £50 billion by the end of 2011, and withdrawing from several non-core businesses.
- **Align the organisation and operation of Northern Rock** under a new executive management team with a proposed downsizing and reshaping of the organisation, while supporting employees through this process.
- **Build a stand-alone funding and capital position** that will facilitate the earliest possible release of the HM Treasury guarantee arrangements and a return to the private sector, with retail deposits representing a greater proportion of total funding (although at a lower absolute level than before the 2007 crisis).
- **Strengthen the risk and control environment** throughout the Bank by means of improved risk organisation, capabilities and processes.

The overall effect of the Plan, under a base case scenario, would be an improvement in profit before tax from a substantial loss in 2008 to break-even in 2011 followed by progressive profit improvement. In 2008 the business is expected to be significantly loss-making, as a consequence of both the anticipated one-off restructuring costs, which are likely to be substantial, and higher funding costs. In the years following this, and reflecting a lower cost base, the Plan anticipates that Northern Rock will achieve sustainable profitability and a financial structure sufficient to obtain a stand-alone credit rating of at least A- and a return to the private sector.

Section C provides details of Northern Rock's strategic priorities and the actions the Bank proposes to deliver these.

The Plan also recognises that Northern Rock cannot take advantage of the support it receives from Government during the period of Temporary Public Ownership to compete on a basis that is unfair or that

introduces competitive distortions into the markets in which it operates. The basis on which the Bank intends to compete over this period will therefore be constrained by adherence to a set of self-imposed competitive restrictions. These are set out in Section D.

### C. ACHIEVING NORTHERN ROCK'S STRATEGIC PRIORITIES

The Plan, which has been developed on a six year horizon, sets out the Board's present assessment of the actions most likely to achieve Northern Rock's four strategic priorities. As the market environment evolves, the management team and the Board will periodically assess progress and adapt the Plan as necessary, subject to the approval of HM Treasury under the governing Shareholder Framework Document. Any adaptations to the Plan which may impact on Northern Rock's workforce will be the subject of consultation with representatives of Unite and other employee representatives.

#### 1. *Repay facilities provided by the Bank of England and contract to a smaller, sustainable business*

Northern Rock's planned commercial strategy has as its priority the repayment of the Bank of England debt through the contraction of the balance sheet from £107 billion in 2007 to around £50 billion by 2011. Under the Plan, repayment will come primarily from accelerating the pace of consumer mortgage repayment (redemptions) and proposed withdrawal from non-core lending activities. In parallel, modest development of the Bank's retail savings base will create a more balanced funding platform for future growth.

##### — **Accelerate mortgage redemptions**

In order to reduce the size of its balance sheet to a sustainable level, Northern Rock will work to achieve a considerably higher level of mortgage redemptions than has historically been the Bank's practice. Management expects that, by ceasing the Bank's proactive retention programme and encouraging and helping existing customers to transfer their mortgages to other lenders shortly after the customer's fixed or discounted period expires, redemption levels of some 60% can be achieved.

The redemption programme will involve contacting those customers with mortgage products approaching the end of their fixed or discounted period and helping them find a new mortgage product elsewhere. Customers will be directed back to a panel of selected mortgage intermediaries who will assist them in finding a new mortgage with another lender. The company will also explore arrangements to provide mortgages directly to some customers on behalf of other lenders. This would enable Northern Rock to improve its service to customers and help achieve the desired level of redemptions.

It is proposed that, generally, customers who remain with Northern Rock once fixed or discounted periods come to an end will move onto the standard variable rate. The redemption programme will provide customers with sufficient notice of their product maturity and new payment details, at all times observing regulatory requirements to treat customers fairly.

##### — **Develop Northern Rock's savings business**

It is critical for the future viability of the Bank to achieve a more balanced mix between retail and non-retail sources of funding. In order to do this, Northern Rock plans to rebuild its retail savings business, as other funding sources contract, to create a sustainable mix. The Bank will achieve this with gradual growth in its retail funding base from its present market share of around 1.0%—although it will remain substantially below the Bank's pre-crisis level of 1.9% of UK retail deposits stock. This approach aims to increase the proportion of retail funding to around 50% of the Bank's total funding by 2012 (compared to 15–20% in 2008).

