

HOUSE OF COMMONS
ORAL EVIDENCE
TAKEN BEFORE THE
TREASURY COMMITTEE

PROJECT VERDE

TUESDAY 18 JUNE 2013

ANTÓNIO HORTA-OSÓRIO and SIR WINFRIED BISCHOFF

Evidence heard in Public

Questions 1 - 133

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Oral Evidence

Taken before the Treasury Committee

on Tuesday 18 June 2013

Members present:

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

Examination of Witnesses

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

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

Sir Winfried Bischoff: No, it is not. What the board looked at was financial and the ability to execute. Those were the only two things that we looked at; no political.

Q2 Chair: There was no political pressure.

Sir Winfried Bischoff: No.

Q3 Chair: And no indirect contact via others.

Sir Winfried Bischoff: No direct contact either to me or, I think, to António. No, not that we are aware of.

Q4 Chair: Colleagues will come back to aspects of that question in more detail later, but I want to ask a second preliminary question to which both of you may have a response: how difficult is it to peel off part of a bank in order to satisfy, for example, these EU requirements?

Sir Winfried Bischoff: Perhaps I might start on that. There are obviously some technical aspects in relation to peeling off a bank because, whether you distribute it on an IPO basis or whether you do it on the basis of distribution to your shareholders, you have to produce a prospectus and you have to go back three years. To reconstruct that obviously takes some time, because it has to be a separation of the two. Secondly, in our case, that would be something that would need to be discussed both with the Government and with the Commission in that, in our case with a 40%, 38% shareholding, there would be two banks that would be owned 38% by the Government. Those are some overarching technical aspects, but

I think there are some other aspects that António can speak to in relation just to the banking side of it.

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

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

Q6 Chair: The reason I am raising this is that from time to time there are proposals for a multiple breakup of Lloyds, or a multiple breakup, in particular, of RBS. You are both well placed, having just been through the whole Verde process, to give us a view on the obstacles. Mr Horta-Osório, do you want to add anything?

António Horta-Osório: Yes, Chairman. Good morning, everyone.

I think it is a very interesting question. I can tell you that I have, for the last 20 years in different countries, merged banks, but have considered as well spinoffs, like in the case of Portugal where we had to buy a big bank and extract part of it in a complex deal. What I can tell you is it is much more difficult to spin off a bank than to merge a bank. The simple reason to understand is that when you acquire a new bank and you put it together, you always have the option of leaving the systems, and everything that the client doesn't see, separate. When you spin it off, you cannot, because you need to do a new entity, and therefore all the client approaches—in today's world, that is a multi-channel approach through branches, telephone, internet and mobile—have to be totally spun off from the existing bank in a way that customers do not have any disadvantage when it starts operating. That is a much more difficult process than merging two banks, where even if you change a branch, you can leave everything as it is; the client doesn't see it and you complete it over time. That is exactly the reason why you have in the UK, decades after certain mergers that have been done, still separate systems in those existing merged banks.

Q7 Chair: The question there was not to compare merger with separation, but to compare single separation—perhaps a good bank, bad bank split—with multiple separation. Could you answer that question?

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

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

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

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

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

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

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

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

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

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

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

Sir Winfried Bischoff: Sun Capital.

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

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

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

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

Sir Winfried Bischoff: Yes indeed; there was an execution risk in both.

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

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

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

Sir Winfried Bischoff: Yes, they were.

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

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

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

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

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

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

António Horta-Osório: As per our evidence submitted to you, I think the numbers are, firstly, very clear and compelling. NBNK's offer was £750 million, at the lower end, but they

wanted to retain £120 million for the breakup costs, so it came to £630 million. Co-op's offer was £350 million upfront, plus £100 million contribution to the breakup costs—£450 million—and £250 million more in terms of net present value from us for running their systems.

Q17 Mr Newmark: But to be paid over—

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

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

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

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

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

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

Mr Newmark: Okay.

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

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

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

Mr Newmark: I know, but with NBNK specifically—

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

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

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

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

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

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

Sir Winfried Bischoff: It would have been Antonio Lorenzo.

