

HOUSE OF COMMONS
ORAL EVIDENCE
TAKEN BEFORE THE
TREASURY COMMITTEE

PROJECT VERDE

TUESDAY 3 DECEMBER 2013

ANDREW WALKER, WARREN MEAD and JONATHAN HURST

TIM WISE and CONOR HILLERY

Evidence heard in Public

Questions 1094 - 1313

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Oral Evidence

Taken before the Treasury Committee

on Tuesday 3 December 2013

Members present:

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

Examination of Witnesses

Witnesses: **Andrew Walker**, Partner, KPMG, **Warren Mead**, Partner, Financial Services, Transactions & Restructuring, KPMG, and **Jonathan Hurst**, Partner, KPMG, gave evidence.

Q1094 Chair: Thank you very much for coming in to give evidence today. Could you tell us what was KPMG's role in advising on the Britannia merger?

Andrew Walker: Yes, I can. Our role was to perform work in 10 key risk areas. Those key risk areas were defined for us by the bank. We then subsequently went on to agree on more key risk areas where we looked at some further commonality of deposit account customers between Co-op Bank and Britannia, and we did some work on capital forecasts, which I think you have seen.

Q1095 Chair: Yes. How much were you paid, and how was your remuneration structured?

Andrew Walker: Our remuneration was a time-based remuneration, and for the due diligence it was—

Q1096 Chair: So you had no interest in the outcome of the deal?

Andrew Walker: None whatsoever, no. It was £841,000 for the due diligence work.

Q1097 Chair: Were there other things in the offing?

Andrew Walker: We did other pieces of advisory work, and I think the Committee has seen some of those reports. Those were all part of the transaction.

Q1098 Chair: What was the total remuneration to KPMG as a consequence of this deal and the associated work?

Andrew Walker: About £1.3 million.

Q1099 Chair: In a key piece of work you did on what is called Project Vintage Phase II—you will know exactly what I am referring to—you have said, "The capital position of the

merged group should not be compromised either at day one of the merger or going forward as the adjustments unwind”. Do you regret saying that, given what we now know?

Andrew Walker: No, I don’t regret that. If I could spell it out, I think you have taken it—

Q1100 Chair: Do you think that is right?

Andrew Walker: At the time it was right.

Q1101 Chair: Yes, but you were not only talking about it at the time. You were talking about it going forward as the adjustments unwind.

Andrew Walker: In the capital projections report, which I think you are referring to, we were asked to examine certain parts of that report. Our role in that process was not to look at the underlying plans that were being put together by the bank. It was more to translate the plans that had been put together into what the capital position of the bank would be going forward on a combined basis, taking into account fair value adjustments and due diligence findings. From that exercise we could see that the bank was in excess of its capital requirements. Those have been discussed by the bank on numerous occasions, I believe, with the FSA during the process, and so our report was referring to that factual comment—that the bank remained above those headrooms in those circumstances.

Q1102 Chair: So it wasn’t a statement about the robustness of the deal as a whole.

Andrew Walker: No. It was for management to make that decision about the deal as a whole. Our role related to limited due diligence in those risk areas.

Q1103 Chair: Still, do you feel, looking at that due diligence now, that you wish you had done it differently?

Andrew Walker: No, I do not. We have looked back, as you would imagine in the circumstances. We have considered the due diligence carefully. I have asked other transaction services partners in KPMG—Mr Mead, to my right, did that exercise for me as well—and we concluded that it was a thorough piece of work. I think you have heard from other members of the support team who were there at the time who have referred to it as a value added piece of work.

Q1104 Chair: My last question to you before I pass examination over to Mark Garnier is whether you could perhaps just explain what the scope of the responsibility and the limits of responsibility really are for a firm such as yourselves in a major transaction such as this. To give a bit more substance to that question, it is not just technically, is it, that the responsibility for the decision lies with the board? It is in a very real sense their job to make sure they are capable of understanding the numbers that are being put in front of them. Am I right in thinking—I am half answering your question, but if I get it wrong I want you to correct me very rigorously—that your primary role is to make sure that the numbers in front of the board are correct, inasmuch as they can be made correct at the time of their being put together?

Andrew Walker: To an extent. Our primary role is to work to the key risk areas that we identified with management at the start of the deal and to seek out information from the target company in relation to that information, to challenge it, to look upon it sceptically and raise warning signals to the acquirer, which I believe is what we did on Britannia.

Q1105 Chair: Are you saying that the board ignored the warning signals?

Andrew Walker: No, I would not agree with that.

Q1106 Chair: Would you have done this deal if you had been the board?

Andrew Walker: I am not the board, so I don't think it is my position. My position was to advise the board.

Q1107 Chair: A tough question, I agree—the sort of question you find yourself having to answer at the Treasury Select Committee that you don't have to answer in the run of life. Have a go at answering it.

Andrew Walker: Mr Chairman, I don't, in that circumstance, and it would be normal when we are doing due diligence, but in that case I did not see all the facts and circumstances that were laid out to the board in relation to that transaction. I did part of the due diligence in certain risk areas and reported on those to the board.

Q1108 Chair: But you got to know a lot about this deal. You were one of the people who knew a very great deal about this deal and were in a very good position to form assessments of this type. I am just asking you in all frankness, given the huge amount of information that you would have acquired—that you did acquire—at this time, whether you would have done this deal if you had been the board.

Andrew Walker: What I can say to you, Mr Chairman, is that looking back, I believe that the board was asking the right questions in terms of the risks. The risks that they asked us to look at were the right ones. From that piece of information I believe that they had the right level of information to make an informed decision on the risks available in the deal. But as I stress, there were other parts to the due diligence that was done, for example legal due diligence, that I didn't play a role in, that would also inform their decision. So there are several other key things in the whole decision that I don't see.

Chair: That is very helpful.

Q1109 Mark Garnier: Mr Walker, can I carry on with this but with some rather wide-ranging questions on your opinion of the management board? You made a very important point, which was that the evidence you presented to the board gave a lot of detail so that they were in a position to be able to assess the risk. Do you think the board collectively was able, or had the skill to be able, to assess the risk?

Andrew Walker: I reported more extensively to the audit committee, to be precise. There were joint audit committees of the banking group board and the Co-operative Group audit committee. I had most of my time in front of that committee, not so much in front of the board. If I could pass comment more from the context of my role as the audit partner after 2009, I took comfort from the fact that the board, which is a board of a regulated plc entity, had a significant degree of experience on it, including financial services experience. When I look back I can see that of the 26 directors who have been in post since 2009 on the bank board, 18 of those have financial sector experience.

Q1110 Mark Garnier: Does it not strike you as extraordinary that when you look at the current make-up of the board, of the 15 executive and non-executive directors of the Co-operative Bank only three of them have been in the institution since before the beginning of this year? What does that tell you about the previous experience collectively of the board and the fact that there seems to have been a major shake-up from the previous position to the current position?

Andrew Walker: From my position as auditor, I take comfort from the board as a whole. The board as a whole is an important part—

Q1111 Mark Garnier: I am pressing you to make, rather than a quantitative judgment, which is obviously what your job entails, a qualitative judgment. It is very important. The reason I am pressing you on this is that if you look at the two transactions together, the Co-operative Bank was increasing tenfold in size from pre-Britannia to post-Verde, if Verde had gone through. You will have read all the lurid headlines in the press—it isn't just one individual, and I think that to a certain extent, in what we are talking about, that is rather irrelevant to the bigger-picture stuff. The bigger stuff is that you have some questionable expertise on the board. You have a lot of evidence that, for example, with the Project Verde deal two deputy chairmen of Co-operative Bank were appointed, who were insisted on by the regulator, who seemed to say that the Verde deal was a bad idea, yet it went ahead. What I am trying to get a flavour of you from you is—and please, Mr Hurst and Mr Mead, do leap in if you feel you want to join in this qualitative judgment on your client—whether they are actually capable of understanding collectively what you are saying and coming to a rational, sensible decision as to the future of this significant institution.

Andrew Walker: If I answer first, I can then pass over to my colleagues. I am sure they will have some thoughts on this. Whenever I attended the board in my role as auditor, yes, I did get the impression that they collectively were asking the right questions and they were aware of the issues.

Q1112 Mark Garnier: Yet in the Verde deal, those who seemed to have, by the regulator's understanding, significant experience in financial services, and who the regulator had asked to be appointed, Davies and Baker-Bates, voted against the Verde transaction, and yet the board voted in favour of the Verde transaction. It does not create an image of a board that collectively knows what it is talking about.

Warren Mead: If I may comment in relation to Project Verde, I was involved primarily in the independent assurance work that ran from October through to March 2013 and attended four or five boards during that period, and I felt the quality of debate was very good. The board were asking lots of very sensible questions, and when I explained some of the risks that we identified in Project Verde, they understood them, took them on board and set the executive management the challenge of dealing with and mitigating those risks.

Q1113 Mark Garnier: What was the relationship between the board and the executive management, in your opinion? Was it a healthy relationship?

Warren Mead: I observed that from a limited capacity but, yes, it was a good relationship, one of mutual respect and challenge.

Jonathan Hurst: If I could comment very briefly, Mr Garnier, I would have had visibility at audit committees of the bank, not at the board, and those audit committees would have non-executive directors and management present. They were very open meetings, with never any flavour of items either being suppressed or people's opinions being discarded. They were genuinely very open meetings with a sharing of views.

Q1114 Mark Garnier: Yet in the run-up to Verde there were questions about the fact that holes in management expertise had been allowed to build up in anticipation of new management coming in had the Verde transaction gone ahead. That is not a healthy position for a bank to be in, is it?

Andrew Walker: From the point of view of the audit—we reported to the audit committee since 2011, effectively, when a number of projects were in train and Verde came in on the stream as well—the management of the bank was under-stretched, and that was a key risk that we highlighted to the audit committee.

Q1115 Mark Garnier: You are talking about your clients, and I appreciate that you can't necessarily reveal everything you think about it, but nonetheless absolutely crucial to this is that prior to the Britannia transaction this was a reasonably healthy bank. It now has a £1.5 billion hole in its balance sheet and lost £600 million in the last accounts. That is a pretty sorry state of affairs. There must have been something fundamentally going wrong, and there are a lot more technical questions and detailed questions about this, but what I am trying to do is extract from you whether you thought the management—this is the fundamental point—was up to the job. Possibly going beyond that is the question whether you thought the process for the appointment of the non-executive director within the Co-operative Group was a fair process or a very opaque process that resulted in not necessarily the right people. If you look at the Co-op Group board, you had plasterers and botanists in a strategic position overseeing a high street bank, ultimately in a controlling position. That clearly is not a brilliant bit of management of expertise.

I come back to the fundamental point: it is an institution that was in good condition in 2008, let's say, having survived a pretty stressed time. It took some very interesting decisions about trying to increase its size tenfold during a period of severe stress for the banking industry, which has resulted in the thing blowing up. What culpability or what guilt does the management have in terms of being incompetent, Mr Hurst?

Jonathan Hurst: Can I clarify that you are referring specifically to the banking group?

Mark Garnier: Absolutely, yes.

Jonathan Hurst: My own view is that there were a number of interim management members as part of the team, and that is something that we brought to the attention of the board and the audit committee, because in those circumstances I think it is sometimes more difficult to get what I would call a proper team balance when there are a number of interims. In terms of those members of management who were permanent, I would support what Mr Walker has said. There is nothing what we saw—

Mark Garnier: In terms of the executive or non-executive management?

Jonathan Hurst: This is in terms of the executive management, I am sorry.

Q1116 Mark Garnier: What you are saying is that collectively, the board has appointed the right people, where they can, on permanent contracts, on to the executive management team.

Jonathan Hurst: That would be my view of the banking board at the time of the Britannia transaction. I think when the Verde transaction started to take place—and I suspect we will move on to that later in proceedings—that was going to create, and excuse my language, a very different animal. It was much more complicated. It was a significant carve-out, and in those circumstances quite rightly the board was looking at what its collective skills needed to be at both non-executive and management level.

Q1117 Mark Garnier: You referred to the executive management at around the time of Britannia, but what about the non-executive directors? They are the ones who were part of this decision. Were they up to the job of making a rational, educated and informed decision?

Jonathan Hurst: On Britannia?

Mark Garnier: On both, all the way through.

Andrew Walker: If I could comment on Britannia, because I observed part of that process. As I said, I went to the combined audit committees, and in particular the banking group audit committee was chaired by a very experienced non-executive director and had other FS-experienced, financial-experienced non-executives on the audit committee. I think that they had a full grasp of the issues we were talking to them about.

Q1118 Mark Garnier: Mr Hurst, you specifically talked about the executive directors. Specifically, what did you think of the non-directors, notwithstanding what Mr Walker has just said?

Jonathan Hurst: I would concur with Mr Walker's view. In fact, I think the combined board after the merger took the best of the best, so it was able to bring in some of the non-executive directors who came with Britannia and supplemented that with those of the Co-operative Group banking board.

Q1119 Mark Garnier: What about prior to the merger, the ones who were making the decision as to whether to go ahead with the merger?

Jonathan Hurst: There was nothing that I observed that would have made me particularly concerned about their behaviour or their decision making.

Q1120 Mark Garnier: I am trying to work out if you are covering up your true feelings or whether that genuinely is your true feeling. Can you confidently say, hand on heart, that you thought that the management of the Co-op Bank, prior to the Britannia transaction, were sound, intelligent, knew what they were talking about and were in a perfectly reasonable position to be able to read a document such as this, which is quite a substantial document, and fully understand it and come to a proper decision?

Jonathan Hurst: I will give you a very clear answer of yes to that.

Q1121 Chair: It didn't take us very long to discover that one of the people who was on the board was not up to it—admittedly later, but it didn't take us very long—but you didn't get any sense of any difficulties?

Jonathan Hurst: Are you referring to the Reverend Flowers?

Chair: Yes.

Jonathan Hurst: Clearly we were aware that he was not a banking expert, Chairman, and aware that his experience was in controlling boards. Was there anything that had been brought to my attention—and obviously we have debated this—or the attention of any of my colleagues in relation to any of the subsequently alleged behaviour? Absolutely not.