Northern Rock will aim to recapture many of its recently lost customers, develop a better mix of high value and low balance depositors, and encourage a higher percentage of accounts under £35,000. Northern Rock plans to offer a broad product range and utilise all of its existing channels (postal, branch, online and telephone) to attract savings. In particular, Northern Rock's branch network has an important role to play in attracting, servicing and retaining savings accounts. The Bank's branch network will be maintained at its present size throughout the Plan period, although, having regard to the requirement to moderate its competitive impact, the network will not be extended.

The Irish and Guernsey savings businesses will be retained, providing important funding diversity. Northern Rock's share of the Irish market has always been small and will remain below 0.8% until 2011.

Under the Plan, it is proposed that normal non-retail funding activities will very gradually recommence from 2008 to 2012 as Northern Rock's financial profile improves, investor appetite returns and available terms become more attractive.

— **Retain a reduced core lending business**

In order to facilitate its return to the private sector as a mortgage and savings bank, Northern Rock plans to retain a footprint in the new mortgage market averaging £5 billion per annum of gross new lending from 2008 to 2011 (compared to a total of around £30 billion in 2007). New mortgage lending will also assist the management of overall credit quality and the maintenance of Northern Rock's financing programmes (such as Granite) in a prudent manner.

Lending will be offered predominantly to high credit quality customers with standard residential mortgage products. The "Together" product (100%+ loan-to-value lending) has been discontinued for new customers. Credit quality will be managed with more selective credit quality standards and lower loan-to-value ratios for all new business taken on.

New lending will be originated mostly through intermediaries, maintaining this distribution channel and especially Northern Rock's panel representation with key intermediary organisations. The intermediary channel is strategically important to Northern Rock: historically, it has represented approximately 90% of lending volumes. The planned intermediary channel lending envisaged under the Plan represents approximately 15% of Northern Rock's historic volumes through this channel.

— **Re-establish the Northern Rock brand and revitalise marketing**

The "Northern Rock" branding will be retained. Although retail customer confidence has eroded, recent research on behalf of the Bank indicates continuing loyalty to the brand (in particular in the north-east of England and among IFAs). A continuing research programme will confirm the validity of this strategy and assist the development of appropriate marketing activity to support the Plan.

— **Discontinue non-core business lines**

Northern Rock has already announced the run-off and closure of its Danish savings operations in 2008. In addition the Bank will discontinue unsecured lending (2007: £4.0 billion closing balances) and allow these loan books to run down over the period of the Plan.

Subject to consultation with representatives of Unite and other employee representatives over the coming weeks, Northern Rock proposes to discontinue commercial lending (2007: £1.3 billion closing balances including commercial buy-to-let) and to allow this loan book to run down over the period to 2011.

Earlier sale or other options to liquidate these portfolios will be considered alongside any proposals put forward by Unite or the other employee representatives.

2. *Reconfigure Northern Rock's organisation and operations to reflect the new commercial strategy*

In order to achieve its objectives, Northern Rock's organisation and operations must change as follows:

— **Strengthen leadership and capabilities**

The Plan envisages a major restructuring and carries with it a significant number of financial and operational risks. Its successful delivery, particularly in the context of a challenging market environment, requires additional experience and strengthened leadership of the Bank.

In addition, Northern Rock will strengthen its risk management and controls and take additional steps to manage risks entailed in the downsizing strategy.

The leadership of Northern Rock has been strengthened with the appointment of two new executive Board members: Ron Sandler, Executive Chairman, and Ann Godbehere, Chief Financial Officer. Andy Kuipers has continued as Chief Executive Officer working with the new Executive Chairman and Chief Financial Officer.

The Government, in consultation with Ron Sandler, has appointed three new non-executive directors: Stephen Hester (Deputy Chairman and Senior Independent Director), Chief Executive of British Land and former COO of Abbey National plc; Philip Remnant, chairman of the Shareholder Executive and a former banker; and Tom Scholar, a senior HM Treasury civil servant. Several Board directors have retired during the transition to Temporary Public Ownership. Together these changes have significantly adjusted the composition of the Board, bringing new leadership and additional valuable experience and expertise.