Q23 Mr Mudie: Who did he report to?

Sir Winfried Bischoff: António Horta-Osório.

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

Sir Winfried Bischoff: Six weeks.

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

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

Q25 Mr Mudie: Direct?

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

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

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

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

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

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

Sir Winfried Bischoff: Two.

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

Sir Winfried Bischoff: Yes, unanimously.

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

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

Q31 Mr Mudie: You know the document? Yes.

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

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

Sir Winfried Bischoff: I cannot recollect, quite honestly.

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

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

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

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

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

Sir Winfried Bischoff: No, I do not.

Mr Mudie: Do you not remember—

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

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

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

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

Sir Winfried Bischoff: We can confirm that.

Mr Mudie: Okay. Thank you.

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

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

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

Q37 Mr Ruffley: But was it a key demand of the Co-op?

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

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

António Horta-Osório: No.

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

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

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

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

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

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

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

António Horta-Osório: My answer to you would be that, in the course of my duties, I have periodic meetings with the regulators and with civil servants in which, for sure, over the last two years, the subject of the Co-op would have been raised. What I can assure you is that the board and the executive committee have always acted on the best interests of shareholders, obviously taking into consideration in this process the interest of stakeholders such as the employees and our customers.

Mr Ruffley: Sure.

António Horta-Osório: But, for sure, that has been debated in the many meetings that I have with civil servants or regulators.

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

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

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

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

Mr Ruffley: Sir Win, as Chairman—

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

António Horta-Osório: I would like to make two comments, Chairman, given that you are allowing me. I think it is very easy to guess football results on Monday. With the same hindsight, people are now saying we gave a too-generous deal to the Co-op. Using the same hindsight, I should also say that NBNK’s board should be very sorry that I offered 50% for controlling 5% of the UK retail banking market which now, 12 months later, is worth more than double in the market. Lloyds was floating at 40% of book value a year ago and we did

this deal for around 50% of book value. Lloyds is today quoting at one times book value. Therefore, with the hindsight of what happen in the market, I am sure the board is very sorry that it is not sitting on a very nice profit.

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

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

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

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

Mr Ruffley: But it is on the public record.

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

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

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

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

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

António Horta-Osório: Absolutely.

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

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

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

Sir Winfried Bischoff: Yes.

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

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

António Horta-Osório: Just to be precise for the record, as the chairman says, the total costs forecast at this moment of spinning off totally the TSB bank will be £1.6 billion pre-tax. The costs of doing that to the Co-operative Group, as we accepted publicly several times, would have been £1 billion after tax, so £1.3 billion approximately before tax. The additional cost of going to the IPO will be, as we said publicly as well, between £200 million and £300 million.

The costs of the failed bid, as the chairman just said, were minimal because we would have to build the bank in any case. In the case of the Co-operative Group, we would have had to build everything except for a treasury, because the Co-operative Group already had a treasury, and that is the majority of additional costs of £200 million to £300 million of doing the IPO—we have to build the treasury.

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

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

Q51 Jesse Norman: Sorry, just to be clear: you said if you sold it, it would cost £1.3 million gross.

António Horta-Osório: Sold it to the Co-op.

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

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

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

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

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

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

Q54 Jesse Norman: We can explore the reasons for that, but this is just to be clear about it. Okay, that is helpful.

How much did you pay the advisors on the failed bid?

Sir Winfried Bischoff: Sorry?

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

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

António Horta-Osório: I can tell you that in writing.

Q55 Jesse Norman: Was it tens of millions?

António Horta-Osório: No, it is a small amount. We can tell you in writing. I don't recall. If it was a big amount, I would recall.

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

Sir Winfried Bischoff: If I did receive it, I would have circulated it to the board.