Q1122 Andrea Leadsom: Good morning. £1.3 million is quite a significant fee. Mr Walker, was any part of that in any way dependent on a positive outcome to the transaction?

Andrew Walker: No.

Q1123 Andrea Leadsom: It was presumably a very good deal for you to win. Was it material at that time during the financial crisis, when presumably business was thin on the ground? Were you particularly competitive? Would you say it is a normal price for a due diligence of that nature?

Andrew Walker: Yes, absolutely. We feel it was a fair price, and the bank felt the same. Co-op Bank for us is a relatively small part of a national financial services practice that we have, so it was not absolutely crucial that we won the piece of work either, but we were very pleased to do so.

Q1124 Andrea Leadsom: But it was a competitive price for that sort of piece of work, was it?

Andrew Walker: Yes.

Q1125 Andrea Leadsom: Did you at any point during your due diligence question the timing, as by the time of that merger it was known that we were in the throes of perhaps

the biggest financial crisis ever? Did you make any recommendations to the board about the fact that this was a very uncertain time to be doing a transaction of this nature?

Andrew Walker: Yes, I think we did. We highlighted in our report warnings in connection with rising arrears in the non-conforming mortgage book of Britannia. We highlighted a number of treasury assets of about £100 million to weak counterparties such as Lehmans at the time and we highlighted some of the risks inherent in the securitisation structure that Britannia had that could trigger defaults in the securitisation structure. All of those are very much connected to the circumstances at the time.

Q1126 Andrea Leadsom: Did you at any point discuss with other partners or colleagues within KPMG concerns that you had about the transaction?

Andrew Walker: All our work in circumstances like that is reviewed by a second partner, who we call a concurring partner, who would have reviewed that work.

Q1127 Andrea Leadsom: In discussing with that other partner, did you express concerns about the transaction? Did you express personal concerns about it to that other partner?

Andrew Walker: About whether it should go ahead or not?

Andrea Leadsom: Yes.

Andrew Walker: As I explained earlier, it was not my role to do that within the transactions.

Q1128 Andrea Leadsom: No, I understand. Obviously you have reputation risk and so on, and I am sure with hindsight you probably wish you had strongly come out and advised against it, but I am asking you whether, at the time, within KPMG, you expressed reservations to colleagues?

Andrew Walker: At the time the discussion that we had internally was around, were we pointing out the right risk factors in our report? The answer was yes.

Q1129 Andrea Leadsom: If we were to ask for it, would we find that there was a minute of a meeting within KPMG expressing reservations, or would we not find that?

Andrew Walker: No, there would be none. We didn't ask ourselves that question because it was not within the scope of our work.

Q1130 Andrea Leadsom: You undertook due diligence in 10 areas for the Co-op.

Andrew Walker: That is correct.

Andrea Leadsom: Are you able to tell us what those 10 areas are?

Andrew Walker: I have a list, if you would allow me to just turn to that list.

Andrea Leadsom: If you have a list, then it probably does not need reading out. I was more interested to know whether you could actually recall the 10 areas than read them from a list. I am quite sure you can read them from a list.

Andrew Walker: Broadly, it was impairment of the loans and advances position. It was treasury assets. We looked at fair value in about four or five different areas—the fair value framework that was put in place to fair value those assets and liabilities—so that would account for about four of them. Taxation, pensions, securitisation—I am just looking to see if I have missed any—underlying earnings of the bank and the fair value of the consideration for the deal, which was an imputed consideration where you have a merger of mutuals. As I said, subsequently we added to that one other area, where we looked at the commonality of the savings customers between Britannia and Co-op.

Q1131 Andrea Leadsom: Specifically what recommendations did you make to the board about impairments and also off balance sheet transactions?

Andrew Walker: I can't recall any about off balance sheet transactions. A considerable part of the report was in connection with the securitisations that Britannia had at the time and Co-op did not do securitisations. That was of particular relevance to them and value to them.

Q1132 Andrea Leadsom: What recommendations did you make on securitisations?

Andrew Walker: Our role was to highlight where we felt that there were key risk areas in the securitisations and give an explanation of how securitisations worked in practice.

Q1133 Andrea Leadsom: Did you highlight securitisation off Britannia's balance sheet as a key risk to the Co-op board?

Andrew Walker: To be clear, it was not an off-balance-sheet transaction. The loans and advances, the subject of the securitisations, are on balance sheet.

Q1134 Andrea Leadsom: But the mortgages are effectively part of the securitisation. What recommendations did you make to the board about the securitised portfolio?

Andrew Walker: We highlighted areas where in particular one or maybe two of the securitisation vehicles, the more recent ones, were more at risk of triggering default or ratings downgrades, and we highlighted those issues and the implications of those to Co-op.

Q1135 Andrea Leadsom: What did you feel the implications of those greater-risk areas were?

Andrew Walker: The potential implication of triggering or hitting a trigger in a securitisation is that ultimately the whole securitisation has to be unwound and the proceeds of the securitisation financing repaid from the proceeds of the mortgage pools. That has not happened, but it was a risk that we pointed out.

Q1136 Andrea Leadsom: What about your recommendations on impairments?

Andrew Walker: I am particularly talking about the non-conforming part of the Britannia mortgage book, which was about £10 billion. We could see in that that arrears were increasing throughout 2008, which in the circumstances that you refer to was not wholly surprising. But we also did some very high-level projections of that looking forward, where we saw additional impairment risk from that portfolio to what Britannia was seeing at the time. We highlighted that to Co-op in our report, and that was factored into the fair values that were subsequently made.

Q1137 Andrea Leadsom: If you were to give us perhaps your top three concerns highlighted to Co-op, what were they?

Andrew Walker: The top three would be the impairment one that I have just highlighted, the treasury assets and the securitisation areas. There were several other recommendations as well. The other thing I would say about the work that we did is that we did not do due diligence on the corporate part of the Britannia book because we were not given the access during the time. We recommended that that should be done as part of phase II.

Q1138 Andrea Leadsom: Are you aware that that was done as part of phase II?

Andrew Walker: That was done by Co-op.

Q1139 Andrea Leadsom: You have talked about impairments and securitisation. What were your recommendations on the treasury assets?

Andrew Walker: That they should make downward adjustments to them as part of the fair value adjustments.

Q1140 Andrea Leadsom: Do you feel that the Co-op accepted your advice?

Andrew Walker: Absolutely.

Q1141 Andrea Leadsom: Do you feel that at the time they took sufficient account of it in making their decision?

Andrew Walker: Yes. I presented my findings to the combined audit committees and they were discussed, and there was a good discussion on them, I think.

Q1142 Andrea Leadsom: Your own personal conclusion would have been, along with theirs, to go ahead anyway, having taken into account the concerns that you have raised.

Andrew Walker: As I have said before, I only see part of the information on that. So I highlighted the risks. They took those into account in making their decision.

Q1143 Andrea Leadsom: At the point where you left the transaction, if it was your money on the table and you were personally buying Britannia with your money, would you have been going ahead with it at that point, on the basis of the analysis that you had done?

Andrew Walker: I only did a very small part of the analysis, so I couldn't make that decision based on the information I had available to me. If it was my money, I wouldn't make that decision on part information.

Q1144 Andrea Leadsom: So you are not willing to say whether, given where you had got to, you would have at that point been minded to say yes or minded to say no. Would you have been firmly on the fence thinking, "I need more information", would you have been thinking, "This is an absolute steal" or would you have thought, "I'm not going to touch this with a bargepole" at the point you were at?

Andrew Walker: It would be that the board should take in the information I have given them. As part of that information, I pointed out other areas to be done. My advice would be that they should not have gone ahead with the transaction without having completed that additional work that I recommended.

Q1145 Andrea Leadsom: In hindsight, bearing in mind that we all learn from experience, in future days, if you were doing due diligence, might you be more inclined to be more assertive in the sense of, "At this point I wouldn't be doing this transaction without X, Y and Z" or would you continue to say, "You just need to look at X, Y and Z before you make a decision?" Do you think that from the point of view of due diligence there is a lesson to be learned whereby there is some kind of qualitative view or advice to be given by advisers, rather than their simply laying out the facts, or do you think laying out the facts is perfectly adequate?

Andrew Walker: I think we have to bear in mind in this transaction that, as there are in many other larger transactions like this, there are other advisers whose job it is to do just as you have outlined. I think in this case it was JP Morgan.

Q1146 Andrea Leadsom: In your role you had absolutely no need or desire to express an opinion?

Andrew Walker: Correct.

Q1147 Chair: We know that there has been a sort of rail crash at the end of this line. What we are doing now is going back down this railway line to try to find the spot at which the sleepers were loose or something caused the train to come off the rails. What you are saying is that on your bit of work, checking the points or whatever you were doing, there was no problem. This deal, as far as you were concerned, was correctly analysed by you guys, and the right questions were asked by the board with respect to your part of this work. As far as you could tell, staring them in the face, they all looked pretty reasonable, bright guys who understood what they were looking at. Is there anything you want to say no to in that?

Andrew Walker: Without saying a double negative? As I said before, they asked me to look at certain types of risks. We presented that information to them and they took that into account in their decision making.

Chair: We heard what you said about JP Morgan. They are mixed up.

Q1148 John Thurso: Can I ask a quick follow-up question to that? You quite correctly pointed out that you were doing a part of the overall advisory work and due diligence, and that JP Morgan were doing another part. Are you satisfied that all of the correct advisers were in place for all of the different aspects? Was there a legal adviser? In the answer you gave to Andrea Leadsom, you said that there were other areas that needed to be covered. Were you of the opinion that all of the areas were covered by somebody?

Andrew Walker: I didn't see that work, so I can't comment on whether all that work was done correctly or to an appropriate standard.

Q1149 John Thurso: Let me rephrase it. You presumably knew who all the advisers on the home team were.

Andrew Walker: We saw that the bank had appointed legal advisers, and they had appointed financial advisers in JP Morgan and appointed us to support on due diligence.

Q1150 John Thurso: Would it have been your expectation, knowing all the players on that team, that all of the points would normally have been covered?

Andrew Walker: It would.

Q1151 John Thurso: I don't know if it is germane, but I have employed KPMG on a number of occasions and I have been on the other side of transactions from KPMG. I don't recognise any of you, but that does not mean anything. I don't know whether that is germane.

Can I ask, for the record, were you appointed as auditors to Co-op before this transaction came up, or was that appointment afterwards?

Jonathan Hurst: If I could answer that, Mr Thurso, we have been auditors of the Co-op Group for probably over 30 years, so we were auditors already.

Q1152 John Thurso: Thank you. It is quite natural and normal to go to your auditors, to appoint them. I just was not sure whether you had been appointed or not.

A second technical question, really. You have stated in the preamble to the report the scope of your work, together with what you did and did not have access to, and you have drawn attention to some of the things you didn't have access to. You did have access to the data room, which would be very normal in these transactions. You have stated you did not have access to management and you had no access to the audit files, or presumably the audit letters from the target. In your view, would you have liked that access? Did it have any material impact on the advice you were able to give?

Andrew Walker: We pointed out those areas where we did not have access and pointed out areas that we felt should be followed up as part of the transaction. As I said earlier, I felt it necessary that all of those areas should have been followed up as part of phase II.

Q1153 John Thurso: You would have advised at some point that having access to the audit files and the annual audit letter would have been an important part of the due diligence.

Andrew Walker: Yes. I believe it was in my report.

Q1154 John Thurso: To your knowledge, was that followed up at any point, and if so by whom?

Andrew Walker: I don't know to the best of my knowledge whether it was followed up.

Q1155 John Thurso: But you would have expected at the very least the audit committee, and probably the whole board, to have had the benefit of that advice as part of the advice they were getting in some part of the due diligence?

Andrew Walker: Yes. I think in all of those areas where I have recommended that follow-up work be done, it is my expectation that it was done.

Q1156 John Thurso: You state in the final executive summary under "due diligence", under "status" that phase I is complete and so on. "The findings summarised in this report includes responses to questions raised by the CFS RMC", which I assume is risk management committee.

Andrew Walker: Correct.

John Thurso: That was "on 31 October 2008 and the combined Claret group ARC on 3 November." Presumably the draft report that you kindly gave us was what they were looking at in those meetings, and the final report is post those meetings.

Andrew Walker: Yes. During the phase of the due diligence, which was predominantly in the second half of 2008 and more towards the end of 2008, we attended a number of meetings to discuss status updates, and then we presented our final findings in a draft report in December. We subsequently finalised that draft report in March, but it did not change from the December one.

Q1157 John Thurso: You pre-empt the next question, which is, when you presented the original drafts for discussion prior to the finalisation, what were the material points that were asked to be looked at?

Andrew Walker: As follow-up areas? There is a list on the page. I think the most material of those was to perform a review of the watch-list items in the corporate book.

Q1158 John Thurso: Thank you. Three more areas, if I may. The first is in respect of the very helpful table you have in respect of the adjustment to earnings, which makes quite clear that—from memory—the £50 million half-year profit had something in the order of £25 million of one-offs, so that the underlying would be £25 million, and then benefited from a series of favourable impairment judgments and so on, which actually took the bottom figure into a loss, so that if you were looking at the underlying number you had a half-year loss. Is that a correct reading of your table?

Andrew Walker: I believe that is the case. Part of the scope of the role was that we were instructed to look at the underlying earnings of the society, and that is the output of that work.

Q1159 John Thurso: Having read a few of these things in my life, I found it a very helpful and well constructed report, for what that is worth. Sitting on the audit committee, I would have asked a lot of quite searching questions as to the quality of the profits going forward, based on that table, and I would have asked quite a lot of questions of my board colleagues as to the advisability of a deal for buying a loss-making business. Did those discussions take place in your hearing?

Andrew Walker: In the audit committees that I attended, they understood all of those points. Subsequently I am sure, but I can't comment on this because I didn't observe it, that they took into account those risks against some of the opportunities in the transaction.

