

HOUSE OF COMMONS
ORAL EVIDENCE
TAKEN BEFORE THE
TREASURY COMMITTEE

PROJECT VERDE

TUESDAY 28 JANUARY 2014

RODNEY BAKER-BATES and DAVID DAVIES

Evidence heard in Public

Questions 1748 - 1915

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Oral Evidence

Taken before the Treasury Committee

on Tuesday 28 January 2014

Members present:

Mr Andrew Tyrie (Chair)
 Mark Garnier
 Stewart Hosie
 Andrea Leadsom
 Mr Andrew Love
 Mr Pat McFadden
 Jesse Norman
 Teresa Pearce
 Mr David Ruffley
 John Thurso

Examination of Witnesses

Witnesses: **Rodney Baker-Bates**, former Chair, Britannia Building Society, and former Deputy Chair, The Co-operative Bank and **David Davies**, former Deputy Chair, The Co-operative Bank, gave evidence.

Q1748 Chair: Thank you very much for coming in to give evidence this morning on this vexed question of Project Verde, the Co-op and what has now widened into a more broad-based inquiry—in fact, seven inquiries are now on the go, which is why this Committee, as was made clear a few weeks ago, is intending to wind up shortly and pose some questions for those other inquiries to look at.

Could each of you begin by saying whether you thought this was a good quality, well-functioning board that you were serving on during your respective periods? I will start with Mr Baker-Bates and then I will turn to Mr Davies.

Rodney Baker-Bates: My own view is that the board functioned reasonably well, in the sense that there was a wide range of opinions on the topics we were discussing and everybody was there with a common intent to reach sensible conclusions. However, I think the problems with the board were several. The first is, of course, the size of it: it was a very big board, and as a result it was hard to have a discussion and interaction around an issue. That is the first point. Secondly, the board, although it met as a single board, was in fact overseeing three different businesses: it was overseeing a bank, a general insurance business and a life business. Therefore the range, scope and complexity of the issues that we were trying to cover in a meeting made it difficult to get a focus on what I think were the key issues. The third point I would raise is that there was a wide spectrum of knowledge and ability. By that I mean that among the independent directors there was a good cross-section of knowledge of banking. Just on banking, when I arrived there, there were only two members of the board who had hands-on executive experience: myself and Peter Harvey. That was the interesting thing—that we were coming in new to the board, but we were the only bankers who had hands-on experience. Particularly among the democrats, as we call them, there was not really enough knowledge of the risks and opportunities in banking and financial services.

Q1749 Chair: Is there anything you would like to add to that or disagree with, Mr Davies?

David Davies: Nothing I disagree with. I agree with Rodney: the difficulty we had was growing the board and getting the right skill set on. By growing the board we also at the same time had to reduce the number of Co-operative delegates who were on the board. That was a struggle for the chairman—successive chairmen—to get the balance right and gradually change the balance and move more towards an IPNED, shorthand at the Co-operative Group for independent professional non-executive director, and to get the balance right between those who understood the business and those who were from the Co-operative Group board who added a wider dimension.

I thought the Co-operative board members who came from the group were of good calibre and quality and were very diligent and tried really hard to master the issues that we were wrestling with.

Q1750 Chair: That is not quite the same as Mr Baker-Bates' conclusion that was that, on the basis of quality and experience, there were shortcomings in that group.

David Davies: There were shortcomings in that group because they did not have the experience of financial services, which is why—

Q1751 Chair: You were describing them as diligent and trying very hard.

David Davies: Yes.

Q1752 Chair: So they were doing their best but not up to it?

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

Q1753 Chair: Which individuals do you think were responsible for the bank's near-collapse?

David Davies: You would have to start with Chief Executive. I am still not clear in my own mind as to whether the corporate loan book has deteriorated to the extent that our impairments show. If it is proven to me that that corporate loan book has deteriorated and is suffering significant losses, which is not yet the case, then one would have to look at the people who were monitoring the corporate loan book and say that they have some responsibility in this.

Q1754 Chair: We will come on to that in just a moment. Before I leave corporate governance, am I right in thinking that a report was prepared by an outside consultant, Dr Tracy Long, on the quality of the board? Do you know anything about this?

David Davies: The report essentially was on board effectiveness.