Within Northern Rock, the executive team will take steps to further strengthen the organisation's capabilities, in particular in risk, internal audit, finance, treasury and human resources.

— **Restructure the organisation and reduce operating costs**

Under the Plan, Northern Rock will become a more focused and smaller business in order to facilitate a return to the private sector as rapidly as possible. The achievement of a viable and efficient business in the future will require a lower cost base and reconfigured operations.

The Plan targets a reduction in underlying operating costs of about 20%. It envisages about a one-third reduction in staff levels over the next three years based on projected business volumes with the majority of the reduction occurring in the first year. The timing and nature of the proposed downsizing, including any redundancy arrangements, will be subject to consultation with representatives of Unite and other employee representatives.

Northern Rock is committed to open communication with staff and to providing them with substantial support during the restructuring. The Bank will continue to work closely with Unite, One NorthEast and other agencies and stakeholders to minimise the impact of the proposed downsizing on staff and local communities; this includes providing outplacement services to help staff obtain alternative employment in the region.

— **Review performance management**

The Plan includes a proposed review of Northern Rock's performance management practices and changes to incentive programmes. A staff incentive scheme will be introduced linked to achievement of the Tripartite Authorities' objectives under Temporary Public Ownership.

3. *Build a stand-alone funding and capital position*

Under the Plan, Northern Rock's financial strategy will focus on rapid repayment of Bank of England funding and release of HM Treasury's guarantee arrangements while developing a sustainable stand-alone funding and capital position with appropriate controls and risk management.

— **Repay the Bank of England debt by 2010**

The priority for Northern Rock's financial strategy is the rapid repayment of the Bank of England's facilities. While the timing will depend to a degree on developments in the UK housing and mortgage markets, the Plan envisages that in the base case, these facilities will be repaid before the end of 2010. A back-up liquidity facility may remain for a longer period until sufficient alternative liquidity arrangements are in place.

— **Complete the release of HM Treasury guarantee arrangements by 2011**

The intention of the Plan is that HM Treasury's guarantee arrangements will be released as the Bank's financial and strategic positions progressively improve. While release may be achieved earlier, it is prudent, given regulatory capital requirements, to expect that this will not be completed before the end of 2011. Given the limited practical experience of the consequences of releasing state guarantees of Bank deposits and wholesale liabilities, the viability of the Plan's proposals for release of the guarantee arrangements will be kept under review in the light of customer feedback, market circumstances and the requirements of the FSA, as regulator, for adequate capitalisation, liquidity and free assets.

— **Establish a stand-alone funding strategy with balanced retail/non-retail funding and managed contraction of the "Granite" funding structure**

The Bank aims to achieve a long-term credit rating of at least A- on a stand-alone basis following repayment of the Bank of England loan and release of guarantees. This will be based on the achievement of a significantly improved financial profile: a halving in balance sheet size; a greater proportion of retail deposits (~ 50% of funding); a return to profitability and the end of support from HM Treasury and the Bank of England.

The Granite securitisation vehicle, a funding arrangement created and operated by Northern Rock, has been an important source of funding for Northern Rock at an attractive overall cost. The modest amount of new mortgage lending will assist the orderly operation of Granite over the Plan period. Substitution of mortgages into Granite will be substantially reduced from 2009 onwards.

— **Ensure adequate capital is held under all scenarios**

The Plan anticipates that Northern Rock will comply with FSA requirements regarding capital adequacy and liquidity at all times.

4. *Strengthen the risk and control environment*

The Board and the management of Northern Rock have commenced a substantial review and strengthening of risk management and controls within the Bank both at the enterprise and operational level across all major risk categories.

- The risk and control review has commenced with a broad scope.

- The review addresses enterprise risk management as well as an in-depth review of major business risk categories—market, credit, operational and regulatory.
- The review will develop a programme to strengthen Northern Rock’s risk and control environment covering governance, organisational issues, policies, processes and reporting.
- The review commenced during March 2008 and is expected to move into implementation during June/July 2008 following Board and management approvals.

In addition, the Board and management have assessed the sensitivity of the proposals in the Plan by stress-testing it under different scenarios. They will take additional steps to manage the execution risks involved in its implementation.