Q1160 John Thurso: Was there a discussion of the fact that the underlying earnings trend, adjusted to take one-offs out, had a half-year loss, and was that taken into account in valuing the performance going forward?

Andrew Walker: There are probably two parts to the question there. I can't recall specifically having a discussion about it, but I only say that because it was almost five years ago. What I do recall, though, is that the specific findings of the due diligence were then taken forward and addressed in the capital forecasts of the combined business.

Q1161 John Thurso: I would have thought that when you are looking at a merger or a takeover or anything else, whether or not there is an underlying profitability or loss in a given time period is a relatively important question that you might expect the board to be giving you a bit of questioning on and even having discussion on among themselves.

Andrew Walker: I agree with the general comment, I just can't recall the specificity of the conversation. I think there is one other important factor to bear in mind, which is that this transaction was against the background of economic projections of a recovery back to normal UK trading, normal GDP and normal interest rates by 2011. When you set this transaction in that context, those points were taken into account as well.

Q1162 John Thurso: Absolutely. I remember that period extremely well. We are in the period immediately following the rescue of RBS and the takeover by Lloyds of HBOS, and post the nationalisation of Bradford & Bingley. It is a period of extreme movement in banking at a time at when people are still saying that it is a financial problem and not yet an economic recession. I remember all that, so I am aiming off. I am saying that even in fairly ordinary times, taking a half-year statement at £50 million-plus and turning it into a significant minus is something I would want to ask a lot of questions about before I said I wanted to get involved with this business. That is why I am pushing you a little bit to try to find out what the board actually thought or did on this.

Andrew Walker: Forgive me, I can't recall the specific discussions about that, but we presented the whole key findings to the board.

Q1163 John Thurso: You presumably still have your notes. You would have had your daybook and kept your own notes.

Andrew Walker: Going back that far, I am not too sure.

Q1164 John Thurso: If you ever happen to find them, I would be delighted to know what you thought at the time.

The second area that I wanted to ask you a brief question about is the comments you make about risk weights and capital. It makes it very clear that, even under moderate stress, there are significant potential problems around the future capital requirements. What discussions did the audit committee or the risk committee have in regard to that?

Andrew Walker: I think the capital position of the combined organisation received a great deal of focus by the bank. As a result of that and comparing the risk weights, which is the job that we did as part of the process, and looking at some of the stresses applied in the forecasts, we were very clear that the moderate stress was the right scenario to think about as the revised base case. That was accepted.

John Thurso: The moderate stress, going forward, became the base case.

Andrew Walker: That is my recollection, yes.

Q1165 John Thurso: That is quite a significant change to Tier 1 ratios.

Andrew Walker: It is, but I think in the circumstances that were rapidly evolving at the time we felt it more appropriate.

Q1166 John Thurso: I don't want to put more words in your mouth, but I am getting the sense that if you had been asked for advice on this—you weren't and I accept that—you might have wished your clients in the Co-operative to home in on capital and capital requirements going forward as a key part of making a decision.

Andrew Walker: I think they did focus on the capital requirements, certainly in the projections, and they had a number of discussions with the regulator. I wasn't part of those discussions, but I am aware that those discussions took place in terms of assessing the headroom of the capital forecasts against the combined capital requirement of the two organisations.

Q1167 John Thurso: I have one last question, if I may. You have given evidence that is very loyal to your clients, as I would expect of a professional, which basically has said that it is all in there if you choose to read it, but the decision was theirs, not yours, and you were not an adviser on that. You were there to illuminate the risks.

As the Chairman said, we know where this all ended up, and we know the quality of some members of the board. What we are really trying to find out, looking at advice one might give on governance in the future, is whether or not the people to whom you were reporting had the technical skill, ability and experience to understand what you were saying to them. When I read this I said to myself, "If I was on that audit committee, I would ask a lot of very searching questions, and I would need a lot of persuasion before I did the deal". You are saying that they had a discussion, but they carried on. I now ask the subjective question: to what extent do you think, as so often happens, that this board was captured by deal-itis, and that the desire to get the deal done was taking them further than they might naturally and cautiously have gone before the deal kicked off?

Andrew Walker: I think the board set out to examine the risks of the deal and the opportunities in the deal. I have very clearly highlighted some of those risks in my report. I had confidence when I was presenting to the audit committee members of that board that they were aware of what I was telling them and were asking pertinent questions about those risks. I can't comment on the subsequent discussions at the board, because I didn't attend them.

Q1168 John Thurso: Every good partner has a good feel for the board and the committee he is talking to, and relationships are well formed. Did you at no time feel, "This is beginning to gather a pace that maybe it shouldn't, and maybe people should be asking me a few more questions about some of these things I am raising"?

Andrew Walker: I think at the time I was asked the right questions during my presentations.

John Thurso: How very loyal.

Q1169 Chair: Did you get a sense at all that some members of the board were more doubtful than others?

Andrew Walker: I can't recall that.

Chair: It is a very straight bat indeed we are getting this morning.

Q1170 Mr McFadden: What is due diligence?

Andrew Walker: It is an examination, to a prescribed scope, of particular areas of work. It is for us to request the right information about those areas, to examine that and to report on what we see as the key factors and issues coming out of that information. It is not to recommend a deal specifically.

Q1171 Mr McFadden: A client asks you for due diligence because a deal may be costly. Is it fair to compare this to a potential house buyer commissioning a surveyor to look at a house? They may want to buy that house, but they want you to tell them whether or not the roof is about to cave in.

Warren Mead: Do you mind if I pick that up? I am a transaction services partner. I often hear the analogy that we are the surveyors of a house and the investment bankers are the estate agents, and you are going to extend the analogy.

Q1172 Mr McFadden: I am asking you, is that the right analogy? I want to understand what due diligence is, what it can be expected to do and what it can't be expected to do.

Warren Mead: Due diligence is to highlight the key risks and opportunities in a transaction.

Q1173 Mr McFadden: Is the house purchase analogy a fair one, or do you think it is not relevant to think about this?

Warren Mead: I think it is a helpful analogy but it is perhaps an oversimplification.

Q1174 Mr McFadden: Let's look at this in terms of some of the specifics. This transaction resulted in a £550 million hole in the purchaser's balance sheet. When you were looking at the numbers, how much did you look at the commercial property and non-standard mortgages that contributed to the lion's share of that hole?

Andrew Walker: The £550 million you refer to is the subsequent impairment that arose from that book over and above the fair value adjustments. The lion's share of that did come from the corporate book. As I think I mentioned earlier, we did not do due diligence on that part of the book.

Q1175 Mr McFadden: Why didn't you do that?

Andrew Walker: Because at the time we were not given the access to the files and the personnel we needed to complete that work.

Q1176 Mr McFadden: The Co-op would have liked you to have done this but you couldn't get the information from Britannia. Is that what you are saying?

Andrew Walker: That is correct, but they subsequently went on to do that piece of work themselves.

Mr McFadden: The Co-op?

Andrew Walker: Yes.

Q1177 Mr McFadden: This is important. You are saying that you did not do due diligence on the part of Britannia's asset base that contributed the lion's share of the £550 million hole in the Co-op balance sheet that subsequently appeared as a result of the transaction. Is that what you are saying?

Andrew Walker: To be very clear with you, we were given some initial information in the initial management presentations by the Britannia management team to the Co-op management team that we attended right at the outset of the due diligence process. That was limited to an analysis of the top 10 counterparties in the corporate book, and it was a confirmation that at that time there were no arrears in the corporate book. Subsequent to that, we weren't given any further information, so no, we did not do due diligence.

Q1178 Mr McFadden: How uncomfortable were you about this? Given that other banks around this time had commercial real estate exposures that were turning bad in a very dramatic way—if you look at RBS and HBOS, for example, they were losing billions on commercial property—you are asked to do a due diligence job, and you don't have the information on the commercial property aspect of the potential purchase. How loud were the alarm bells that that set ringing?

Andrew Walker: We pointed out that that work needed to be done.

Q1179 Mr McFadden: That is a very mild way of putting it, given what was happening elsewhere in the banking system.

Andrew Walker: In the circumstances, there is not much more I could have done other than to point out, "You need to do due diligence in this area and I recommend you do it or somebody does it".

Q1180 Mr McFadden: You say that the Co-op subsequently did the due diligence on the commercial loan book themselves. Did they come back to you and ask you to review that, or did you have any further involvement in that?

Andrew Walker: No.

Q1181 Mr McFadden: Did you ever see the work that they did?

Andrew Walker: No. There was no KPMG report on that, and I didn't see any subsequent Co-op reports to the board.

Q1182 Mr McFadden: What is the value of due diligence if you don't have access to the data that you need from the business potentially being purchased?

Andrew Walker: The value of the due diligence we did was that in the areas where we were able to do work, we did an in-depth analysis. It just so happens that we were not able to complete some areas of the due diligence and scope.

Q1183 Mr McFadden: The Co-op didn't pay anything for this deal. It was called a no consideration deal. Did that influence your judgment about the risks in any way?

Andrew Walker: Not at all.

Q1184 Mr McFadden: Looking back on this, this deal resulted in a £500 million-plus hole in the Co-op's balance sheet. How do you feel about the work done on this? If we go back to our house purchasers analysis, if I went ahead with the purchase and I suddenly

found I was left with an enormous repair bill because of structural faults, I would feel pretty annoyed at the people I had asked to look at the purchase. How do you feel about that?

Andrew Walker: I think if I step back and look at the facts of this book—I am able to do this because of the involvement as the auditor subsequently—and in particular if we pay attention to the problem assets, just singling out the top 10 on the watch-list, which add up to about £1 billion or £950 million, 80% of those exposures don't mature until 2015 or beyond, and they are usually loans to single purpose vehicles that let a commercial property. Alternatively, the leases on those properties may not be due for renewal until 2015 or beyond. So when we look at this in 2008 or 2009 against the context of a full economic recovery projected by 2011 or 2012, looking at assets that don't mature until 2015 or 2016, it is a reasonable expectation that those would be capable of being refinanced at those points in time.

Q1185 Mr McFadden: You are blaming the lack of economic recovery for this black hole?

Andrew Walker: That is a contributory factor to the situation.

Q1186 Mr McFadden: Does this explain why the hole in the Co-op's balance sheet emerged later than other banks who were doing the big part of their write-offs earlier in 2009?

Andrew Walker: What I have done in looking back—and we do this as part of the work at the time of the audit—is to benchmark the Co-op Bank's impairment charges and their impairment provisions, including the benefit of the fair value adjustments that were set aside at the merger as well.

Q1187 Mr McFadden: But the fair value adjustments were an underestimate, as things turned out.

Andrew Walker: They were reasonable estimates at the time those adjustments were made.

Mr McFadden: But they proved to be £500 million.

Andrew Walker: They were reasonable estimates at the time those adjustments were made. If I could just finish on the benchmarking point, aside from Royal Bank of Scotland, which actively pursued an exit strategy of its non-core business, Co-op Bank had a reasonable level of impairment coverage when you compare it to other peers. It had the highest level of impairment cover plus its fair value during 2009, 2010, 2011 and 2012. I certainly don't share the view that Co-op was behind others on its impairment.

Q1188 Mr McFadden: If it had all this cover and it was in such a healthy state, why did it fall over?

Andrew Walker: In 2012 there were essentially two things that happened. A number of the larger exposures that were going through refinancing and renegotiating discussions either hit some form of problem or it became increasingly likely that the commercial real estate markets were not going to recover in the near term. The FSA subsequently wrote a letter to UK banks to confirm their view, or the FPC's view, of the likely prospects for the commercial real estate market, which was to effectively say "Don't assume that there is going to be any recovery in these markets as a permanent state of affairs." Taking those two factors together, the Co-op Bank evaluated its individual provisions at the end of 2012 and arrived at a large number, but it was correct to be recorded at that time.

Q1189 Mr McFadden: I will just finish with this. You have said it was all reasonable at the time and you couldn't predict the failure or the delay in securing any

economic recovery. Does that mean that if you were doing this exercise today you would take a different view, a more conservative view of commercial property assets, based on the specific failures in that market and based on the economic situation in recent years.

Andrew Walker: Can I clarify which exercise you are referring to?

Mr McFadden: If you were looking at commercial property now, would you take a more conservative view of it than you would have done five years ago because of the factors you have just cited to me? In other words, have KPMG learned from this, and would they shoot lower on the potential value of these assets in the future?

Andrew Walker: I would say two things in response to that. I don't have the benefit of hindsight when I am doing my work. I have been back and relooked at the work, and I have asked other people to do so, and indeed the bank has asked independent advisers to look at its 2012 financial statements and the impairment positions in particular. The conclusions from those look-back exercises are that the accounts were appropriately stated at the time.

Q1190 Chair: Was there any work that you think should have been commissioned by the Co-op that was not commissioned?

Andrew Walker: In relation to anything in particular?

Chair: You said that you advised them to do some key work on commercial real estate impairment, and that they did that subsequently. I am asking you whether you asked them to do all the work that you think, on the basis of what you saw, they should have done.

Andrew Walker: I am not in a position to instruct them to do work, so I recommended that they complete particular areas.

Chair: I was talking about asking or suggesting.

Andrew Walker: I didn't make any recommendations to that effect.

Q1191 Chair: None at all? So was there any work you think should have been commissioned that was not commissioned? It is the same question that I have just asked.

Andrew Walker: As I said earlier, I felt it important that they completed the work that I said should be completed to complete the due diligence exercise.

Q1192 Chair: Right, and that did complete it? That is what I am asking. That is exactly what I am asking. Are you confident that everything you asked for, once done, did complete the due diligence?

Andrew Walker: I was not asked to go back to do an exercise to confirm that it had all been done.

Q1193 Chair: I will ask it again. When you came to them and said, "Our advice is that you should do this very important bit of due diligence that has not yet been done", was there also in the back of your mind any other area that you thought required attention that you did not alert them to at the time?

Andrew Walker: My report contained a couple of pages—forgive me, I can't remember exactly which ones—where I pointed out additional work that should be done as part of phase II, and the most important one of those was corporate.