Q1755 Chair: So there was one.

David Davies: Yes, towards the latter half of 2010.

Q1756 Chair: Trying to answer the question I just asked you?

David Davies: Yes.

Q1757 Chair: What did that conclude?

David Davies: Firstly, the balance of the board in terms of its discussions was geared more towards reviewing the minutes of committee meetings and the issues that came up in

there, so there was a suggestion that we should relegate committee minutes to the end of the meeting. The balance of the papers was essentially too detailed—more quantity than there was quality—and we had to focus on changing the nature of the papers, and to bring the strategic issues more to the forefront.

Broadly—and this seems somewhat ironic now—the conclusions of Dr Long and the people who reported into her was that the chairman was a very good chairman and was leading the board effectively.

Q1758 Chair: Have you seen that report recently or is that from memory? It is quite impressive, as it is nearly five years ago.

David Davies: I read the report again in October last year and since then I have reviewed the minutes.

Q1759 Chair: I think this Committee will want to take a look at that report rather than pursue that issue further with you both now. Unless there is something particular you want to add, I will turn to another subject.

Mr Baker-Bates, you resigned from the Co-operative in July 2012, did you not?

Rodney Baker-Bates: Yes.

Q1760 Chair: Was that because of their decision to push ahead with Verde?

Rodney Baker-Bates: Yes.

Q1761 Chair: Did you feel, given you came on specifically to the board to perform the task of taking a decision like that, that you were now being ignored?

Rodney Baker-Bates: I was ignored, yes.

Q1762 Chair: And you therefore had no choice but to leave?

Rodney Baker-Bates: I think as an NED your responsibility is to state your opinion and to apply your expertise to the issues. I failed to win the argument. I set out to convince the board that I felt Verde was a giant step too far when overlaid on another major error, which was the whole Project Unity and bringing the bank's and the group management together, because that changed the whole nature of the relationship with the group and made the group executive and the group management have a much more direct role in the strategic and operational overview of the bank. I think there were two related major errors.

Q1763 Chair: You also went, Mr Davies. What would you answer to the same questions I have just posed Mr Baker-Bates?

David Davies: I knew that Rodney was standing down. I too felt immediately after the Verde vote in July that I could not in all honesty continue because—

Q1764 Chair: So the answer is yes, you went because of the Verde deal really?

David Davies: No, I did not go at that moment in time. Do you mind if I spell it out?

Chair: A little later, yes.

David Davies: The consequences of that was that I was asked by Len and Paul—Len Wardle, the chairman of group and Paul Flowers, the chairman of the bank—to stay on because they felt that to lose one deputy chairman post the Verde vote was inconvenient, but to lose two deputy chairmen—

Chair: Was carelessness.

David Davies: Yes. So the pressure was on me to stay on until the end of the year, and we agreed I would stay on until then, by which time they anticipated the SPA would come up

and would be signed. I made it very clear that I could not and did not think that I would be “turned” so to speak and vote in favour of the SPA. Gradually, as the next few months unfolded, the tide turned in my favour and my discussions with other directors suggested that they were having similar misgivings.

Q1765 Chair: We are going to explore all the aspects of the points you are raising in more detailed questions from colleagues. Just one last general point: you both had a hand in appointing the chairman?

Rodney Baker-Bates: No, I had no responsibility.

Q1766 Chair: None whatsoever?

Rodney Baker-Bates: No. I was a candidate.

Q1767 Chair: Ah. Mr Davies?

David Davies: I was asked to be a candidate and I refused; I made it clear that I thought Rodney was the better candidate. I had a hand in it, however, in the sense that I was part of the board that approved Paul Flowers’ appointment.

Q1768 Chair: If you had a better chairman, do you think you might have come to a decision that could have prevented you having to resign—by which I mean somebody who had some general idea about the subject matter?

David Davies: I think it is quite possible, given that other well-informed and intelligent directors came to a different conclusion initially, other than myself, on Verde, but even another chairman might have concluded that Verde was worth pursuing. I am pretty sure that whoever you appointed as chairman would have got the picture in the end, because we ran out of steam and when we reached the end of 2012 it was clear to me, and I think other members of the board, that Verde was not going to happen.

Q1769 Chair: It takes guts to resign, Mr Baker-Bates. Is there anything else you want to add?