- The stress-testing has included consideration of key execution challenges to the Plan as well as the impact of hypothetical market risks (for example, a mild downturn or a severe recession).
- Under all scenarios the Bank remains compliant with the current FSA capital requirements set for the Bank.
- The Board is taking measures to manage the risks to timely execution of the Plan while managing business risks and ensuring regulatory compliance.
- Regular stress-testing is planned to be performed in the future.
- The timing and method of releasing the HM Treasury guarantees will always be subject to Northern Rock’s obligation to remain compliant with FSA capital requirements.

#### D. WORKING WITHIN THE COMPETITIVE FRAMEWORK

Northern Rock recognises the responsibilities it has during State aid period and the need to avoid competitive distortions in the markets in which it operates. With this in mind, the Bank has committed itself to a “Competitive Framework” to provide stakeholders and market participants with confidence that it will not use its support from HM Treasury to compete on an unfair basis during this period.

The Competitive Framework comprises a public set of principles and specific commitments, capable of external monitoring, which are designed to minimise risk of competitive distortion while at the same time allowing the Bank the flexibility it needs to compete tactically and respond to customer demand and competitor activities as necessary. Northern Rock has developed a monitoring regime to ensure adherence to the framework.

The principles of the framework provide that while in receipt of State aid Northern Rock: (a) does not promote the Bank’s offering on the basis of Government guarantee arrangements; (b) does not sustain a prolonged market leadership in any product category; (c) maintains market shares at well below historic levels; (d) seeks to achieve greater competitive differentiation through service and innovation; (e) treats all customers fairly; (f) regularly monitors and reviews adherence to the framework.

Specific commitments within the framework include the provisions that Northern Rock will limit its share of retail deposit balances to 1.5% in the UK and 0.8% in Ireland, and its share of gross new mortgage origination to no more than 2.5%, and accept constraints on its ability to compete among the top 3 rankings in major retail savings market categories. Details of the Competitive Framework are contained in Appendix I.

#### E. KEY FIGURES AND MILESTONES UNDER THE PLAN

<i>Balance Sheet</i>	<i>2006 actuals</i>	<i>2007 actuals</i>	<i>2009 plan</i>	<i>2011 plan</i>
Total assets, before fair value adjustment, £bn	101	107	61	49
Retail funding, £bn	23	10	15	20
Retail as percentage of all funding, %	24	10	26	43
Government funding, £bn	—	27*	1	—
Securitised funding, £bn	40	43	27	14
<i>UK market share of stock, %</i>	<i>2006 actual</i>	<i>2007 actual</i>	<i>2009 plan</i>	<i>2011 plan</i>
Mortgage	7.1	7.5	3.7	2.4
Retail deposits	1.8	0.8	1.0	1.2
<i>Debt repayment and guarantee targets</i>			<i>Target date</i>	
25% of facilities provided by Bank of England repaid			2008	
75% of facilities provided by Bank of England repaid			2009	
Facilities provided by Bank of England full repaid			2010	
Release of all HMT guarantee arrangements, subject to FGSA requirements			2011	

\*Excludes open market repo arrangement

## NORTHERN ROCK COMPETITIVE FRAMEWORK

### *Overview*

Northern Rock is determined to return to private ownership as rapidly as possible, as a viable, competitive bank, requiring no support from Government.

We are aware that during the period of temporary public ownership, Government support could enable us to compete, or be seen to compete, on an unfair basis.

We are determined to ensure that we will not take unfair advantage of Government support during this interim period as it is not in our long term interests to do so.

We are committing to this framework of principles and commitments while in receipt of State aid. These will be kept under review and remain subject to the requirements of the European Commission.

### *Our Principles*

- We will not promote our Government guarantee arrangements in any market.
- We will not sustain a prolonged presence as a market leader in the marketplace or in any product category.
- We will maintain market shares below historical levels while in receipt of State aid.
- We will strive to differentiate ourselves on the basis of service and innovation.
- We will at all times treat our customers fairly.
- We will regularly review our competitive offering and performance to ensure adherence to the framework.

### *Our Commitments*

- We will not explicitly refer to Government ownership in marketing literature.
- We will not allow our share of retail deposit balances to exceed 1.5% in the UK and 0.8% in Ireland (well below our historic levels of 1.9% in the UK and 1.3% in Ireland).
- We will limit our share of gross new mortgage origination to no more than 2.5% in any calendar year.
- We will not rank within the top 3 in any one of the defined 15 Moneyfacts retail deposit categories for the remainder of 2008.