Q1194 Chair: Are you confident that that list was comprehensive?

Andrew Walker: Yes.

Chair: Okay. We have got to the answer.

Q1195 Mr Ruffley: Mr Walker, the major loan impairment losses emerged in 2012 and the first half of 2013. On a point of information, you gave an answer to Mr McFadden

that seemed to suggest that Co-op Bank was not any different from the average of all other banks when it came to impairment losses. Is that true, or would you say, on the other hand, that the majority of loan impairment losses of other banks took place before 2012?

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

Q1196 Mr Ruffley: Some of the evidence we have received is to the effect that the regulator and its higher regulatory capital requirements became a problem for Co-op more than other banks. Is that true?

Andrew Walker: It is certainly the case that the capital requirements for Co-op Bank were increased, and they were informed of that as part of the normal capital assessment exercise that the FSA runs. That happened in January. So at that point there was a shortfall against the FSA's capital planning buffer. I can't comment relative to other banks, because I don't see other banks' capital requirements. It is a confidential matter.

Q1197 Mr Ruffley: In calculating the impairment provisions, can you just take us through how that is arrived at? That essentially is a number generated by the bank and then you take a look at it.

Andrew Walker: That is correct.

Q1198 Mr Ruffley: In relation to the bank's capital position as it was summarised in the financial statements of 2012 to 2013, were KPMG issuing any warnings?

Andrew Walker: In the 2012 financial statements, when we were doing the audit it became apparent in January that there was a capital shortfall against the FSA's capital planning buffer of approximately £1 billion. At that point, going concern was a heightened risk as part of the audit for us. We concentrated initially on liquidity, because liquidity is the first thing for us. Any loss of customer confidence and withdrawal of deposits from the bank was the primary risk that we focused on first, and we were comfortable by the time we signed off in March that the bank had built up a considerable liquidity war chest, as it were, to insulate itself against any potential impacts like that.

We then concentrated on the capital actions, and the bank had agreed at the request of the FSA to draw up a capital action plan to close that capital gap. It was under a project called Project Pennine. We examined the actions within Project Pennine and the forecasts that were put together to support it. Although Project Pennine was not due to complete until the end of April and be presented to the FSA at that point, it was in a relatively advanced stage when we signed off, and the board had scrutinised the actions in that plan. I was comforted as well by the fact that the FSA were meeting with Co-op's management weekly to discuss that plan in particular. An additional part of my procedures was to have discussions with the FSA around that plan and the risks within it, and seek their views on the capital position of the bank.

Q1199 Mr Ruffley: Barry Tootell's 20 March 2013 overview in the 2012 financial statement said, "Our balance sheet remains strong", yet shortly afterwards Moody's downgraded the bank and the £1.5 billion shortfall was laid bare for all to see. You signed off on those accounts, didn't you, Mr Walker? Why were you so completely wrong about the scale of the bank's problems?

Andrew Walker: To be very clear, I do not sign off on the chief executive's report or the chairman's report or the business and financial review.

Mr Ruffley: You sign off the accounts.

Andrew Walker: I check that they are consistent with the accounts and, in doing so, when we first read the drafts of those reports, we effectively asked for a rewrite, because they were not reflective of the circumstances in the accounts. The references that were made—

Mr Ruffley: You asked for a rewrite in relation to what particular element of the draft statement?

Andrew Walker: We asked that optimistic references or references to strength in the bank overall were removed. I think what was left was references to the liquidity position of the bank and the core bank as being the stronger areas of that bank, and we felt that was consistent with the financial statements.

Q1200 Mr Ruffley: Could I just be clear what your status is in this process? I am reading here from the Barry Tootell statement: "Our balance sheet remains strong," and "The bank's underlying financial strength remains intact." Did you challenge that drafting and, if not, why not?

Andrew Walker: We did challenge the aspects of the drafting, as I said, and we asked for substantial rewrites of that. I think that those—

Mr Ruffley: But what about those two statements? Let's just focus on those two statements. Did you allow that to go out? Well, manifestly you did, but without any protest at all?

Andrew Walker: Those two statements were consistent with the projections that I was seeing and looking at, at the time, as part of the audit for the core bank, which was profitable, and the capital and liquidity positions of the bank. The liquidity position, as I have said, was robust and the capital position at the time I signed off was 9.2%.

Q1201 Mr Ruffley: When precisely was the decision taken, to KPMG's knowledge, to pull out of Verde?

Warren Mead: If I may answer that, my understanding is that the decision was taken in a board meeting in April 2013.

Q1202 Mr Ruffley: Were you party to that decision?

Warren Mead: I was not at that board meeting, but I had attended—

Q1203 Mr Ruffley: Were you asked to give advice prior to that meeting?

Warren Mead: Yes.

Q1204 Mr Ruffley: What advice did you give?

Warren Mead: We reported to the board in March 2013. The Co-op had set itself 15 objectives for the transaction and our advice was that they did not meet those objectives.

Q1205 Mr Ruffley: Which were the main sticking points, from your point of view? What were the big ones? Don't go through all 15. What were the showstoppers, if I can put it that way?

Warren Mead: In my mind there were four showstoppers. The first was an ongoing reliance on Lloyds' IT platform for 10 years. Outsourcing your IT platform to a competitor for 10 years is a fairly uncomfortable position. The second was around the risks of integration. It was going to be a hugely complex task to bring the two organisations together. The third was around conduct risk and, in particular, the view that there were legacy conduct

risk issues in the book that were being transferred that could not be fully mitigated through indemnity. If you brought all of those things together, it was just too high-risk for the capital that the combined group would have had.

Q1206 Mr Ruffley: What discussions did you, Mr Walker, or you, Mr Mead, have, in the time you at KPMG advised Co-op, with the regulator—the FSA and then the PRA—specifically on the capital position?

Andrew Walker: During the audit I met with the FSA, over the course of 2012 and 2013, seven times.

Q1207 Mr Ruffley: Who at the FSA?

Andrew Walker: With the supervisor at the FSA, the bank supervisor.

Mr Ruffley: Who was?

Andrew Walker: Andy Cope, and colleagues of his. Specifically towards the end of the audit, when we were focusing on the capital position, we met three times during February and March.

Mr Ruffley: What did the regulator say to you on those occasions?

Andrew Walker: The regulator had two principal concerns at that stage. Bearing in mind that the Pennine capital action plan was not due to be delivered to them until the end of April in its final form, clearly, as I said, they were very aware of what was going into Pennine and the actions in it. They had two principal concerns, the first of which was that the bank should be prepared to take what they called dial-turning actions to improve their capital position; for example, the sale of the general insurance business, which the group then went on to do. Secondly, they were concerned that the group, which they do not regulate directly, was in a position to take more radical action should that become necessary. They received confirmation, as I understand it, from the group that they were prepared to do that as a last resort.

Q1208 Mr Ruffley: Did you get the impression that Project Pennine, which was in prospect, was not only giving you comfort but giving the regulator comfort?

Andrew Walker: Yes.

Mr Ruffley: That everyone's eggs were in the Project Pennine basket?

Andrew Walker: Correct.

Mr Ruffley: That was not probed, other than to say, "This is a plan that is going to be activated by Co-op"?

Andrew Walker: To correct you on that, absolutely it was probed by us. As part of the audit process we assessed the viability of each one of the individual capital actions in that.

Mr Ruffley: Why do you think it did not come off as a plan?

Andrew Walker: Several parts of the capital action plan are still in train. The sale of the life and savings business was completed. The sale of the GI business was embarked upon and offers were invited for that business. The bank has started to actively deleverage its corporate book. On all of the three principal actions that we looked at, we have seen substantive progress at the time we signed off and subsequently.

Mr Ruffley: Yet there is still a £1.5 billion capital hole.

Andrew Walker: There are two events that happened after I signed off, to be very clear. One is that new management came in. They started to pursue an exit programme of their non-core business more aggressively, and to do that, they set themselves additional provisions, because they were going to get out of those corporate exposures at a greater discount. The impairment provision for that was about £250 million. Secondly, the regulator revised its expectations of core Tier 1 capital for Co-op Bank, as it did for all other UK banks.

As part of that the capital requirement changed as well. Those two circumstances happened after I signed off the 2012 accounts.

Mr Ruffley: No one saw that regulatory change coming?

Andrew Walker: The regulator did not say that to me. I think those changes stand out from the Financial Policy Committee meeting in late March, and the findings of that were not known to me.

Q1209 Mr Ruffley: I just wish to ask one technical question. It bears on the answers you gave at the start of my questioning and the end of Pat McFadden's questioning. It is about the question of the peak of impairment losses, and our supposition that the peak was higher for other banks and that your peak came after the other banks'—that you were an outlier. I am told that your answer includes fair value adjustments. You cannot explain, or you have not explained, why the actual profit and loss impairment charges occurred later at the Co-op than at other banks.

Andrew Walker: I do not necessary agree with that assertion. As I explained earlier, in the benchmarking that I have done against other UK banks of a similar peer group to Co-op Bank, they also incurred significant impairment charges against their corporate books, in particular in 2012.

Q1210 Mr Ruffley: You stand by the KPMG statement that basically there were no alarm bells ringing. Co-op was not in any different a position when it came to impairment losses from the average of all other banks. That is what you are saying.

Andrew Walker: Against the banks that I had been able to benchmark Co-op against.

Mr Ruffley: Just remind us which banks those are.

Andrew Walker: They were Nationwide, Santander, Clydesdale and RBS, from their public financial statements.

Q1211 Chair: Can we just go back to the questions that Pat McFadden was asking earlier, which seemed to be pretty important? You presumably asked for access to the Britannia corporate loan book. Did you?

Andrew Walker: Yes.

Chair: On what grounds were you told that information was being withheld?

Andrew Walker: There were certain elements of the transaction that simply meant Britannia did not have the capacity to have people coming into the premises to do work, or it was from a confidentiality and sensitivity point of view. I don't know of any other reasons beyond that why we were not given access.

Q1212 Chair: The papers were scrambled or, alternatively, were in a mess, so they did not have them sorted into neat files for you. That seems to be the first point. The second point is that there might be confidentiality concerns, but there was a confidentiality agreement in this deal. There must have been a sign-off that access to all information required to do the deal would have been provided. Correct?

Andrew Walker: If I may just—

Chair: Just clarify that point first. Correct?

Andrew Walker: I believe there were the appropriate confidentiality undertakings on the table, but when you have—

Chair: That would have covered this.

Andrew Walker: If I may, when you start to spread out a due diligence exercise more widely and start to speak to more junior members of the management team, confidentiality becomes a particular risk.

Q1213 Chair: You are buying this outfit, or at least you are merging with this outfit. You want to know everything that you reasonably need to know about this. That is a central thing you reasonably want to know. You are not suggesting to me that this could be withheld, are you?

Andrew Walker: No, I am not.

Warren Mead: Sorry, may I come in, Mr Chairman.

Chair: You have wanted to come in three times. Now we will let you in.

Warren Mead: Thank you very much. It is very standard in due diligence processes for information to be released in phases, so often you will get some more high-level information at the start. When you get further in the process—

Chair: But this is not being released in a phase. This is being withheld.

Warren Mead: I believe it was released to Co-op later in the process.

Andrew Walker: That is correct, as part of phase II.

Q1214 Chair: How hard did you press to see this yourself?

Andrew Walker: We pointed it out in our report.

Chair: How hard did you press?

Andrew Walker: Other than pointing it out in our report and spelling that out for management, no further.

Chair: Not very hard.

Andrew Walker: I think you have to set this in context—the initial information we had been given around the counterparties and their arrears, and the fact that this was £2 billion of a £24 billion book.

Chair: It is a pretty important corner of this book, don't you think?

Andrew Walker: I agree with that, but that is why I flagged up that more work needed to be done.

Q1215 Chair: Even at the time you thought that, never mind what has happened subsequently. You were the financial advisers. What discount did the Co-op receive for the incompleteness of the due diligence on this point in the deal?

Andrew Walker: As in consideration?

Chair: Yes.

Andrew Walker: There was no consideration paid.

Chair: None whatsoever?

Andrew Walker: No. It was a merger of two mutuals.

Chair: No, but there would have been a value written in for this.

Andrew Walker: I did not do the business case for the merger. I just did the due diligence towards it.

Chair: You do not know?

Andrew Walker: I don't know I am afraid.

Q1216 Chair: Were you satisfied with the Co-op's decision to conduct the due diligence on Britannia itself on the corporate loan book?

Andrew Walker: The corporate credit team in Co-op already had a book of a similar nature, and the people who were the corporate credit officers in that area of the bank subsequently completed that work. I had no reason at the time to doubt their capability to do it.

Chair: You think they had the requisite expertise?

Andrew Walker: They had the right experience to be able to do that piece of work.

Chair: Okay. Well, we are still looking for those loose sleepers. Thank you very much indeed for coming to see us this morning. We may need further information, which we hope we will be able to obtain in written form. With colleagues' agreement, I intend to go straight on to the JP Morgan hearing. Thank you very much indeed.

Examination of Witnesses

Witnesses: **Tim Wise**, Managing Director, UK Investment Banking, JP Morgan, and **Conor Hillery**, Managing Director, UK Investment Banking, JP Morgan, gave evidence.

Q1217 Chair: Thank you very much for coming to see us this morning. First of all, can you tell us what a fairness adviser is, for those who may not have been through this experience? Some of us have and some of us have not.

Tim Wise: The fairness opinion was part of our overall advice. Our overall role was as a financial adviser, and essentially that is to advise on the financial terms of the transaction, taking into account the management's judgment on commercial matters. Sometimes, as part of that, you are asked to give a formal fairness opinion and sometimes you are not. In this case we were asked to give a fairness opinion.

Essentially, what that fairness opinion says, based on the management's view of the commercial opportunity, the management and board's commercial assessment of the future and the terms of the transaction, is that those are fair from a financial point of view for, in this case, the Co-op.

Q1218 Chair: How much were you paid for this work?