Rodney Baker-Bates: It takes guts to stay on. Once I understood the implications—and I may have been a bit slow as they were not immediately clear—of Unity and the likely impact of that on the bank, and then Verde following on, I had a private meeting in October 2011, I think, with Paul Flowers and Len Wardle, the group chairman, to say that I wished to resign and that I was convinced that Verde was a giant step too far, given what was also happening in the bank’s day-to-day business. They made the perfectly reasonable point that they had not made a final decision to proceed with the transaction, that they valued my opinion and experience and that they wanted me to stay on the board.

There was a second, slight complication in that under the original merger documentation between Britannia and The Co-op Bank, four directors had come across, of which I was one, and that was to look after the interests of Britannia members as part of our other roles. My position on that was that the decision had not been made and that frankly it was my duty to stay on and try to win the argument, which I did not.

Q1770 Chair: Things would have been very different if you had become chairman, judging by what you say.

Rodney Baker-Bates: Yes, they would have been.

Q1771 Chair: We would still have the Co-op.

Rodney Baker-Bates: Yes, I think you would, but that may be arrogant.

Chair: We are going to come on now to the question of whether the Co-op was already holed below the waterline by Britannia.

Q1772 John Thurso: Good morning. Mr Baker-Bates, can I come to you first? Just so that I have this right, you joined the board of Britannia in 2006?

Rodney Baker-Bates: Yes, the summer of 2006.

Q1773 John Thurso: You became chairman in April 2008?

Rodney Baker-Bates: Yes, after the AGM.

Q1774 John Thurso: And through, then, until the merger went ahead, when you went on to the Co-op board. Neville Richardson became the Chief Executive of the enlarged organisation, while the Co-op Bank's chair remained the chairman. How was that arrangement arrived at? Was that part of the deal?

Rodney Baker-Bates: I do not remember it being part of the deal. What was laid out and discussed with me was that David Anderson wanted to stand down, and we knew that before, therefore Neville Richardson was the obvious candidate. The group appointed the chairman and there was no question that I would have a role there, but I put myself forward having strongly supported the transaction as one of the four directors to go on to the board.

Q1775 John Thurso: The critical point is that it was not an arrangement, as is very often the case with a merger, that one side gets the chair and the other gets the chief executive?

Rodney Baker-Bates: No, it was not an arrangement.

John Thurso: Neville Richardson was judged to be the best person and the Co-op chairman was judged to be the best person and you joined the board? It was a straightforward arrangement?

Rodney Baker-Bates: It seemed a perfectly natural one to me, particularly as David Anderson had resigned.

Q1776 John Thurso: When you and your colleagues from Britannia joined that board, do you consider that Britannia's board had the greater financial services experience?

Rodney Baker-Bates: We certainly had greater banking experience. We had no insurance business, which of course David and Bob Newton represented, therefore when choosing the directors who would come across with us—it was a discussion among the Britannia directors—I clearly picked Peter Harvey because of his strong, quite recent corporate banking experience; myself with banking experience; Stephen Kingsley, who had very good financial services and accounting skills; and Chris Jones who had a legal background and had been very helpful for us on the board, who I thought would make an excellent NED.

Q1777 John Thurso: The point I am really making is that when any two boards come together there are obviously differences of culture, approach, organisation and so on and these have to be melded together into one. Reading particularly some of Neville Richardson's evidence and indeed the note in relation to his script for his departure, it is quite clear that he views the Britannia as having had greater—I will not say superior but certainly greater—experience in financial services. Is that something that you would agree is a fair view?

Rodney Baker-Bates: Yes, I think I would, but qualifying it by saying banking rather than insurance and life insurance. That is the point.

Q1778 John Thurso: Regarding the commercial real estate loan book which was originated by Britannia and is now being said to be one of the principal sources of Co-op's losses, do you share Neville Richardson's surprise that these assets are turning sour now, and so badly, so long after their origination?

Rodney Baker-Bates: Yes, I do. Loan books generally do not function that way. If you make a poor loan—the word “toxic” has been used particularly—it is fairly obvious in the first two or three years, for whatever reason, and this portfolio was quite mature, even at the time when I came on the board.