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

Sir Winfried Bischoff: On the assumption that I did receive the letter. Obviously we looked at the Co-op bid in as critical a way as you would expect us to as against another bid. We found that the Co-op bid was, in fact, the superior bid in terms of the execution, despite what you have just read out. It had an existing banking licence; it had a rating. It is quite interesting that there is an assumption, or there is an assertion, that the Co-op was in fact not a credible financial institution. If you look at the way that the Co-op's bonds were traded, they were single A minus or triple B. The expected shortfall was in fact discovered by the market only between February and April 2013.

This was a highly respected institution. There may have been 50 people that NBNK has been able to identify. They were obviously not operating the market, because the market still valued this paper of the Co-op at exactly the same—or at certain times slightly inside—as our own paper. It was as highly regarded as our own paper or slightly outside and slightly inside the paper—i.e. better than Santander. The evidence of concern by the market, not by the 50 people who were mentioned by NBNK, became apparent only in February of this year and became, to some extent, apparent to us in December.

Q58 Jesse Norman: Let me just record my surprise that in the middle of a bid process with this coming—if it did come—to the board, it would not have made more of an

impact on you because, after all, it is posing fundamental questions to a process of due diligence in which you were thoroughly involved at that time. Can I just ask what due diligence you did perform on it, and whether at any point you felt that you were being misled about the Co-op's financial position?

Sir Winfried Bischoff: The due diligence that we performed was obviously together with the Co-op, and to the extent that the Co-op in fact was able to open its books to us. That was to some extent limited, because it is not a publicly-listed company, so we had to rely on the information that was given to us, and we relied on the view in the market and in rating agency terms, and from the regulator, as to the Co-op. The Co-op after all was—

Q59 Jesse Norman: They set up a room; they co-operated; they put tonnes of information into it.

Sir Winfried Bischoff: Yes, absolutely.

Jesse Norman: And your people went into it—

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

Q60 Jesse Norman: This is a shortfall in financing capability.

Sir Winfried Bischoff: No, in capital terms.

Q61 Jesse Norman: So they did give you access to some form of information about the state of their balance sheet?

Sir Winfried Bischoff: Yes.

António Horta-Osório: Yes. The reason why we had doubts, at that moment in time, of their capability, as the chairman says—

Sir Winfried Bischoff: In December 2012.

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

Q62 Jesse Norman: That would potentially also have imperilled your view of the capability of the Co-op to meet the downstream commitments made in its offer as well?

António Horta-Osório: No, not necessarily, I am sorry, because one thing is the capital capability of acquiring something. The other is their operating profitability and the capacity of making payments throughout—

Q63 Jesse Norman: You were worried only about the capital side.

António Horta-Osório: We had the first indication that the previous plan they had given us had changed materially in December 2012.

Q64 Chair: We are seekers after truth here, and we are getting some very interesting replies. None of us has any reason to doubt anything that you have said, but there will be quite a bit of documentation that can support a number of the points that you have made. I think it

might be helpful if you could take a look at some of the documentation that was prepared in the context of the due diligence to see what could be put to the Committee in the public domain. A good deal of it will not be capable of being put into the public domain, in which case we might try and think through some arrangement for those papers. Perhaps someone on our behalf can take a look at them and report back to the Committee, but we will put thought to that.

I just want to follow up one point very quickly. You said, basically, that you had discovered there might be a hole in the balance sheet of the Co-op in December 2012, to cut a long story short. Correct?

António Horta-Osório: Yes, a shortfall.

Q65 Chair: What did you do about that?

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

Chair: No, you spotted it.

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

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

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

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

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

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

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

Q69 Chair: And you believed them.

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

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

Sir Winfried Bischoff: No, not at that stage. Again, I think it is worth remembering, Chairman, that the market also basically still—in December and January—took a positive view. The market began to worry about the Co-op at the end of February, and then there

came a downgrade. We were aware that there was a shortfall. We did not know, in fact, how the other business might be affected by it systemically.

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

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

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

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

António Horta-Osório: No.

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

Sir Winfried Bischoff: Before the announcement—

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

Sir Winfried Bischoff: Yes, we had done due diligence. We had looked at combined plans—what it would in fact look like, obviously. We had discussed with the FSA because it would have had an impact on our own position. There were discussions with the regulator, and they will have had discussion with the regulator also.