Tim Wise: Our fee on this was £7 million, which was paid as £2 million on announcement and then a further £5 million on completion.

Q1219 Chair: So you had an interest in the deal?

Tim Wise: Like all advisers, in any participation in a deal you have an economic interest in the deal, yes. We certainly had an interest.

Q1220 Chair: You were not sitting there neutrally giving the advice. You were thinking, "There is £5 million riding on this".

Tim Wise: No, I think that is not a particularly fair way of characterising our role. Clearly that is a significant fee and there is no other way of looking at that.

Chair: Most people would consider £5 million a pretty significant fee.

Tim Wise: Yes, and I accept it is a very significant fee, but that is the way that the industry works, and that is—

Chair: I am only picking you up on this because it is understatement like that that people outside this place find pretty astonishing, frankly. £5 million is a shed-load of money for advice, isn't it?

Tim Wise: As I have said, it is a very significant fee. It is the way that the industry works and clients work with the industry in terms of—*[Interruption.]*

Chair: Sorry about this noise. It will only last a few seconds. As a matter of fact, I have tried hard to get these tones adjusted in this room at this time, but unsuccessfully. I have been told that that requires a very significant fee as well. Do carry on.

Tim Wise: I think I did use the words "very significant", so I hope that was not an understatement. It is a very significant fee, and the way that clients choose to pay us, whether it is M&A transactions or capital markets transactions, is based on the transaction happening. That is the way the industry works, and that is the way clients choose to pay us. In terms of

the integrity of our advice, the clarity of our advice and the honesty of our advice, that is something that is absolutely fundamental to the way we work and the way the vast majority of the industry works. Frankly, a lot of professions work that way. People get paid if something happens.

Q1221 Chair: Just going back to that first question, you had a considerable financial interest in seeing the completion of this deal, didn't you?

Tim Wise: Yes, absolutely. If the deal does not happen we do not get paid. If the deal happens we do get paid. That is a fact.

Q1222 Chair: Therefore you like to see the deal done, and it is asking for the objectivity of a saint, is it not, not to be biased in thinking, as you prepare this advice, that you would like to see a particular outcome over another?

Tim Wise: No. I have alluded to the economic fact that you have stated, but the fact is there are many more occasions when we advise clients not to do deals than do deals, whatever the economic consequences for us. One's reputation and integrity and ability to stay in business, whether it is individually or corporately, is absolutely dependent on giving objective advice based on integrity and fairness, so there are many times when one does not advise that. I can't deny the economic reality of it, but what I would assert very strongly, and I think I could prove in numerous occasions or if one talks to clients, that we are prepared to do a lot of work advising a client not to do a deal and receive no remuneration.

Q1223 Chair: When people go to firms like you they obviously want good advice. They also want it to be known that they have you working on the case, and your fees reflect the fact that there is some value in your brand, wouldn't you say?

Tim Wise: Yes. I think it is probably almost a given, though, that if a company, in this case, of this size and importance doing a deal of this size and complexity and importance is going to go to a firm of high standing and reputation, I would not claim that we are the only one who could fit in that category.

Q1224 Chair: Do you think it might enhance the long-run reputation at the top of this industry—the advice industry in which you work, with respect—if fees were not contingent on a particular outcome where you are advising specifically on whether to do that transaction?

Tim Wise: I think that is a very fair point to raise, and what I would say is that it is not generally in our gift to decide how we are paid. It is the client who engages us and determines how to pay us.

Q1225 Chair: Are you saying that the Co-op said, “We're only prepared to hire you if we are allowed to pay you £5 million if we pull off the deal and nothing if we don't”?

Tim Wise: No, what I am saying is that how they paid us was absolutely in line with industry practice.

Q1226 Chair: I know you began with that, but I am not asking that question. I have asked you the question: do you think we—perhaps we in this Committee or perhaps you in the industry—ought to reconsider whether this is a sensible way to provide remuneration for fairness advice and other parts of the financial advice you gave?

Tim Wise: Yes, I think it is a perfectly fair and open discussion to have.

Chair: I am asking your view. I am asking you to discuss it.

Tim Wise: Yes, okay. There have been times when clients have said to us, “What we would like to do is pay you on just a retained basis and, regardless of whether there is an

outcome or not, we will pay you” that does happen from time to time. I have to say, it is not in the generality of cases. One of the problems is that, when it has come to the client finally deciding how they want to pay us, they would rather pay us on this basis, and quite often they tend to resile from paying us a significant fee for something that does not happen. It is as much, if not more, in the client’s gift and the corporate’s gift as to how they pay us than it is in ours. But do I think it is a debate that should be had more broadly? Yes, I am sure it will be a debate that is had more broadly.

Q1227 Chair: That comes back to the point you made a moment ago when I said to you, “Is it the Co-op’s fault that this transaction had its remuneration biased in this way?” You did not want to say yes to that, but you appear to be saying yes to it now.

Tim Wise: No, I am not saying that. I am saying that, between the two of us, clearly we are both complicit in how we are paid. There is an engagement letter that it takes both of us to agree, but I am saying that how we are paid is not entirely within our gift, across the board or in respect of this transaction. It is a two-way agreement.

Q1228 Chair: I have been involved in hiring fairness advisers. What goes on is that somebody comes to you and says, “We want you to give fairness advice on X”, and you say, “Okay, this is the fee”. Isn’t that what happens?

Tim Wise: Just to be clear about the process of this transaction, the fairness opinion and the—

Chair: That was only part of the fee.

Tim Wise: Also, it came late. In fact, the decision on giving a fairness opinion came after we had discussed fees. The fee was not specifically related or attached to the fairness opinion.

Q1229 Chair: Even for the wider advice, it is quite likely that, although there will be a discussion about fees, and possibly a bit of to-ing and fro-ing, and giving the board comfort by shaving a little bit off to make them feel happy, broadly speaking, you say what your fees are and they try to amend them. Isn’t that correct?

Tim Wise: There is a process of negotiation that will differ from transaction to transaction.

Chair: Is what I have said correct?

Tim Wise: Yes. In this case, I cannot recollect every detail of the fee discussion.

Chair: They do not come to you with a proposed fee structure in the first part of this discussion, do they?

Tim Wise: In this case what happened was that they said, “Give us some reference points for comparable deals and what might be a fair range”. We discussed a fair range and they then came back to us and said, “Okay, we have looked at the evidence, and we have looked what is paid elsewhere. Here is the fee we are paying you”.

Q1230 Chair: Can I turn to the due diligence? Was it your job specifically to identify all the due diligence that needed doing and to advise the Co-op to that effect?

Tim Wise: No, it wasn’t. It was principally the Co-op’s job to decide the due diligence, but we were very much involved in reviewing the scope of the due diligence that was undertaken.

Chair: I did not say to decide. I said to advise.

Tim Wise: Yes. We helped advise them on what the scope of their due diligence should be.

Q1231 Chair: I will go back to the question I just asked—this is hard pounding so far. I am asking you whether you considered it to be your primary responsibility to make sure that you advised them on all the areas of due diligence that they should cover and to make sure that they were aware of those.

Tim Wise: No, I do not think the starting point for the due diligence process and the scope of it was ours. That was the Co-op's, but we played a material part in talking to them about that and advising them on that scope and giving them a view on whether that was the appropriate scope.

Q1232 Chair: I have your engagement letter of 19 January 2009 here in front of me, and I am looking at paragraph 1.1, third tiering "In conjunction with the company and its other professional advisers determining the overall scope of an appropriate due diligence exercise in relation to Britannia Building Society." Do you think what you have just said to me is entirely consistent with what is sitting there on the engagement letter?

Tim Wise: I think it is consistent with that, yes. I think it is a combined effort in terms of deciding the scope of the due diligence.

Chair: Your job is to identify the due diligence that needs to be done, isn't it?

Tim Wise: Yes. I think if the due diligence has large gaps in it we are answerable for that.

Q1233 Chair: Do you think the due diligence had large gaps in it in this case?

Tim Wise: No, I don't think it did, actually.

Q1234 Chair: Where was the loose sleeper?

Tim Wise: Where was the loose sleeper at the time or where has the loose sleeper turned out to be? Clearly, the loose sleeper has turned out to be in the commercial loan book.

Q1235 Chair: How vigorously were you pressing for that to be examined?

Tim Wise: That was a very important part of the scope of the due diligence as, I think, has been discussed in this Committee before and as David Anderson discussed. That was looked at in detail by the Co-op.

Q1236 Stewart Hosie: Mr Wise, can you describe in your own words precisely what the role of JP Morgan was, as agreed with the Co-op, in relation to the Britannia deal?

Tim Wise: Yes. Our overall, over-arching title is that we are the financial adviser. In the scope of that, we are advising on the financial terms. We are advising on the negotiation, and obviously the terms include both the consideration and the dividend and member loyalty schemes. We have discussed the due diligence process. We are not primarily responsible for undertaking due diligence, but we are responsible for reviewing it and guiding on the scope of it.

Q1237 Stewart Hosie: Were you mandated to give a final decision, a final opinion to the Co-op of whether to go ahead with this transaction?

Tim Wise: No, that is not part of the mandate to give that advice on that decision. Ultimately that is a commercial decision for the board. Our advice relates to the financial basis of doing the deal.

Stewart Hosie: That is the advice that you did give, you believe?

Tim Wise: Yes. Essentially the core of that advice is contained in the fairness opinion.

Q1238 Stewart Hosie: Indeed. In the engagement letter of 19 January that the Chairman referred to, which you signed, the services are, as you describe them, “advising and assisting in the negotiations with Britannia including the tactics to be adopted in relation to the negotiations, providing advice in relation to the valuation of Britannia Building Society, helping determine the overall scope of an appropriate due diligence exercise, reviewing, in light of the knowledge of the transaction, due diligence that has been undertaken, participating in that review having regard to the directors’ commercial assessment of Britannia Building Society.” That is quite a chunky piece of work. Could that be interpreted, do you think, in any way as you providing more than you believed you were providing to the Co-op?

Tim Wise: No, I think that is a good and accurate description of what we did.

Q1239 Stewart Hosie: When we get to the conclusion of this letter—again, this is dated 19 January, so I am assuming the date is wrong—it lays out four points that you note: a description of the work you have done, a page and a half of the caveats explaining how you are not responsible for anything, and then a one-sentence paragraph that reads, “On the basis of and subject to the foregoing it is our opinion as at the date hereof that the terms of the proposed transaction are fair from a financial point of view to Co-op.” That is effectively giving the Co-op the green light to proceed, isn’t it?

Tim Wise: You talk about the page and a half of caveats, which are fairly important in terms of the commercial assessment. That is effectively saying that, if you have sufficient confidence in your commercial assessment and the projections, the financial terms of this transaction and what that effectively means—because there was no consideration—for the value that is going to be created for the Co-op and its members, is of an order where we think that the transaction is fair and in your interest to do from a financial point of view.

Q1240 Stewart Hosie: The Co-op brought you in at a significant fee in order to make a series of judgments. Clearly the caveats are important from a commercial point of view, and clearly it is the decision for the Co-op board to make, but when JP Morgan, with their reputation and their large fee, are around the table and saying, “This deal makes sense”, that is more than simply saying to Co-op, “This is our opinion and you now make a decision”. That is effectively you rubber-stamping this deal and saying, “Yes, it is safe to proceed”, isn’t it?

Tim Wise: I do not want in any way to minimise the influence we can have or the importance of our advice, but I do think that you have to take, fundamentally and seriously, the point about the commercial judgment. I don’t think you can gloss over that and, in some way, spread our role into effectively substituting ourselves for the board and management in making that commercial assessment. That is a commercial assessment that they have to make. I think that the scope of our role and the scope of our advice is precise, and I think the analysis of it lives or dies on the basis of that letter.

Q1241 Stewart Hosie: Perhaps, but not necessarily, in the case of this engagement, are you ever concerned that senior people who engage you are substituting your advice for their own commercial judgment?

Tim Wise: That is a very difficult question to answer across the board, but, no, I generally don’t. The vast majority of our clients are going to be extremely senior, experienced, responsible, professional people who are going to see our advice in the proper context. Certainly in this case, the management team of Co-operative Financial Services were, in our view and opinion, an experienced, objective, dispassionate, competent and professional team. I think they genuinely did understand the risks, and I think they genuinely understood

the role they were taking on and the decision they were taking on, and they went about it in a very thorough and rigorous way.

Q1242 Stewart Hosie: Did you see any confusion or conflict between the role you undertook and the role KPMG undertook?

Tim Wise: No, I don't think so. They are quite distinct, although they join in several places. One of the important points to make about the KPMG advice is that it is not a complete certificate of health. Again, it is not substituting for the commercial judgment. Effectively, the commercial judgment and the due diligence, as I think has been said to you by a couple of people who have been before this Committee from the management team, is their role. KPMG are supporting, guiding and assisting them in that role. Our job then is essentially to look at the output of the management's view of the business and the management going forward as assisted by KPMG. We do not feel, in practice, that the roles do conflict. They are fairly complementary.

Q1243 Stewart Hosie: Particularly on the Co-op management side, then, were you not at all concerned on reviewing the due diligence, which was one of your tasks, that the review of the commercial loan book was undertaken by Co-op management internally and not by another external? Did that not cause you any concern when you did that review?

Tim Wise: No, that genuinely did seem a sensible way of doing it. Again, as I think has previously been discussed, on the commercial loan book, it was the Co-op management and the Co-op team that had the real expertise in that area. One of the reasons that they asked KPMG to focus so hard on the specialist mortgage area was because they had a lesser level of expertise in that area. I think it was the right thing to do, and the sensible thing to do, for them to send their own teams in to look at it. A lot of the decisions around something like that are going to be based on a particular view of credit risks and the markets they are operating in. The Co-op management team was always going to have better view on that than KPMG probably could.