Q1779 John Thurso: Just on that point, to give a rough idea of the maturity of the portfolio, many of these loans would have been originated three, four or more years before?

Rodney Baker-Bates: Yes. I have a broader range of experience, but when I came on to the board I had been in two particular areas. I had been chairman of, interestingly, the other half of the platform business, which I had sold, and one of the recommendations I made in my first meeting was that we dispose of the platform business, because I felt the market was very topky. Equally, I was chairman of a property company at the time, which we were in the process of selling because again I shared the view that the property market was very topky and it was quite dangerous. The board took that on board—talking about maturity—so we were already not putting on new loans; we were winding down that aspect of the business, so by the time we went into the merger I would say the average life in that book was at least four and half to five years.

Q1780 John Thurso: Having a look at our report on HBOS will show you what happens to people who have had long experience in commercial lending and how they can be taken by surprise, so the fact that they were mature does not necessarily mean that they were good. To what do you ascribe the fact that those loans, which if they had behaved like HBOS or RBS would have been looking very suspect in 2010 to 2011, only started to appear to need such a large impairment? I think you said just now you still do not quite understand why that happened. To what do you ascribe the need for such impairment so late in the cycle?

Rodney Baker-Bates: I was not there but I do know that the regulator changed the criteria by which you would judge the likely outcome on any particular situation, especially on commercial loans, where, as I understand it, unless they could be refinanced within three years, then they needed to be impaired and written down to their market value, which would be a significant discount. Just to make the point, these are provisions—

John Thurso: Absolutely: you could end up writing it all back up again.

Rodney Baker-Bates: I could give you an example of one that has been. Lehman's collapsed in 2008 and Britannia held a three-year certificate of deposit with four days to go. It was for \$90 million and we provisioned it immediately by a third; on fair value it was written down to \$10 million. My understanding is that was then sold subsequently in 2010 to another holder for \$25 million, 35 cents in the dollar has already been recovered and it looks like the holder of that will get 100%. So in fact, although it was provisioned down to 90%, over the cycle they will get the whole lot back.

Q1781 John Thurso: Can I take you to a minute of a meeting between Andrew Bailey, Paul Flowers, Peter Marks and Barry Tootell on 28 July 2011, which we published after our last session, where Andrew Bailey then set out his view that Britannia would have failed, had it not been for the Co-op, and Richardson had been lucky to survive not least as CEO of the merged entity? Did you share that view at the time?

Rodney Baker-Bates: I did not share it at the time and I do not share it now. Looking back over five years with hindsight, that assumes that had Britannia remained on its own the

board would have taken no action, the board would have done nothing, and that it did not have the capability to change the course of history. I do not believe that.

Q1782 John Thurso: Your view as chairman of Britannia would be that if the merger had not gone ahead, you and your team would have successfully managed through the bumps ahead and not found yourselves in difficulty?

Rodney Baker-Bates: Under my leadership we would have made a good job of it, to avoid where we have ended up. That is what boards are for.

Q1783 John Thurso: Mr Davies, you were on The Co-op Bank at the time of the merger. Were you in favour of that merger, and did you vote for it?

David Davies: Yes, I was.

Q1784 John Thurso: Did you have any inkling of the difficulties that it would now seem were being imported into the Co-op?

David Davies: Not of the specific difficulties. We certainly were aware of the economic climate that we were in. Our advisers warned us—not that we needed any warning—of the situation we were in. We did what we thought was a very thorough piece of due diligence, both through the advisers and through our own team, and we came out of that due diligence feeling pretty confident of the future. Our overall conclusion was that the combination of the two entities was stronger than the two entities on their own.

Q1785 John Thurso: What scrutiny did the board pay to the due diligence on the deal, particularly the work of Britannia's commercial real estate book, which Co-op Bank itself performed?

David Davies: I know you are aware that we gave KPMG doing the due diligence a list of 10 issues that we were specifically really interested in at the time. The commercial loan book was one of those issues. They came back and said they had not done as detailed a review of the commercial loan book as they thought they should do, and cited lack of availability of the data and of the people to talk to. Consequently we put our own commercial loan book team on to it, who reported back to us that they had done a line-by-line review of Britannia's commercial loan book and could find very little that concerned them. At the time there were no arrears with regard to that loan book, and so we felt basically we were satisfied with the level of due diligence.