Q74 Mark Garnier: Let me come back to the Chairman's point: was any wool pulled over your eyes by anybody? The regulator presumably would have had a pretty clear idea of what the balance sheet of Co-op looked like.

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

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

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

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

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

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

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

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

Sir Winfried Bischoff: No, approved.

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

Sir Winfried Bischoff: I suspect the regulator may have also been doing its own due diligence. It did not approve the deal; it looked at the deal. I don’t know to what extent the regulator, or when the regulator, will have become aware of these matters, because the Co-op had their own regulator. Inside the FSA, as it was then, we had our regulatory team; they had their regulatory team. There were Chinese walls between those two teams.

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

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

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

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

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

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

Q83 Mark Garnier: The reason I am asking these questions is there is a picture emerging of how due diligence is carried out and that a huge amount of credibility is given to bond yields, for example, of what the market is saying. These are almost a smell test of the market. You have the rating agencies that we all hate, as you know. We beat them up

regularly here and I am sure they will come back again. We will have another go at them and that will be good. The regulator should be having a good “under the bonnet” look at all of these organisations and they did not seem to pick it up at the time.

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

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

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

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

Q85 Mark Garnier: To a certain extent where I am heading with this one is the terms of the deal that you came up with, which is that potentially you were going to be underwriting this perpetual bond that was going to be issued by Co-op to pay for the rollover bit. I just want to be clear about this. Is this underwriting the issuance of the bond, or underwriting the bond in perpetuity?

Sir Winifred Bischoff: Underwriting the issuance of the bond, which would have been sold to the—

Mark Garnier: So once it has gone—

Sir Winifred Bischoff: We would receive cash for it, yes.

Q86 Mark Garnier: Nonetheless, you were taking on quite a lot of risk on this. You had quite a lot of eggs in that one basket. If you had underwritten this deal in order to finance the sale of the thing and the deal did not go through, you would be wearing, what, £400 million-worth of virtual bonds?

António Horta-Osório: £350 million.

Mark Garnier: £350 million. What is £50 million among friends? It is a lot of money to be holding on to, isn't it? It is quite a big commitment financially that you guys have made, in terms of a lot of different things, and yet there seems to be a huge amount that has fallen down on the due diligence. This is the slightly alarming thing at so many levels.

Sir Winfried Bischoff: I think there is a risk, but we would not have reached this stage, of course, of underwriting if the position of the Co-op as an entity that was capable of buying the Verde disposal would not have been approved. It would only have been done on an approved basis. It was only a question as to whether there was sufficient market appetite and, from what we had seen of other issues that the Co-op Group had done, there was sufficient market appetite. But it would not have gone ahead, of course, if it had not been approved by the FSA and if it had not been approved by our Board. This was an agreement in principle.

Q87 Mark Garnier: As a model of due diligence in doing a deal, do you think this was a good example or a bad example of due diligence, looking at it holistically from the regulatory point of view all the way through to just going through the books?

Sir Winfried Bischoff: The iterative process was good. Was it as clear until December to us that there might be a shortfall? No, but there was no withholding of information. The

modelling was done entirely appropriately. The Co-op looked in reasonable shape, but obviously, once it had looked at its own position and then come up with a revised plan, that caused us some concern.

António Horta-Osório: Mr Garnier, I think that your points are fair and legitimate. We were surprised in December to see that suddenly there was a shortfall in capital, no doubt. We did not share the view that the economy was worsening. I have said publicly several times that I think this is a long and difficult recovery, but that the UK is slowly recovering. We were surprised. We obviously shared that immediately with our counterparty, the Co-operative Group, and had answers that in a sense made us decide to give them more time, because we had still three months until March, which was reaching the deadline and, as I said to the Chairman, because we had to build the bank in any case.