Q1244 Mr Newmark: I just want to focus a little bit more on what Mr Hosie was saying about your role versus KPMG's versus the company's, in drilling down and understanding what is on the balance sheet. I have spent 20-odd years in the City, and at the end of the day you guys, the advisers, see all the cards. Your job is to see all the cards that are there. Internally, were you doing a lot of your own work in running the numbers and understanding the balance sheet on both sides of the equation, and in understanding where the impairment was, if there was any impairment. Or did you completely outsource that and have no guys running the numbers internally?

Tim Wise: We ran a lot of numbers and analysis leading into both valuation and, very importantly, capital modelling. Conor, do you want to talk about what we did in terms of the analysis and valuation, and also the stress testing?

Conor Hillery: Yes. To underpin our advice, in particular the view that we gave as to the fairness of the financial terms of the transaction, we did extensive valuation work. The purpose of that work was to help us assess and advise the management team on the value creation from this transaction. We used several approaches in doing that work. Some of them took reference from public benchmarks, valuations of listed banks and similar transactions in the sector, but where we spent most time in our valuation was on reviewing the business projections and the business plan prepared by management. Our objective was to come up with a view as to the economic value that would create if it was delivered.

To your point, we reflected extensively before we did our valuation work on the findings of management and the findings of KPMG. The approach that we took to valuation

was forward-looking, assessing the plans that the management team felt that they could deliver. Our approach was forward-looking so that we could take account of what we felt were the key sensitivities and stress scenarios to this business plan, drawing on KPMG's work.

Q1245 Mr Newmark: But KPMG, according to them just before you, were only looking at a small piece of the pie. You guys were looking at the whole pie, I am assuming. Correct?

Conor Hillery: Correct. In doing that we drew on KPMG's work and, very importantly, the management team's assessment of the prospects of the business. We did not restrict our work or focus to the plans that the management team had come up with. We challenged those. We felt that they should be stress tested very conservatively.

Q1246 Mr Newmark: I am curious on the stress testing. The sense that I got was that the Co-op management were dead keen to do this deal. This was going to make them a very big organisation compared with where they were before. I am sure they were focusing on the synergies, the upside and everything else. You guys as advisers are not simply stress testing the P&L, but looking at the balance sheet and understanding the downside. On one side of the equation you had management who, my gut tells me from all the conversations we have had, were dead keen to try to make this deal work for them somehow. Then you guys were there, I hope, to act as a form of caution by saying, "Given the work that we have done, what we see from what you guys are doing and what we have seen from what KPMG are doing, these are the downside risks". I am curious: did you drill down on to that yourselves, or were you relying on the information that management were feeding on one piece of the balance sheet and KPMG on the other side?

Conor Hillery: The management team and KPMG reviewed the P&L projections and the balance sheet and we did, as we always do, rely on their commercial assessment and their view of the prospects, the profitability, the balance sheet and the capital position of the business. But, we felt very strongly that we did need to take account of the views of management and KPMG, and indeed of our views, in the prevailing economic environment, as to what the risks around the implementation of this business plan and merger would be.

To that end, we focused particularly on impairment levels, because we felt that that was where the greatest downside risk to this transaction was. We thought carefully about how we would reflect that in our work, not just in the valuation but also in stress testing the capital position of the combined business. What we felt it was prudent to do was to rely on objective tests—a stress scenario that was based on a formulation devised by the Bank of England and the FSA, and a more extreme, severe scenario that followed the Bank of England's definition of a stress scenario. We felt that those two scenarios were the best way of reflecting the downside risks to the business, because they—

Q1247 Mr Newmark: I hear what you are saying. I am trying to understand what went wrong, given what we have seen with the benefit of hindsight, on both bits of the balance sheet, which got highly impaired from where you started. I am trying to get an intellectual bridge analysis from you, from all the stress testing that you did, of what happened in reality. What happened in reality was effectively that the mortgage book and the commercial book were a lot worse, and ended up being a lot worse, than you guys, who had the big picture, saw. Did you see it? You gave the green light in the end, notwithstanding all the caveats that you had in there. At the end of the day, from what I saw that you wrote, you gave the green light that this was an okay deal to go ahead and do.

Conor Hillery: Maybe I could just put that in—

Mr Newmark: I am trying to understand that link between the stress testing you did—the analysis you did on top of what KPMG and the management team did on the balance sheet—and what actually happened. At the end of the day, I appreciate that it was the management of Co-op’s ultimate decision to make the decision. Looking at the competency of management, they were good, but you guys are pretty smart and you are paid a lot of money really to drill down and say, “Hey, hold on a second”. I do not quite get the sense that you did that at all.

Conor Hillery: Maybe I can just put in context the level of stress testing that was done to take account of the detailed review of the business. Management’s base plan assumed impairment levels for the four-year period to the end of 2012 of just over £200 million. The moderate stress scenario, which we anchored our valuation work on, assumed almost a doubling of the level of impairments—getting on for about £400 million—and the severe stress scenario implied impairments consistent with an impairment level of over £700 million. At that time—

Mr Newmark: Remind us what happened in the end. What was the ultimate—

Conor Hillery: I do not know the precise breakdown of the impairment levels, but the actual impairment levels coming from the Britannia book would have been somewhere in between the moderate stress scenario and the severe stress scenario.

Chair: It was about £500 million.

Tim Wise: Yes. Clearly subsequent factors and events have compounded that, but the work that we did, which we anchor on the moderate stress scenario, did project the creation of economic value. The capital projections showed that the pro forma business would remain adequately capitalised during the period modelled, albeit that the capital ratios would be at a weakened level. That capital modelling was the basis of discussion with the regulator and with other parties who obviously took a keen interest in the output of the work undertaken to stress test the capital position and the resilience of the combined business.

Q1248 Mr Newmark: Notwithstanding the point that the Chairman made, which is one half of that equation, there were two halves of that—that is the balance sheet and the assets of the Co-op. You must have been looking at the balance sheet, effectively making a merger analysis, showing both balance sheets together.

Conor Hillery: Yes.

Mr Newmark: The stress testing that you did showing the merged entity showed a much bigger number than you guys ultimately saw, even in your stress testing. Am I right?

Tim Wise: Just to go to your point about—

Mr Newmark: Hold on, Mr Hillery is nodding. Things were a lot worse.

Conor Hillery: The numbers I was giving you were the impairment scenarios for the Britannia business. We also looked at—

Mr Newmark: I understand that, but you do a merger analysis as well.

Conor Hillery: Absolutely. The combined business plan and stress testing around that did look at the capital impact of the various scenarios on the combined business. To put that in context, the actual experience was about £1.1 billion over the period we were reviewing, and the scenario that we had run implied a level of impairment of about £1.3 billion.

Q1249 Mr Newmark: At the end of the day do you think, given the analysis and stress testing that you did, that giving the green light was the right decision?

Conor Hillery: Based on the environment at the time, and having taken a prudent view of what we felt were realistic adverse scenarios—in particular the moderate stress scenario, which was based on projections by the Bank of England in November 2008 and assumed an

economic downturn in 2010 but some recovery thereafter—we felt that that scenario supported a transactions on the terms that—

Q1250 Mr Newmark: If you are a shareholder, do you think you feel you got value for money from you guys?

Conor Hillery: In hindsight, clearly not. Based on the advice that we gave at the time, which ran various scenarios on a prudent basis, we felt we gave very professional and prudent advice. That advice just—

Mr Newmark: But it was not value for money at the end of the day, though, was it?

Conor Hillery: I would not say it was not value for money. I would say that based on the advice that we gave—

Q1251 Mr Newmark: But you were rewarded, as Tim Wise said earlier, you were rewarded on success. At the end of the day you made a bet. You gave the green light because you thought that given your analysis, notwithstanding what happened, this was the right thing to do. But you have said with the benefit of hindsight that it probably was not the right thing to do. Shareholders did not get value for money, did they?

Conor Hillery: I think it would be unfair to look in isolation at the impairments that have contributed to the position that the Co-op group is in now. The reality is that there were a series of events and costs to the Co-op group that emerged subsequent to this transaction and were unrelated to it.

Mr Newmark: Yes. I am looking up to that point in time.

Chair: Just go through those.

Conor Hillery: They relate to a combination of things.

Chair: Are you talking about the IT, or are you talking about—

Conor Hillery: IT, PPI—and in my understanding those costs were in the order of £650 million.

Q1252 Chair: Do you agree with the conclusion of the regulator that the Britannia overhang was absolutely crucial to the severe weakening of the Co-op's position that led directly to the need for capital injections?

Conor Hillery: I think it played a material part in it, but the Britannia deal, taken in isolation and based on the advice we gave at the time and the modelling we were doing, demonstrated that the combined business could withstand a level of impairments under quite significant stress scenarios.

Q1253 Chair: You already knew they were going to be pretty stressed, didn't you, because global markets were distressed, to put it mildly, in 2009, weren't they?

Conor Hillery: Yes, the outlook was very uncertain at that time. That is why we focused our work on what we felt was the right scenario, which was a stress scenario that assumed an economic downturn for a period of another year.

Q1254 Mark Garnier: Can I just go back to your fee structure again? I want to be absolutely clear. You were paid a £2 million retainer to start off with, on the signing of the intention to go ahead with the deal, plus a further £5 million that can be properly looked at as a performance fee on the completion of the Vintage transaction. Is that right?

Tim Wise: Yes, the second bit of £5 million was paid once the transaction completed.

Q1255 Mark Garnier: If it did not transact, then you would not receive the £5 million?

Tim Wise: We would have received £2 million, yes.

Q1256 Mark Garnier: You would have just received the £2 million. Subsequent to that, what other fees have you received from the Co-operative group for any other transactions or any other advice you might have given?

Conor Hillery: We have not provided any corporate finance advice since. Our funding and capital markets colleagues have worked with them on some transactions in that area.

Mark Garnier: There is an ongoing relationship between JP Morgan and the Co-op?

Conor Hillery: JP Morgan has been active in advising them on some normal flow business when it comes to funding and capital markets.

Q1257 Mark Garnier: The basis of a lot of the questioning that is going on is this. Have you been steering Co-op towards a transaction that they perhaps should not have taken in order to try to make a fee that was two and a half times the base fee? Your incentive is two and a half times the amount just to sign the original contract.

Tim Wise: I am not sure that is quite the right way to characterise it, because our advice effectively ceased on the point of announcement. Our advice was given at the time of announcement.

Q1258 Mark Garnier: You were quite keen that an announcement was made. You will see there is an incentive. There was an incentive for JP Morgan Cazenove, in order to get £7 million as opposed to £2 million, that an announcement of a transaction or an intention of a transaction was to be made. Is that right?

Tim Wise: To be clear, what was going to happen between announcement and completion was that the regulator had to give its final approval, which obviously we had no real participation in.

Q1259 Mark Garnier: Your fees carved out any risk of a regulatory hurdle?

Tim Wise: No, they did not. We received the £2 million, but we would not have received the subsequent £5 million if the deal had not happened for whatever reason.

Q1260 Mark Garnier: Sorry, I am a bit confused. It is completion of the deal, not the announcement of the deal?

Tim Wise: On the announcement of the deal, we received £2 million.

Mark Garnier: On the announcement of the deal you received £2 million and on completion you received—

Tim Wise: I think it is right to characterise the fee as a £7 million fee.

Q1261 Mark Garnier: Sorry, just ease back a little bit. There had to be an announcement of the deal before you received any money at all?

Tim Wise: That is right.

Q1262 Mark Garnier: To a certain extent, this was speculative. How speculative was it?

Tim Wise: Sorry, speculative in what sense?

Mark Garnier: When you were engaged, had the deal been announced?

Tim Wise: No. We were engaged in June 2008 and the deal was announced some seven months later.

Mark Garnier: In order for you to get anything at all, the deal had to be announced.

Tim Wise: In order for us to get anything at all the deal had to be announced.

Mark Garnier: Okay, so it was speculative.

Tim Wise: In terms of our work.

Q1263 Mark Garnier: To receive the first £2 million you had to have the announcement, and then for you to receive the remaining £5 million the deal had to be transacted. Is that right?

Tim Wise: Yes. We did not receive anything if the deal was not announced. If it was announced and did not complete, we received £2 million. If it completed we received a further £5 million, to give £7 million.

Q1264 Mark Garnier: You have to make a profit on that, but it could have cost you £1 million or £1.5 million for the work done on a speculative basis within the department that you guys run.

Tim Wise: It would have been a material amount of outlay, yes.

Q1265 Mark Garnier: The reason I ask this is because clearly there is a big incentive for a transaction to be announced, and when you look at the *Claret Financial Services Report* produced by you guys, at page 3 it says, “A combination of complementary businesses will benefit customers. Introduction.” This is point one on the first page. “Vintage represents a one-off transformational opportunity for Claret. Shares strategic vision, purpose and values between two groups; becomes number two mutual in banking sector; total loans and advances of £34.5 billion; enhanced financial services offering customers,” and so on. That does not sound like a very impartial document to me. That sounds like a real sales tickler.

Tim Wise: In terms of the commercial logic, which is what you are referring to there, we believed at the time, and management believed at the time—and general comment was at the time—was that the commercial and strategic logic for the transaction was compelling. You can quibble with the precise way of describing it but, if you look at the facts of the combination and how it fulfilled the very clearly stated strategic ambition of Co-op, it was a very compelling deal. I think the superlatives, or however you characterise it, are justified in the strategic logic.

When it comes to the financial analysis and the stress testing, which we were referring to earlier, they were extremely dispassionate and rigorous and conservative. We did not use a base case. We used a stress case, which was an FSA one-in-25 case. I think the financial analysis goes against that partial view.

Q1266 Mark Garnier: In answer to questions from Mr Newmark you said you used a moderate stress test, I think. Shall I go through the pre-tax profits underlying under the moderate stress? 2006 actual, £164 million; 2007 actual, £115.2 million; 2008 estimate, £88.1 million; 2009 estimate, £28.4 million; 2010 estimate, £38 million; 2011 estimate, £96.5 million; 2012 estimate, £146.9 million. According to your chart you have a 14% compound annual growth rate between the 2008 estimate and the 2012 estimate, and that is on a moderate stress test. You still stand by that?

Tim Wise: By those figures?

Mark Garnier: Yes. You are happy with that?