## APPENDIX B

### NORTHERN ROCK SHAREHOLDER RELATIONSHIP FRAMEWORK DOCUMENT

#### INTRODUCTION

1. This framework document (the “Framework Document”), as drawn up by Northern Rock plc (the “Company”) and its shareholder, Her Majesty’s Treasury (the “Shareholder”), sets out the structure of how the day-to-day shareholder relationship between the Company and the Shareholder will work in practice. The Framework Document may be revised from time to time where required by the Shareholder as circumstances change. The Framework Document should be interpreted in the light of the Company’s memorandum and articles of association and English company law and is without prejudice to the Shareholder’s statutory and other rights and obligations.

#### OVERALL AIM

2. Northern Rock and the Shareholder share the common objective of having a working relationship which achieves the objectives of Northern Rock and the Tripartite Authorities (comprising the Shareholder, the Bank of England and the Financial Services Authority) and in which:

- the respective roles of Northern Rock and the Shareholder are clearly defined;
- Northern Rock and the Shareholder recognise and respect those roles, and the demands placed upon each party to fulfil them; and
- dialogue and interactions are professional, efficient, and based on trust.

The ongoing relationship between Northern Rock and the Shareholder as shareholder, the Shareholder and the Bank of England as providers of financial support and the FSA as regulator will operate in light of the Tripartite Authorities’ stated objectives:

- (i) to protect taxpayers;

- (ii) to promote financial stability; and
- (iii) to protect consumers.

3. The Board is responsible for developing and recommending its strategic and funding plan (the “Plan”) to deliver the objectives of the Tripartite Authorities referred to in the paragraph above with the aim of public ownership being temporary.

#### GOVERNMENT AS SHAREHOLDER

4. The basic relationship between Northern Rock and the Shareholder operates according to the following principles under which the Shareholder:

- appoints the Chairman of the Board and appoints two Non-Executive Directors in consultation with the Chairman;
- must give its consent for the appointment of other members of the Board proposed to be appointed by the Nominations Committee and agrees the terms on which the Directors are appointed and incentivised;
- determines the high level objectives that the Plan is designed to achieve and agrees the Plan with the Board;
- must agree any subsequent updates to the Plan;
- reviews with the Board from time to time the Company’s strategic options;
- requires that the Board is accountable to it for delivering the agreed Plan;
- gives the Board the freedom to take the action necessary to deliver the Plan;
- monitors the Company’s performance to satisfy itself that the Plan is on track; and
- must give its consent for certain significant actions.

The following paragraphs show how these principles are to be put into practice.

#### PRINCIPLES IN PRACTICE

##### *Board structure and governance*

5. The Company will operate a corporate governance structure that provides a framework for the relationship between the Board and the Shareholder which, so far as practicable and in light of the other provisions of this Framework Document or as otherwise may be agreed with the Shareholder, takes appropriate account of best practice for a company listed on the Official List, including the Combined Code on Corporate Governance. The Board will constitute the following committees:

- Audit Committee.
- Risk Committee.
- Remuneration Committee.
- Nominations Committee.

##### *Board appointments*

6. The composition of the Board is a critical factor for the Shareholder. The aim is to secure an environment in which the Shareholder and the Chairman share a common view about Board composition (including size, and balance of experience and background) and succession. To achieve this, the following will take place:

- the Chairman and either the Chancellor of the Exchequer or a senior official nominated by the Chancellor of the Exchequer (the “Nominated Official”) will discuss and confirm Board composition and succession initially, and regularly thereafter, in the light of performance and the requirements of the Plan;
- two Non-Executive Directors nominated by the Shareholder (the “Shareholder Directors”) will be appointed to the Board. The Company acknowledges that the Shareholder Directors intend to liaise with and report to representatives of the Shareholder from time to time in relation to the business of the Company and decisions made or to be made by the Board in order to assist with the exercise of their powers and duties as directors of the Company;
- the Chairman will discuss with the Nominated Official any impending changes to Board membership;
- the Nominated Official will meet the Chair of the Nomination Committee as necessary to discuss any proposed Board changes before they become subject to the formal appointment/consent procedure outlined in paragraph 4 above; and

- the Board will ensure that suitably rigorous appraisals are made of the effectiveness of the Chairman and Board.