Of course we were not happy with it, as you can imagine. We shared with the regulator as well. In July, as the chairman said, there was no information whatsoever—and the due diligence was properly done—that there was any problem; so this was in December—six months later. As you say, we would obviously have preferred to have a solution of financing that would not incur so many potential risks for us—you are absolutely right—but you have to bear in mind that this was a punitive action from the European Union.

We had a tight deadline to meet by 13 November this year and, should we not meet that deadline, having shown that we had done all our best efforts to have this deal done, the EU might do it themselves at any cost. We have always acted in the best interests of Lloyds shareholders, as I said at the beginning, taking into consideration the stakeholders such as customers and the employees, but this was not a deal that we wanted to do ourselves. We were mandated to do this as a punitive action and our fiduciary duty was to execute it with the least cost for Lloyds shareholders. That was why we had to take certain risks, such as the one you mention, which is absolutely fair, but we absolutely believe that at every point in time we were acting in the best interests of Lloyds shareholders.

Q88 John Mann: Why did Neville Richardson resign?

António Horta-Osório: I have no information about that; I can't answer you. He was on the Co-op? You are speaking about a Co-operative Group employee, right?

John Mann: Yes.

António Horta-Osório: We have no idea.

Q89 John Mann: It is just that when he resigned he described his reason as being lukewarm towards this deal, and he was the chief executive of Co-op Financial Services in July 2011, but your answer is sufficient on that. Thank you.

Which Government Ministers did you meet or discuss this issue with by telephone and how often?

Sir Winfried Bischoff: I with none.

António Horta-Osório: As I said in my previous answer to Mr Ruffley, in the normal course of my duties, I have spoken several times with different officials and different Ministers, and, in the course of those discussions, for sure, the Co-operative Group has been raised.

Q90 John Mann: Which particular Ministers?

António Horta-Osório: In the course of my normal meetings, I always meet the Treasury Secretary. I meet civil servants in the Treasury and I also meet sometimes the Chancellor.

Q91 John Mann: The City Minister at the time was Minister Mark Hoban. How often did you discuss this issue with him?

António Horta-Osório: I normally met Mr Hoban every four months, so three times a year.

John Mann: Three times a year.

António Horta-Osório: Yes, and in the course of those discussions for sure I have discussed this with him, as I discussed many other matters.

Q92 John Mann: So three times a year you discussed this with Mr Hoban when he was in post.

António Horta-Osório: Not necessarily.

Q93 John Mann: Up to three times a year.

António Horta-Osório: Not necessarily.

Q94 John Mann: More than three times a year.

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

Q95 John Mann: Obviously. Other than those fixed meetings, have there been any other meetings or discussions with Government Ministers in relation to this deal?

António Horta-Osório: I am sure that, in the course of these two years, I have had phone conversations with Government Ministers that have included discussions about how the Co-operative deal was going, for sure.

Q96 John Mann: How often?

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

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

Q97 John Mann: Would any of your other employees or representatives, such as the two financial advisers that you raised, have any meetings or discussions with Government Ministers on this deal—that would include Mr Lorenzo and Mr Rougier?

António Horta-Osório: I think our financial advisers, it is highly unlikely. We may check but I will tell you—

Sir Winfried Bischoff: We can check.

António Horta-Osório: I will tell you no, subject just to checking. In terms of Toby Rougier, our corporate development director, or Antonio Lorenzo, it is possible, like in my case, that at their level they have had discussions with Government Ministers or civil servants. It is possible.

Q98 John Mann: And they would report back in if they meet a Government Minister to discuss this deal.

António Horta-Osório: Yes, of course; they would report to me and to the chairman of the board, yes.

Q99 John Mann: So all Government communication of any kind in relation to this deal would be directed to yourself.

António Horta-Osório: I think it would be directed either to me or to the chairman, as we just said.

Q100 John Mann: Were there any exchanges of correspondence or e-mails from Government Ministers specifically on this deal?

António Horta-Osório: Not that I can recall.

Sir Winfried Bischoff: Not that I can recall.

Q101 John Mann: Would this be the case with direct representatives of Government Ministers as well—someone acting on their behalf?