Tim Wise: You cannot be happy with the outcome or the way it has gone, and there are obviously a number of factors that have gone into that, but in terms of the analysis that we did at the time, based on the projections at the time and using a stress test that we felt was conservative, yes, we absolutely stand by what we did at the time.

Q1267 Mark Garnier: The reason I am pressing on this is because when you merge the two businesses together, you have a lot of different things that are going on, and one of the things that is pretty clear is the overview of the lending mix and the overview of the relative capital requirements. On the lending mix, you have 45% of the loans of Britannia coming from member business, but I think that less than 10% of the capital requirement comes from member business. So the relative capital required is over 90%. You are bringing what is quite a subjective and risky amount into the merged group, and you are doing it at a time when Bradford & Bingley and HBOS are going bust. There is quite a lot of evidence out there that this type of lending is extremely dodgy. Discuss, Mr Wise.

Tim Wise: You are absolutely right to point to the environment, and I recognise that that is a view not just given with hindsight. A lot of people held a valid view at the time about the risks and whether this was the time to do a deal or not, but I think you also have to accept that there were a lot of banks run by highly professional and credible people who took a different view. What I think we should not have any disagreement over is your point that it was a very heightened risk, and you had to take account of that. Clearly a lot of economic and credit data was trending in the wrong direction.

The reason why this took so long—and it was abnormally long in terms of due diligence and stress testing—was to take account of those points. Can we say that we ran a severe stress test scenario that was consistent with what has happened, and therefore say, “Didn’t we get it right?” We can’t say that. We did not use that as our core case. We used a moderate stress scenario that clearly undercooked the eventual impairments, but it was looked at very, very materially. We tried as best we could to run stress scenarios in keeping with FSA and Bank of England scenarios.

To your point, the £9 billion of specialist lending was absolutely the area of focus. That was the biggest area of concern for the Co-op board, and that was the biggest area of stress testing. In fact, as has been pointed out in this Committee, the stress testing on that book has turned out to be significantly over-conservative. It is the corporate book that has given rise to all the problems.

Q1268 Mark Garnier: Let’s look at another area, because we are trying to create a package of good reasons to go ahead with the merger, and I am finding it quite difficult to find any really good reasons, but we will come to that in a minute. Let’s look at the second negative, the wholesale funding problems within the market. Wholesale funding is today’s big issue. Britannia is bringing back £9 billion-worth of wholesale funding, compared with Co-op, which has about £1.6 billion of wholesale funding. Your Vintage, representing a one-off transformational opportunity for Claret, is a one-off opportunity to ship in £9 billion of wholesale funding, which has brought down Northern Rock, for example. Why would increasing the wholesale funding requirement on this business by a factor of six be a good idea?

Conor Hillery: The due diligence looked at the composition of the funding structure. Relative to the funding structures of a lot of other banks at the time, Britannia was relatively conservatively funded. 50% of the funding was from retail deposits, about 25% from corporate deposits and then the balance, as you referred to, from wholesale funding in the market.

Q1269 Chair: All the other banks were in deep trouble as a consequence of the wholesale funding dependency, weren’t they? Just as you were advising this bank to—

Conor Hillery: Many banks were, but I think we took some comfort from the more conservative funding structure of Britannia’s balance sheet, a large quantum of which came from retail and corporate deposits.

Q1270 Mark Garnier: Sure, but we are talking about the interests of the Co-operative members, aren't we? This is the key thing about it. You are recommending to Co-operative members that they go ahead with this transaction. As I said, and I will keep repeating it, it "represents a one-off transformational opportunity for Claret"—to put it into less sneaky-beaky words, the Britannia transaction represents a one-off transformational opportunity for the Co-op, and so for the Co-operative members. I fail to understand how shipping in £9 billion-worth of wholesale funding against the wholesale funding requirement of £1.6 billion is good news for the Co-operative members.

Let's look at something else that is important for the Co-operative members and do this side-by-side analysis. Britannia has 2.8 million members; Co-op has 2.1 million members. We agree with that; it is in your report. Co-op represents 43% of the membership of the combined group. Yet when you look at the dividend being paid, Co-op represents 68% of the combined group, so this is a significant dilution for Co-op members on just the dividend alone. How is that a "one-off transformational opportunity" for Co-op members?

Tim Wise: In terms of the dividend, the way it would have worked out, in terms of the calculation and why it was changed, was that Britannia members, relative to Co-op members, would have suffered a dilution in terms of what they got as a dividend per member.

Q1271 Mark Garnier: Alright, well, let's look at profit before tax. In 2007 Co-op has 70% of the combined group—that is an estimate—in 2008, 79%; 2009, 76%; and the NAV 75% in 2007 actual. Whichever way you turn it on its head it is a—

Tim Wise: But I do think you have to look at the economics from two standpoints.

Mark Garnier: So dilution is a good idea?

Tim Wise: No, I think you have to look at the economics from two standpoints. One is from the group's value-creation point of view, and in that context they did not pay anything. They did not pay anything for the business. It did not really matter if one was worth 50 and the other was 50—one could be worth 75 and the other is worth 25. The fact is that the Co-op got the benefit of the 25 or the 50. It did not really matter. What mattered was whether it took on board a balance sheet that would hole it below the waterline, and of course so it does with the impairments.

In terms of the benefits per member and the dividend payments, your point is absolutely right—it was about whether the new dividend payment structure would benefit or dilute one party versus the other. That is really the point about dilution from the Co-op member point of view.

Q1272 Mark Garnier: You would agree there was a dilution.

Tim Wise: In terms of overall value, no. In terms of overall valuation, fundamentally—

Q1273 Mark Garnier: They have effectively a smaller share of an enlarged group. If you are a Britannia member, you are doing extraordinarily well out of this transaction.

Tim Wise: That scheme is very complex, and what it is based on is a hypothecated approach to getting dividends out of the bit that you will relate to as a customer. In terms of the dividends they got, it was in relation to—

Q1274 Mark Garnier: Is this the discounted dividend valuation?

Tim Wise: No, that is not. That is the overall valuation of the business. That dividend related to their dealings with the financial services business. In that context, the Britannia members were actually going to suffer a dilution relative to Co-op members in terms of their

payment per member, which is why there was an £11 million top-up in 2010 and 2011 to take account of that.

Q1275 Mark Garnier: What was good about this deal?

Tim Wise: With hindsight or based on our advice at the time?

Mark Garnier: Based on your advice at the time, and we will come on to hindsight in a minute.

Tim Wise: I think it revolved around two things. One was the commercial strategic logic, which you have referred to.

Mark Garnier: This is going from 100 to 350 branches?

Tim Wise: Yes. There was a very complementary product fit between the two in terms of savings and mortgages on the one hand and unsecured on the other hand, and in terms of branches, so the distribution and product fit was good. There was obviously a point that a number of people had made about having a larger-scale financial services business was going to make investment that much easier to spread across the business.

Q1276 Mark Garnier: This is the increase in the value from synergies, the increase in the earnings from—

Tim Wise: Yes, and then the significant—

Mark Garnier: Wouldn't that be locked down as £70 million?

Tim Wise: £70 million in terms of costs, yes. We kind of ignored the revenue side, but the cost was key.

Coming back to our role, of course, the significant benefit, which has turned out to not be the case, was the value creation. There you can have the debate about the level of stress testing and the level of foresight at the time.

Q1277 Mark Garnier: And in hindsight?

Tim Wise: With hindsight, would you have done the Britannia deal and has it benefited Co-op?

Mark Garnier: In hindsight, what were the good things about the deal?

Tim Wise: I think the strategic logic still holds water, for what you regard that as being worth, and there will be deals done in the future that are based exactly on that type of strategic logic in terms of complementarity, benefits for customers, broader product range and so on. Economically, clearly that has not stood the test of time. Demonstrably it has not stood the test of time, although I would say that is quite a long period of time.

Q1278 Mark Garnier: What has happened, though, in terms of the economics, was all known at the time. This is what we are all collectively really struggling to understand. You have a huge amount of evidence, an absolutely colossal amount of evidence around. The wholesale funding markets are screwed. You have the banking system as a whole in real, real trouble. We have had enormous great groups going bust, bailed out by the taxpayer. Nothing has materially changed. We are just emerging from this financial crisis. We have another financial crisis coming at us around the corner in the form of the euro crisis, and the European banks are all about to go bust. Clearly we weren't going to know all of that at the time, but nonetheless there was an enormous amount of writing on the wall. You're bankers and you know what the wholesale funding markets look like on an hour-by-hour basis. You really do know this.

The key problem that we as a Committee are finding is that when you look at your fee structure, it is hard-wired to get an announcement of a transaction. If you are then lucky and the regulators approve this transaction, you then get the transaction going through. But you

are hard-wired on a speculative bit of work, because to get any sort of payment at all, an announcement or an intention to go ahead with the transaction has to be made. This is at a time when we know that banks are still potentially going bust. We know there are a huge amount of problems. You come up with a statement saying that this “represents a one-off transformational opportunity” for Co-operative members. Some of your analysis that you do is, frankly, heroically optimistic under your moderate stress test. You are looking at the stress test at a time when other banking groups are increasing their provisions for bad loans and the Britannia is not. The Britannia is very, very marginally making any difference. It does not make any sense.

Tim Wise: Can I just put a bit of context around the moderate stress case, which clearly undercooked the eventual position, exactly as you said?

Q1279 Chair: Before you do that, Mr Wise, could you just say whether there is anything that you have just heard from Mark Garnier with which you want to take issue?

Tim Wise: I think what I would take issue with is that the decision made at the time and the assumptions that we made were in some way reckless, that in some way we ignored the economic environment around us at the time and did not take account of the fact that the Britannia had within its books the potential to suffer significant stresses over the coming period. I think you can argue about whether we got it right—no, you don’t have to argue whether we got it right, because demonstrably, like a lot of economic commentators, we did not get it right, so we don’t argue about that. But the argument has to be about whether the position we took was reasonable at the time. I am not going to rely on the severe stress case, even though it was almost completely in line with what happened, because we did not base it on that. That was run for prudent purposes, although I think it does say something about the mindset of us and the company that we ran that. I have not seen that level of severity run on any other deal I have worked for before, so it says something.

But let’s go to the moderate stress case. The moderate stress case was all about impairments, because I think everybody agrees now, and everybody agreed then, that it is about impairments. It was entirely consistent with the FSA’s stress case, the one-in-25 stress case. The economic assumptions about interest rates and inflation were different from what happened, but essentially it was based around inflation going up and interest rates going up and causing a significant drop in house prices, leading to impairments.

I don’t think it really matters whether economists got it right or wrong five years ago. What matters is that we took a stress case that carried in it significant impairments. We ran a stress case based on the base cases, and we doubled the level of impairments. Our base case was a doubling of the level of impairments over the four-year planning period for capital evaluation purposes in the Britannia book. That was undercooked, but it was not for want of prudence or rigour of going about it, and it was consistent with the FSA and Bank of England stress scenarios at the time. They were not enough.

Q1280 Mark Garnier: You have just described a stress test that looks at increasing interest rates, yet interest rates are still at a 300-year low and still this problem has come through. What good is a stress test? To ask this a slightly different way, you can produce a 1,000-page document looking at all this kind of stuff. You can run the numbers any way you like. We all know, any of us who have worked in the City, how you can construct anything—accountancy is an art form. We get that; we understand that.

What was your finger-in-the-air judgment at the time, just from looking around your dealing room—you may have a Chinese wall—and seeing what was going on in the wholesale banking market, and seeing what was going on in the other banks? JP Morgan is stiff with banking analysts. What was going on elsewhere, and what general impression were

you getting? Did anybody at some time turn around and say, “Look, guys, this looks rubbish, we shouldn’t be doing this”? Or did you just absolutely resolutely stick to the completely bogus and failed models from which you can construct any argument you like, and ignore your own personal gut feeling?

Tim Wise: No, we didn’t. Just one point on the interest rate assumption, which was obviously wrong. The problem with running a low interest rate assumption is first that it would have gone against what the Bank of England and FSA were suggesting, which with hindsight really would not have been a good idea. Secondly, it would have kept the lending impairments low. We went with something that kept the impairments high, because that was clearly the sensitive bit.

In answer to your specific question, as I said before, there were people who had shied away from doing a deal at the time, and there were plenty of people who thought it a highly opportune time to do something. The gut feel and the intellectual view were pretty much the same—it was a case of significantly heightened risk. What you had to do was downside protect yourself as much as possible. The first thing we did was not pay any consideration. Two years before, the Nationwide, when it merged with Portman, paid out £500 million and there was an expectation early on in the discussion process there would be a payment to Britannia members similar to that. There was no payment.

Secondly, there was the stress testing. Of course, with the benefit of hindsight that stress testing was too aggressive, but at the time, based on some good evidence and data from elsewhere, it felt like a sensible stress case to use. We tried as hard and prudently as we could to model something that we thought reflected a sensible stress scenario at the time.

Q1281 Andrea Leadsom: Mr Hillery and Mr Wise, why are you both here to talk about this transaction? Were you both jointly accountable for it or was one of you taking the lead role.

Tim Wise: The former.

Q1282 Andrea Leadsom: You were both jointly responsible for that. Why is that? What is the procedure that means that you have two—I believe you are both called managing directors of UK investment banking.

Tim Wise: It was a large, significant and complex transaction, so it merited having a team that reflected that.

Q1283 Andrea Leadsom: How many managing directors of UK investment banking are there?

Conor Hillery: About 25 to 30.

Q1284 Andrea Leadsom: And they are all the directors that are managing the UK investment bank, so it is management by a very large committee.

Tim Wise: I am afraid investment banking titles have possibly been devalued a bit by how broadly they are used, and we are probably as guilty of that as anybody.

Q1285 Andrea Leadsom: Exactly, and that is really the point, isn’t it, that in investment banking, there are any titles and any pay but no accountability? Would you agree in hindsight that that has been the case here? You have told us that you have had a clearly one-sided incentive, first to get the deal to be declared and then to get the deal to go through, with no downside to you personally or professionally. It was upside only, and there was a very clear one-way incentive to make the deal happen. Or is that not the case?