Q1786 John Thurso: Finally, if the board was content with the quality of the work, if the advisers had said they could not have done it so you had done it yourself, my question is the same as I asked Mr Baker-Bates: why is it that, if you had done so much due diligence on a relatively mature and established loan book, originated by to all intents and purposes a seemingly relatively conservative organisation, this should all appear so late in the cycle?

David Davies: I agree with the comment about so late in the cycle. Over the intervening four years our impairments on the corporate loan book climbed from £60 million to £140 million. When we went into December 2012 we were forecasting that for the year end, being three weeks away, impairments totalling £185 million across not only the corporate loan book but all the other loan books. We then received a letter from the regulator advising us that they thought that a number of institutions had been sufficiently imprudent—and that is too strong a word—but needed to be more prudent with regard to their corporate loan books, and inviting us to reconsider our impairments.

I have to say that KPMG, our auditors at the time, expressed concern and surprise because we were working within accounting guidelines and certainly within what we thought

they would approve and had been, clearly, for the intervening four years. They expressed surprise at the letter, particularly coming so late in the day, given that we were now a week away from year end. But we set to and we agreed that we should make changes, and the outcome of those changes was that we increased our provisions to the tune of £470 million—in other words, an increase of over £300 million on account of the letter. Management told us that this was basically recognising the subsequent three years' impairments early, and that future profits would improve as a consequence.

Looking at the evidence that I have seen from Andrew Bailey, I am less confident of that, and quite frankly worried about it. I understand why the regulator is saying what he is saying, and only time will tell if he is right or if we were right in terms of the provision that we have made for three years.

John Thurso: Knowing what you knew at the time, yes.

David Davies: Yes.

Q1787 Jesse Norman: Mr Baker-Bates, just to pick up on one point that the chairman raised, when you were expressing your concerns about Verde, did you write down any of the conversations that you had, or did you put in memo form any of the concerns that you had?

Rodney Baker-Bates: I expressed my concerns in two ways and some of them I wrote down. I have speaking notes for all the intercessions that I made to the board. The nature of the board was a bit like this, question and answer, rather than a discussion, so I usually prepared what I wanted to say and I have all those notes, although they would not be intelligible to anyone except me. Secondly, that was in general forum talking to the board as I am talking to you now. Privately, I sought to influence three key opinion-makers as I saw it, or opinion-leaders. They were the Group chief executive, Peter Marks; the Group chairman, Len Wardle; and the bank chairman, Paul Flowers. Also, I had conversations with Ursula Lidbetter who I saw as a powerful influence, who was the chairman of the food business. I wrote a series of emails from September onwards to them expressing my concerns privately.

Q1788 Jesse Norman: Could you let us have copies of any of that material, redacted as required?

Rodney Baker-Bates: I would be delighted to let you have them, but I would ask that you treat them confidentially. They express personal opinions on situations and people to which they might object.

Chair: We will have to have a discussion outside this meeting about that because in general when evidence is provided it is with the intention to publish. We will take that further outside the meeting.

Q1789 Jesse Norman: Thank you, Mr Chairman, and thank you, Mr Baker-Bates. You have said that you were a candidate for the post of chair of the bank. Can you very briefly tell us what you thought of the selection process? Was it effective, impartial, detailed, thorough?

Rodney Baker-Bates: It was certainly different from the selection processes I have perhaps been through on plc boards. It started with an informal conversation with the chairman in November 2009, asking if I would put myself forward and he would welcome it if I did, and I agreed to do that. Not a great deal happened and there were, I understand three other candidates. I was interviewed on the afternoon of 24 February. The interview as I recall it was primarily focused around my knowledge, which was not as deep as others', of the Co-operative Group and the Co-operative movement. I do not remember much discussion about my banking and other experience, but I presume they took that from my CV. I think there

were three other interviews and no references were asked for. There was an announcement at the board the following day.

Q1790 Jesse Norman: That is interesting. Was that a political assessment? Were they trying to work out whether you were sound on the Co-operative in some way?

Rodney Baker-Bates: People who interview you ask the questions to which they want answers. They may have got answers to all the other questions they were asking other colleagues.