António Horta-Osório: Not that I recall. As I told you, what I can recall is it would be more in the sense of briefing or answering questions in the course of normal meetings, not specifically about this deal. I don't recall any e-mails from Government Ministers or civil servants on this specific deal. I can check, but I don't recall.

Q102 John Mann: What you are saying is there were a very limited and minimal number of exchanges with Government Ministers—purely in passing—in relation to this deal.

António Horta-Osório: What I would say, Mr Mann, is that I do not have any recollection that my exchanges with Government Ministers or civil servants on this matter have been different from what would be normal on important matters relating to Lloyds, which has a 39% taxpayer stake.

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

António Horta-Osório: I think it is publicly well known that Government Ministers saw favourably the mutual model, and therefore the Co-op, as a destination for Lloyds' branches.

Q104 John Mann: So they expressed their preference for the mutual deal.

António Horta-Osório: No. Given that we thought at the board unanimously that, both on financial grounds and the execution risk, the Co-operative's bid was better, Government Ministers, in those briefings and those conversations, expressed that they liked the mutual model, and that they agreed and saw Co-op as a good destination for Lloyds' branches. But that was given our decision—

Chair: Could Sir Win just come in on that point? Sorry to interrupt, John.

Sir Winfried Bischoff: Yes, because I think you mentioned preference. There was no preference expressed to us. In fact, when we told them that we had unanimously decided that it was the Co-op, they said that they were pleased that it had gone that way, but they had no preference whatsoever. There was no preference expressed to us by Government Ministers.

Q105 John Mann: Well, you are saying different things. Mr Horta-Osório, you are saying that their view in preference towards a mutual model was well known and, indeed, is public. When did they first know? What was the date they first knew of your preference for the Co-op as opposed to other bidders?

Sir Winfried Bischoff: It would have been just before 14 December 2011.

Q106 John Mann: Before that, did they express any views in relation to the mutual model and Government policy in relation to it?

António Horta-Osório: Not to me, Mr Mann.

Sir Winfried Bischoff: Nor to me.

Q107 John Mann: To any of your employees or advisers involved.

António Horta-Osório: Not that I am aware of.

Q108 John Mann: And afterwards they did.

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

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

António Horta-Osório: Yes.

Q110 John Mann: So what impact did the Government view—regularly express to you on their preference for the mutual model in line with Government policy—have over the due diligence process that you carried out after December 2011?

António Horta-Osório: Mr Mann, as I told you, none. The best evidence I think that it was none was that the board had decided, in March 2012, to readmit NBNK to join again the Co-op and make a second bid. As you know, in March, the NBNK wrote to us and said, “We want to improve our bid and we think it is in the best interests of Lloyds shareholders that we are readmitted into the process”. The board decided to readmit NBNK into the process because, as I told you before, we thought it was in the best interests of our shareholders. I think that is absolute evidence of the good faith in this process because NBNK were readmitted into the process, given they told us they would improve their offer in March versus what they had presented in December, and also because Co-op took more time in that process than we were led to believe in December. NBNK was readmitted to the process. As you can see, there was no obvious pressure for us, because it would be contrary to what you just asked.

Q111 John Mann: Sure. Two more questions on this. Am I right then to presume that there are no notes of discussions or e-mails from Government Ministers that might in any way embarrass them in the light of events?

António Horta-Osório: I would think so. I would think that you are right in saying that, but I cannot check all my notes one by one. I am absolutely clear, as I told you, that we acted on what we thought in each moment in time was in the best interests of Lloyds shareholders, taking into consideration also stakeholders such as the customers and our employees.

Q112 John Mann: While you are here, because you sent us a letter on PPI, you described mis-selling PPI as unacceptable, but it does appear that you have been trying to avoid paying full and proper compensation. Is that behaviour unacceptable?