Tim Wise: I think that is a little unfair.

Q1286 Andrea Leadsom: I am not really interested in whether it is unfair. Is it true? Are you going to tell me that there was a downside? If so, what is it exactly?

Tim Wise: The downside for us?

Andrea Leadsom: Yes.

Tim Wise: I think that on the reputational downside for us as individuals, time is going to tell. Clearly there is significant potential for reputational downside if you are involved in a transaction in which, however much you plead, there are all sorts of other extraneous factors, beyond your control. There are all sorts of factors that have come in five years later, and there has been a significant change in the capital and balance sheet. If a transaction has gone wrong and you have been involved, however much you plead at the time that your advice was extremely rigorous and prudent, if it goes wrong I think inevitably you are going to suffer personally. It is just a personal point of view, but you are going to suffer some personal reputational damage. I think there is a huge downside personally from being involved in transactions that do not go well.

Q1287 Andrea Leadsom: Mr Hillery, clearly £7 million is not a payment for the hours spent, unless you are earning vast hourly rates. It is clearly a success fee basis, isn't it? Clearly, as we know, investment banking is incentivised by the money, and that has always been the case. Having spent time in that industry myself I am perfectly relaxed about that. But would you agree, Mr Hillery, that the problem in this case is just that there is no accountability? You have had an enormous fee that bears no relation whatsoever to the time spent by any one individual, and it has everything to do with the fact that you made this transaction happen.

On the financial upside, there was no equal and opposite financial downside. Although Mr Wise points to potential reputational damage, it is hard to imagine that the investment banking sector could have done more damage to itself than it has in the last few years anyway, but can you point to where the financial downside is for you?

Conor Hillery: I will answer first on the general point, and I will come back to your specific question. In terms of accountability, we are accountable. We are here today.

Andrea Leadsom: Financially accountable.

Conor Hillery: In terms of our advice overall, we are here today and we put our name publicly to these transactions.

Q1288 Andrea Leadsom: I am asking specifically about financial accountability. Mr Wise has already mentioned reputational accountability, but I am asking about financial accountability. You have a £7 million upside. What is the financial downside?

Conor Hillery: The fee that we earned for this transaction was based on the advice that we gave at the time, which we felt was fully justified by the complexity of the deal, the extent of work that we did, the seniority of the team and ultimately the terms of the transaction that were agreed and structured at the time in the light of the prevailing environment.

Q1289 Andrea Leadsom: So there is no element of success fee in there; it is all the hourly rate for the time spent, is it? It is not a success fee, in your opinion.

Conor Hillery: As has been mentioned earlier, the fee is linked to the successful conclusion of the transaction.

Q1290 Andrea Leadsom: So it is a success fee. We have just heard from KPMG that they earned £1.3 million, which they argue was for the time spent at the hourly rate. You are

not suggesting that £7 million was time spent at an hourly rate. You are acknowledging that that was a success fee.

Conor Hillery: It took account of a range of factors, including the amount of time that we had committed to it, but ultimately, yes, it was only payable on the successful agreement of the transaction.

Q1291 Andrea Leadsom: Yes. Can you tell me, did you at any time talk to the regulator? Clearly the £5 million, the second fee, was dependent on the regulator agreeing and approving the transaction. Were you at any stage involved in discussions with the regulator during their decision-making process?

Conor Hillery: We had no discussions with the regulator. One or two of our team may have attended some meetings at which the management team discussed the transaction with the regulator, but we had no direct interaction with the regulator.

Q1292 Andrea Leadsom: So there would be absolutely no merit in us investigating whether there was any attempt to persuade the regulator to approve this transaction?

Conor Hillery: No.

Q1293 Andrea Leadsom: You said that part of your rationale for advocating the Britannia merger was that scale was increasingly important in the current environment. Presumably you were already at that point of discussing all the arguments about “too big to fail” and the problem that we had with too many large banking organisations. Can I specifically ask whether you evaluated the implications of “too big to fail” in the context of this merger and whether it would tip that organisation over the edge into the “too big to fail” bracket? Did you do any due diligence on that point?

Conor Hillery: We were not focused specifically on the “too big to fail” scenario. Ultimately, this combined business was still a relatively modest financial institution in the scheme of things.

Q1294 Andrea Leadsom: You would not have considered that it was getting into the area of being systemically important as a result of this merger. Did you consider that at all?

Conor Hillery: That is not something that would be a particular area of focus for us. We were focused on stress testing the capital resilience of the business under the various scenarios and in projecting the value that would be created for the members under the various scenarios.

Q1295 Andrea Leadsom: At the time, were you aware that this whole discussion about taxpayer bailouts and banks being too big to fail was a problem for the British economy?

Conor Hillery: Yes, very much so. That was after the period when several of the banks had been recapitalised, not in the UK but globally.

Q1296 Andrea Leadsom: You did not consider, however, whether there were implications for this merger from that systemic risk that we were seeing and that taxpayers were having to bail out at that time?

Conor Hillery: What we took account of was the resilience of the balance sheet under various scenarios, which I think goes very much to the point that you are making. We wanted to get comfortable and to review the pro forma projected balance sheet of this business over a period of several years into the future, under several scenarios. Those were the scenarios that were discussed with the Bank of England and with the FSA. That stress testing demonstrated

a resilience of the combined business under the moderate stress scenario, and indeed under the severe stress scenario it still projected a healthy level of capitalisation for the combined business.

Q1297 Andrea Leadsom: Going forward, then, if you were to advise on a bank merger, would you consider “too big to fail” and the implications around systemic risk, and the potential for taxpayers having to bail out that transaction, or would you not see that as any concern of yours?

Tim Wise: No, I think it has to be some concern of ours, but I think fundamentally that has to be an issue for the regulator and the regulatory authorities. As we have said, and as Conor has said, in the context of this transaction I really don’t think that was a relevant consideration. Obviously when you look at the independent—

Andrea Leadsom: I am not really asking you whether it was relevant so much as whether it was something you did consider and then ruled out.

Conor Hillery: No, we didn’t.

Andrea Leadsom: You did not consider that.

Tim Wise: No, we didn’t, and clearly the Independent Commission has talked specifically about the Co-op as enlarged, and specifically about the right size for challenger banks and the benefits for the economy of having the right-sized challenger banks in the banking system. This was clearly well short of a challenger bank, so I do not really think in this context—

Q1298 Andrea Leadsom: My point, Mr Wise, is precisely that: are you concerned about what is good for the British economy? Mr Hillery has said that you did not consider the issue of “too big to fail” and what was right for the British economy. You did not consider whether in fact it would be good to have this merger for the sake of having more challenger banks and so on. What I am asking you is, did you consider it in the context of, “How does this work in the British economic context, is this good for the economy or is it merely a transaction that is about shareholders and matching up of assets and a good marketing story?” In the future, bearing in mind that you have just been burned, will you consider what works in the context of the British economy? That is incredibly important, wouldn’t you agree? Or do you think that advisers have nothing to learn from the financial crisis?

Tim Wise: No, I think they have plenty to learn from the financial crisis in the context of their prescribed role as financial advisers. We are engaged by our clients and we are asked to do things for those clients as set out in our engagement letter. That is what we do, and that is the nature of any client-advisory relationship in any sector. Clearly the broader structure of the regulatory structure of banks is something that our bank, particularly given its status, spends a huge amount of time on.

I don’t want to delude you about the broader macroeconomic role we play. We are advisers to a company, and they engage us to carry out a specific role and specific parts of that role, and that is what we do. It is really in their gift to decide what we do; it is in our gift to decide how we then do it properly.

Q1299 Andrea Leadsom: So our advice to regulators needs to be to not really look at the due diligence as anything more than the numbers, and that it is for them to consider the implications for the wider economy.

Tim Wise: Yes, I think due diligence on a transaction revolves around the commercial aspects, the financial aspects and the legal aspects. In terms of the broader fit within the economy, the sort of animal you are creating and what further systemic ramifications arise from that, I think that probably is more of an issue for the regulator.

Q1300 Mr McFadden: Mrs Leadsom read out a slide from your papers saying that scale was increasingly important in the current environment. Scale is of course, in a way, what eventually brought the bank down. We have talked about Britannia for the whole session. Did JP Morgan advise the Co-op on the Verde deal?

Tim Wise: No, we did not. We were advising Lloyds on the Verde deal.

Q1301 Mr McFadden: You advised Lloyds on the Verde deal. If you were advising Lloyds on the Verde deal, did you play any role in warning them about the problems that your former client, in this case the Co-op, might have in conducting that deal?

Tim Wise: No, we did not.

Q1302 Chair: You have told us today that you got the money if the deal came through; you have also told us that your advice was completely unaffected by the fact that your remuneration was biased in that way. That is correct, isn't it?

Tim Wise: That is correct.

Q1303 Chair: Would you have given the same advice if, for example, in 2009 you had been told, "You can get your money in 2014"?

Tim Wise: If that was the basis on which they decided to pay us, I think we would have argued fairly strongly that that was not a fair basis on which to pay us, but if that had been the basis of payment we would have given exactly the same advice.

Q1304 Chair: And what if it had been contingent on your advice being right, and you would have got more if it had turned out right and less if it had turned out wrong? How about that?

Tim Wise: That is a perfectly plausible and maybe in some cases a thoroughly sensible thing to do, having a portion of the fee that is dependent in that way, but the fee structure would not have any impact on the advice we give and never does.

Q1305 Chair: In that case it strikes me that you should support a fee structure such as I have just suggested to you.

Tim Wise: Whether my personal view is going to have any impact in the broader world, I don't know.

Q1306 Chair: This is an opportunity for it to have some impact, isn't it? It is not just us having a quiet conversation here—there are a few people listening to it. What do you think?

Tim Wise: My problem with your proposal is that, although I think it is perfectly acceptable and sensible to try to have some of the fee aligned to the outcome for the stakeholders and your client I find it more difficult when we look at the detail. My problem with having something where you get paid several years later, and trying to reference that to something, is that your fee is almost certainly going to be determined by things that are outside anybody's control. You are either going to make out—

Q1307 Chair: But your job is to offer advice on the balance of risks on those very things. That is why you are collecting this money, isn't it?

Tim Wise: I think fundamentally we have to be paid for the role that we play, the advice that we given, and the content we give, which, as I have said, is completely impartial and regardless of how our fee structure is. That is how you get paid. If people think it would

be helpful to say, “Regardless of that, we want to have some participation in the long-term economic outcome”, then, fine, that is up to the broader market and to clients to decide. The problem with it is that I think you are going to come up with some very, very unusual results, and it could end up with people being paid a ridiculously large amount for things that have been absolutely nothing to do with them and do not relate to them.

Q1308 Chair: Do you think in all sincerity, after all the exchanges we have had today, that a fee structure like this is perfect in every respect, or do you think that a fee structure such as this for your industry is something that really does need to be looked at now?

Tim Wise: I think perfect in every respect is quite a high test.

Q1309 Chair: You have not shown us even a smidgeon of doubt about whether the way that these fees are structured is flawed.

Tim Wise: No, because I suppose I have complete confidence in our firm and our individual personal integrity. I know that is just an assertion, and people can believe it or not believe it. I have complete confidence.

Q1310 Chair: You have to have a lot of confidence, because people do respond to £5 million-worth of incentive, don’t they? If you were looking at a deal in any other context and you noticed £5 million on one side of the deal and zero the other, you would keep alert and take a close look at the advice, wouldn’t you?

Tim Wise: I am afraid I do have complete confidence in my own integrity and impartiality. The vast majority of clients would have exactly the same confidence.

Chair: I think the overwhelming majority of the British population would have trouble believing that, whether or not it is true.

Tim Wise: That is a fair observation.

Q1311 Chair: I am not casting aspersions on your integrity, but I am saying that when people are offered huge bonuses or huge remuneration to go in one direction and then asked to offer impartial advice on whether to turn left or right, they tend to look to see whether turning one of those directions gives them the bonus.

Tim Wise: I am making an assertion about myself, you are making a generalised point based on observation, which I think is entirely fair. I am not going to disagree with external perception. Fee structures have often been negotiated, people have looked at this particular issue and the potential dynamic between giving impartial advice and something that is success-related. If you are asking whether I think it is a debate that needs to be thoroughly aired and needs to be justified, I completely agree that it does.

Q1312 Chair: You made the important point that you would suffer reputational risk if you kept on offering advice to do deals that keep on going turtle up. What reputational risk do you think JP Morgan has suffered as a consequence of being part of this deal?

Tim Wise: The broader JP Morgan I genuinely do not believe has suffered reputational damage as a result of this deal. It is very difficult now in this extremely febrile atmosphere, where so much has gone wrong and it has so many controversial ingredients, to bring any balance to this debate. It seems to me that the common perception is that all the problems at Co-op are down to, frankly, the Britannia loan book and therefore the people who did that at the time must have been blind to the risk. The first is clearly a significant exaggeration. There are a huge number of factors that have gone into it. I think the second is plain wrong.

Q1313 Chair: If you have followed our earlier hearings, I think you would struggle to support what you have just said. We have looked at a good number of other aspects of the weaknesses in the Co-op.

Tim Wise: I agree this Committee has not. I am just saying I am afraid a lot of people take their views from what they read in the paper. I am saying there is a disproportionate view as to what had been the contributing factors. That is not to back away from the fact that the Britannia and the Britannia loan book was the significant factor when you added the additional capital strain. But I think if you look at the work we did at the time and the role we played at the time, and if people are prepared to look at that, there is no reputational damage.

I made the point earlier about the personal reputational damage, because I think that is slightly different. I don't think JP Morgan will suffer any reputational damage. Whether we will suffer individual personal reputational damage, a bit like the full Co-op story, time will tell.

Chair: Thank you both very much for giving evidence. It has been extremely interesting, occasionally enlightening. We may want to come back to you for more, but in the meantime you have had to wait some time and you have been on for some time. Thank you very much indeed.