Q1791 Jesse Norman: If I look at your CV, you have had extensive banking experience as a non-executive of C Hoare and Company, in the insurance area with the Pru, before that with the Midland, then with the BBC and Chase before that, Glyn Mills. Why do you think Mr Flowers was appointed ahead of you?

Rodney Baker-Bates: I was told afterwards that he had done very well in the psychometric tests.

Q1792 Jesse Norman: So he was psychologically well-balanced, although ignorant about finance?

Rodney Baker-Bates: That is a conclusion that you could draw.

Chair: Psychologically balanced but unbalanced, but psychometrically brilliant?

Jesse Norman: That is an inference, Mr Chairman, but that is interesting. You do not have any other insights as to the reasons he might have been chosen?

Rodney Baker-Bates: No. I was given a short debrief after the meeting by the Group chairman and I was given a copy of my own psychometric test and it was left at that.

Q1793 Jesse Norman: You were happy serving under Mr Flowers as deputy chair?

Rodney Baker-Bates: When you serve on a board, you make that decision to serve on it to the best of your ability. Colleagues have a wide range of skills and I think as my colleague, David, has said, Paul did really work hard—in fact I gave him some tutorials on getting through his SIF interview and so on—to learn about banking and to learn from me the skills he might need to take the role on. He certainly had a much better understanding than I did of the complexity and the politics with a small “p” of the membership in the Co-operative Group.

Q1794 Jesse Norman: You coached him to get through the process of evaluation by the FSA?

Rodney Baker-Bates: Coaching might be too strong a word.

Jesse Norman: It is a gloss on the phrase that you gave him tutorials.

Rodney Baker-Bates: I tried to help him think about the questions that he might be asked.

Q1795 Jesse Norman: Otherwise he would not have made it?

Rodney Baker-Bates: I could not possibly make that judgment.

Q1796 Jesse Norman: Do you think he had sufficient financial experience to act as chair?

Rodney Baker-Bates: Of a bank?

Jesse Norman: Of a clearing bank, yes.

Rodney Baker-Bates: No.

Q1797 Jesse Norman: How about you, Mr Davies?

David Davies: I can add a bit of gloss. It is probably not very sensible of me to do so, but the explanation that was given to the board was that the group had chosen Paul primarily, if not entirely, on his leadership capabilities. They cited as evidence the Walker report where Walker had suggested that ideally you need a balance for a chairman of the board between leadership and financial skills, and if you were not able to have both, then leadership would be the primary recommendation, according to Walker.

That was the explanation given to Group. I can confirm what Rodney said. There were four candidates, two very good independent candidates. Rodney was clearly a very good candidate, and there were two candidates from the Co-operative Group board who are currently on the Co-operative Banking Group board.

Q1798 Jesse Norman: Who did you vote for?

David Davies: I did not get a vote. There was an interviewing panel of three members of the Co-operative Group board, because this was a group appointment. The group is the shareholder here. The financial services companies are effectively wholly-owned subsidiaries. They reserve the right to appoint who they see fit, so they led the process. I do not doubt the integrity of the people doing the interviewing. I know the three people who did the interviews and I would not question for one moment their diligence and integrity. When they say that they thought Paul was the best man, I believe them. I do not think there is any side to that. I am also convinced that the group tried to go through as transparent a process as possible, and that was the point of having the selection process, of keeping the board informed, and of having the psychometric testing.

I have to say the psychometric testing did surprise me in the sense that Paul was a clear winner. When I looked at the scores I was a bit concerned with a couple of the scores, but as Len pointed out to me personally afterwards even if those scores had been increased to what I would call average scores they would not have affected the outcome in the total of the numbers.

Q1799 Jesse Norman: And you thought psychometric testing was a useful way to evaluate potential board members and more useful than financial knowledge?

David Davies: Not more useful than financial knowledge, but it was clearly a Walker recommendation that you should employ objective methods when assessing a chairman, and group had tried to comply with that.

Q1800 Jesse Norman: Just to be clear, do you think Mr Flowers had sufficient financial expertise to be chair?

David Davies: No, and it was very clear that he was dependent on support from financial expertise around the board. When you go back over history, I think I am right in saying there has never been a Co-operative Group appointment to that chair who has had financial experience. This was a whole new departure for the group board. In previous appointments, they would have chosen without any discussion with the financial services board and without any involvement of any of the IPNEDs. At least this time—it sounds trite—they did try to go through a process when they involved Rodney and at least one other director. I was asked to stand, and I am quite grateful to say that I did not take up that offer.