### *Strategic Plan*

7. The Plan will be updated as required and will be subject to review by and the approval of the Shareholder. This process will be achieved through effective dialogue between Shareholder representatives (including the Nominated Official) and Company representatives to enable any proposed changes in strategy to be understood and agreed.

8. Shareholder representatives (including the Nominated Official) and Company representatives will also meet from time to time, as agreed, to review the strategic options available to the Company.

### *Delivering the Plan—incentivisation*

9. The Shareholder's approval will be required for remuneration packages and any incentivisation arrangements for Directors. The Shareholder's interest is primarily in ensuring that remuneration levels are sufficient to attract and motivate high calibre individuals to drive the delivery of the Plan and that incentives for Directors are aligned with the stated objectives of the Tripartite Authorities.

10. The Shareholder requires any incentive arrangements for Executive Directors to be tied closely to performance as measured by the achievement of Plan objectives. The Shareholder is committed to paying market rates for success. Conversely the Shareholder does not condone rewards for failure, and would expect the Board to support the removal of any Director responsible for a failure to deliver the Plan, or for other serious failure.

11. The Remuneration Committee will recommend any proposals for the Shareholder's consent based on performance made against the Plan, and appropriate market benchmarks.

12. The Chair of the Remuneration Committee will discuss proposals at an early stage with the Shareholder in order to input the Shareholder's views into the process.

### *Delivering the Plan—the Board's freedom to act*

13. The Shareholder is committed to giving the Board the freedom to act to deliver the agreed Plan. In that context, and save as provided in this Framework Document, the Shareholder will not interfere in day-to-day operational and commercial matters.

14. Subject to this Framework Document and the Company's memorandum and articles of association, decisions on the day-to-day running of the Company will rest with the Board in accordance with the Directors' fiduciary responsibilities.

### *Monitoring Company performance*

15. The Shareholder will regularly monitor the Company's performance against the Plan by means of the following mechanisms:

- regular shareholder meetings as the centrepiece of the formal reporting relationship between the Company and the Shareholder. These will be monthly at first, and their frequency will be subject to review. The purpose of these meetings between the Executive Directors of the Company and senior representatives of the Shareholder (including the Nominated Official) is to provide a forum to review performance to date against Plan objectives, but each meeting is primarily intended to be weighted towards being a forward-looking and risk-based analysis of Plan progress;
- regular financial and business performance monitoring to assist this process. These will be monthly at first, and their frequency will be subject to review. The Shareholder expects to be provided with prompt and accurate financial and business information at the same level as the Board and which is transparent to ensure that all key financial and business data pertinent to tracking the achievement of the Plan and the Company's performance against agreed objectives can be reviewed and monitored on a timely, regular and appropriate basis;
- the Company will promptly and without delay disclose to the Shareholder any information that would have required public disclosure if it were listed on the Official List or which otherwise may have a significant bearing on the delivery of, or may have a significant impact on the assumptions or objectives set out in, the Plan;
- in addition to the regular shareholder meetings, meetings between Directors and representatives of the Shareholder to discuss the affairs of the Company at the Shareholder's request;
- in addition to the monitoring procedure described above, the Shareholder will be entitled on reasonable notice to such reasonable information in relation to the affairs of the Company, including reasonable access to the Company's financial models and personnel, as it may reasonably consider necessary or desirable from time to time; and

- notwithstanding the above, the Shareholder will not have the right to any documents relevant to matters in issue as against itself in any legal proceedings to which it is a party.

16. The Shareholder will have approval rights over:

- any material acquisitions, disposals, investments, realisations or other transactions;
- transactions or matters that the Board can reasonably foresee will exclude any strategic outcome contemplated by the Plan; and
- any other actions that may have a significant bearing on the delivery of the Plan or prejudice the stated objectives of the Tripartite Authorities.