António Horta-Osório: Mr Mann, as I have said many times, including in this Committee, PPI was totally unacceptable. We took the lead in breaking ranks in starting to compensate our customers on what became one of the biggest scandals of this country. We did absolutely the right thing. That does not mean, like in real life, that you get 10 out of 10 right. So if we had things wrong, we immediately tried to redress them and, as I wrote to you, we ourselves detected these problems in the beginning of the year and had already taken action before they became public.

Chair: We are not going to prolong that discussion because we are on Verde today. Is there anything else you want to ask, John, on Verde?

John Mann: No, I have the answers. Thank you.

Chair: Great. Thanks very much.

Q113 John Thurso: Can I go back to the question of the regulators just briefly, because I think what you have broadly said to my colleagues is that at no point were the regulators questioning the ability of the Co-op to complete the deal until it was pretty well public knowledge in March 2013. During 2011 and 2012, there was no suggestion from the regulators that the Co-operative may not be able to—

Sir Winfried Bischoff: Could I just say that the regulator always told us that the deal needed to be approved, and they had not approved it, so there were risks attached to both sides—NBNK and the Co-op.

Q114 John Thurso: But that would not be construed as there being a problem; it would be construed as a prudent regulator pointing out that, until the ink is dry, it is not a done deal.

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

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

António Horta-Osório: That is absolutely correct.

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

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

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

Q116 John Thurso: No. Thank you very much.

Can I turn to another question about how you discussed this with shareholders? What sort of dialogue did you have with the institutional shareholders during the course of the Verde talks?

António Horta-Osório: Shall I answer?

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

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

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

António Horta-Osório: Yes.

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

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

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

António Horta-Osório: Yes, that is correct.

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

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

Sir Winfried Bischoff: December or early January.

António Horta-Osório: Yes.

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

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

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

with UKFI that may have been an enhanced discussion over what you might have had with other shareholders.

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

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

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

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

António Horta-Osório: Absolutely.

John Thurso: You were operating on the basis of a comparison between plan B, which as you now say will give you twice the value as it would have done a year ago, there or thereabouts. You are saying, “If we don’t do a deal with anybody on Verde, we have plan B,” which is to float it separately or deal with it separately.”

Sir Winfried Bischoff: That was the intention. Obviously the European Commission would still need to approve a plan B, but it would have wanted us to see that we had made the very best effort that we could to sell to an entity, although plan B was something it was aware of. It has not been approved yet, but it is aware of it.

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

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

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

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

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

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

John Thurso: Thank you.

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

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

Mr Love: Yes.

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

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

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

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

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

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

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

António Horta-Osório: As the chairman said before, I seriously contested that because, as you can see from the process that we submitted to you, NBNK were able to make five bids to us. After the Co-operative was chosen initially in December 2011 by the board,

they said they would improve their offer. We readmitted them into the process. Their offer in the end was not substantially better and they lost, as the chairman just said, in terms of the competitive bidding. It was absolutely in the interests of Lloyds shareholders to have the best bid and we chose the best bid. My only conclusion, as I said before, is that NBNK should have offered the better price, which in my view was absolutely compatible with the fact that we were selling 5% of the UK retail market, no legacy issues and a strong bank, fully funded with a loan-to-deposit ratio of 100%. I don't understand why NBNK decided that it did not deserve a better price or a control premium, but that is up to them to answer, I think, to you and to their shareholders.

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

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

Sir Winfried Bischoff: Yes.

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

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

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

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

Q133 Chair: We have had a very interesting exchange and we have picked up a lot of information. I think it would be helpful to have quite a bit of it supported in documentation, particularly on the due diligence, on the alleged degree of political involvement and on the exposure of the hole in the Co-op's accounts and what was done about it, and we can discuss this at staff level outside this hearing.

I think you came in with a large chart, Mr Horta-Osório. I am sure there must have been a question that we should have asked in order to elicit this, so perhaps you would like to tell us what it is.

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

Chair: Thank you very much indeed for that brief explanation, which we have all appreciated, and thank you for coming to give evidence today. We may need further

information; we will see. We have a number of other people and lines of inquiry we want to pursue. Thank you very much indeed.