Q1801 Jesse Norman: Mr Baker-Bates, you avoided answering the question of whether or not you were happy serving underneath Mr Flowers as deputy chair. Let me just ask you a question—

Rodney Baker-Bates: I am sorry, I disagree. I was happy to serve under him, because I stayed on the board. If I had been unhappy I would have left.

Q1802 Jesse Norman: Okay, as in due course you did. Can we just very briefly dwell on the character of the board? You have said that it was very large, that the relationships were more like one to many, rather than a conversation—more analogous to a select committee type hearing, as you have just described it. There was a contrast between democrats or what you considered Co-operative delegates, and outsiders, those who understood something about finance. We have also heard the board was described as unruly by Clive Adamson. Could you just talk a bit about that, and in particular whether there were groups within the board that were operating with different agendas?

Chair: That is a big, open-ended question but we would appreciate a relatively concise reply, if that is possible.

Rodney Baker-Bates: I would first say that the board was not unruly. It may have been unwieldy, but it was not unruly. Unruly implies throwing things at each other, and we never did that. In fact, it was a very decorous board. As I saw it, there were no other agendas; it is just there was a broad spectrum of skill, and therefore on a particular issue—let us say our capital or the reserving in the general insurance—there was a relatively narrow set of expertise that we deployed and then a rather more general discussion. The way in which people looked at the issue was very diffuse, much more diffuse than you would get on a standard plc board.

Q1803 Jesse Norman: But in that context, Mr Flowers' supposed leadership skills were really those of the Charge of the Light Brigade, because they were bringing an unruly and disparate board without a clear sense of direction to a series of decisions that were ultimately ruinous?

Rodney Baker-Bates: I think he tried hard to get the board to focus on the issues and to get everybody to express their views, and everybody's views to be heard. I think he did make a real effort.

Q1804 Chair: On your own application for the chairmanship, did you have the feeling at any time that the interviewers were going through the motions and that you had been put up to create some competition?

Rodney Baker-Bates: I put myself up, sir.

Q1805 Chair: You were tapped on the shoulder, you told us earlier.

Rodney Baker-Bates: Well, there was a discussion. No, I think they were genuinely—

Q1806 Chair: You think you might genuinely have got it, had you done better in those psychometric tests?

Rodney Baker-Bates: That is a question I cannot answer.

Q1807 Chair: But you felt that?

Rodney Baker-Bates: Yes.

Q1808 Mr Ruffley: Mr Baker-Bates, you and Mr Davies, it turns out, were the two people appointed to mind the Reverend Flowers as deputy chairs. Who proposed that arrangement? Where did it come from?

David Davies: It is a bit unfair that Rodney—perhaps by the fact he is alphabetically ahead of me—is getting the lion’s share. It is not that I wanted to jump in. First of all there was a memorandum to the board about the appointment and it looked as if the initiative—

Q1809 Mr Ruffley: From whom?

David Davies: From Paul, the chairman, to the board, indicating that he was going to be chairman of the bank and the two insurance companies, which was a break in tradition. Prior to that there had been other chairmen of those, from within the financial services organisation. It was recognised in the memorandum that he did not have the requisite skills, both in bank and in insurance, and that therefore it was his recommendation that two deputies be appointed—one to cover bank, and one to cover insurance—and that it would be also very good if one of those came from a Britannia background and one from a Co-operative background. It is a surprise to me to see and read that the initiative was put to Paul by the FSA. I have no way knowing the accuracy of that.

Q1810 Mr Ruffley: Sorry, can you repeat what you just said?

David Davies: I am reading, both in the press and I think in Clive Adamson’s testimony to you, that it was an FSA suggestion—requirement?—I do not know the precise word. But certainly when Paul was interviewed as part of his process of becoming chairman, the idea was said to have been put to him that it would be good if he appointed deputy chairmen who had relevant experience. That got lost in translation, I am bound to say: when it was put to the board it came across as Paul’s idea. My memory of the time is that I thought this is a good sign for the future, that Paul has recognised that he needs help and therefore he is appointing two deputy chairs, which we had never had before, one to cover insurance and one to cover banking. I thought this was a good start.