17. These interactions between the Company and the Shareholder need to be underpinned by resolve on both sides to conduct affairs on the basis of a professional, efficient, trust-based dialogue:

- professional: professional people engaged in dialogue relevant to delivering the Tripartite Authorities' objectives, with commitments delivered on time and to specification;
- efficient: both parties ensuring a joined-up and efficient approach amongst their constituent elements; and
- trust-based: open dialogue, based on a shared commitment to providing the Company with the ability to progress.

18. The Company will continue to have interactions with other members of the Tripartite Authorities as and when necessary and appropriate. The Shareholder will be responsible for co-ordinating the Tripartite Authorities' actions in relation to the Company, in accordance with the Memorandum of Understanding between the Tripartite Authorities. The Financial Services Authority as regulator has statutory responsibilities to fulfil and these arrangements are entirely without prejudice to those responsibilities.

#### *Ensuring success*

19. The success of the relationship depends in the end on the nature and quality of the relationship between the Board and the Shareholder. The overall responsibility for ensuring that the intentions of this document are carried out in practice lies ultimately with the Chairman and the Chancellor of the Exchequer. The Chairman will maintain regular contact with the Nominated Official. Below them, senior individuals within the Company and the Shareholder will be nominated who will have the responsibility to ensure that all contacts between the Company and the Shareholder are conducted at the right level, with the right people, and in the right spirit.

*May 2008*

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#### **Letter from the Chairman of Northern Rock to the Clerk of the Committee**

Thank you for your letter of 22 April seeking clarification of one point of evidence given to the Committee by Mr Applegarth on 16 October 2007.

Mr Applegarth said, in response to a question, that the FSA had come to a Board Meeting "*in January I think it was*". According to our records, the FSA was not present at a January 2007 Board Meeting. Two representatives of the FSA, Jackie Sharp and Andy Maysey, had been present at a Board Meeting in March 2006 to explain what was involved in Northern Rock's move to "close and continuous" supervision. Ms Sharp and Mr Maysey also came to Northern Rock's offices on 30 April and 1 May 2007. This was the initial visit under the "close and continuous" supervisory regime. The FSA met Mr Applegarth (on 30 April) and other Executives. At the 30 April meeting, Mr Applegarth and the FSA did discuss Northern Rock's Business Plan.

The above information is based on our records. We have provided this information to Mr Applegarth and he has confirmed to us that the information in this letter is correct to the best of his recollection, his memory now having been refreshed by the checking of the records. Mr Applegarth says that the meeting he had in mind was the April 2007 meeting. At the time he testified to the Committee he mistakenly thought that the meeting had taken place a little earlier in 2007 and that it had taken place at a Board Meeting. Mr Applegarth has asked us to convey his apologies for this mistake and to thank the Committee for the opportunity to set the record straight.

*30 April 2008*

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**Supplementary memorandum from Northern Rock**

I promised to provide a written response to the questions on FSA recognition from Jim Cousins at my appearance in front of the Committee on 20 May 2008 (Q288 and Q289).

The questions asked about the number of staff who have FSA recognition. We can confirm that the number of persons authorised at Northern Rock under the FSA's approved persons regime has not changed materially since August 2007. However, I think that the questions did not refer to this but rather to the "SA Training and Competence (T&C) regime and therefore related to the number of staff at Northern Rock who are able to sell mortgage loans.

As mortgages are a regulated loan product, in accordance with FSA requirements Northern Rock operates a T&C regime for all employees who sell mortgages to customers. This T&C regime requires each seller to continue to demonstrate sales and compliance competency through conducting regular loan interviews with customers.

The very significant reduction in new mortgage business levels at Northern Rock has resulted in a corresponding fall in the number of loan interviews being undertaken. As a result it has been impossible for the same number of staff to demonstrate and maintain competency under the T&C regime as before the drop in new business levels.

However, this does not impact on their job prospects either with Northern Rock or with other organisations. If any of these staff were to seek alternative employment, they would be able to sell regulated loan products subject to receiving training and supervision from their new employer. This is standard practice to meet FSA requirements and would be the case irrespective of their current adviser status with Northern Rock. They would also retain any relevant qualifications they had gained related to mortgage sales, such as the Certificate in Mortgage Advice and Practice (CeMAP).

I hope this clarifies the position.

*Ron Sandler*  
Chairman

*5 June 2008*

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