Q1811 Mr Ruffley: So he appointed both of you two? What was the—

David Davies: Sorry, my apologies. There is a short-circuit here. He asked again for people to stand and be counted. Any volunteers for the roles should make themselves known to him and if necessary we would have an election process.

Q1812 Mr Ruffley: You both volunteered, but did anyone else volunteer to be a deputy chair?

David Davies: Yes, there was one candidate on the insurance side. I believe Paul had a quiet word to him suggesting that it was best if we did not have an election and therefore he stood down, and effectively Rodney and I were elected unopposed.

Q1813 Mr Ruffley: He asked for volunteers and you two emerged to fill those two posts?

David Davies: Again as part of the process we had to submit 500-word dissertations on why we would be good deputy chairs.

Q1814 Mr Ruffley: What did you understand your relationship with Reverend Flowers to be as deputy chairs? Did he write down how you were to operate? There has been a very interesting observation from Mr Baker-Bates that he prepped the Reverend Flowers and helped him do a bit of cramming for his test with the FSA. What was the nature of the relationship set out? What was he asking you to do as deputy chair? To give him weekly advice or tutorials in your case in insurance? How did this relationship—

David Davies: In a similar work, a memorandum board paper, five tasks were listed, one of which was to be a sounding board. The second was to provide him with technical

expertise and help. The third was to help him make the board more effective and to concentrate more on strategy. The fourth was to act very simply as his deputy. And the fifth was a catch-all—whatever we might be asked to do. I think the way that we interpreted that advice was to be in regular contact with him by email, phone, face-to-face meetings. We would always meet him prior to the board, on the night before. We would identify issues either at that meeting or separately that we thought were troublesome or worthy of more debate, or worthy of more intellectual rigour, if you like—it sounds very pompous. Speaking on behalf of us both, I think we did our level best to educate him and make the meetings more relevant.

Q1815 Mr Ruffley: Presumably you took this onerous responsibility very seriously, because you were, in a sense, more responsible than any other board member for keeping Reverend Flowers focused on what was financially important. You two were the most important on the board, in that respect, were you not?

David Davies: I do not think I got the impression we were the most important. I think if I had been aware—

Q1816 Mr Ruffley: You were deputy chair with these responsibilities. This is addressed to both of you. Is it not the case that both of you were more important than anyone else on that board for ensuring that Reverend Flowers was kept as far as possible on the straight and narrow and was advised on financial matters, about which we all agree he had very little knowledge?

David Davies: The short answer to that is yes.

Q1817 Mr Ruffley: Would you agree with that?

Rodney Baker-Bates: Yes.

Q1818 Mr Ruffley: All right. It seems to me that there were expectations placed on you—you have admitted that—to ensure that Reverend Flowers did not make mistakes, and he was a man more ignorant of finance than he should have been. Did you discuss with the FSA how your monitoring of his work was going? Did you keep in touch with the FSA to report back?

Rodney Baker-Bates: That makes an assumption that we were aware that the FSA had asked for us to be appointed, and we were not.

Q1819 Mr Ruffley: Throughout all of this, after your appointments as deputy chairs, how many discussions did you have with the FSA about Reverend Flowers' performance, and when did you have those?

Rodney Baker-Bates: None.

Q1820 Mr Ruffley: Do you consider that surprising, that they did not get in touch with you?

Rodney Baker-Bates: I considered it surprising in light of the fact that they had asked for us to be appointed, but since I was not aware of that I did not consider it surprising.

David Davies: I will add to that, because you have put a slight specific on that.

Q1821 Mr Ruffley: Just to clarify, I am asking if the regulator took any interest in the two deputy chairs who, most people would now agree, not just in hindsight but at the time, as being really rather important in keeping tabs on the Reverend Flowers, a man without any obvious knowledge of banking.

David Davies: Okay. I don't think I ever had any discussions with the regulator as being deputy chair. I had discussions as part of the regular interface with the regulator on Project Arrow, so I can recall two meetings that I would have had with the FSA's case officer, if I can use that phrase, but nobody more senior than that. I do not recall being asked specific questions about how the chair was performing.

Q1822 Mr Ruffley: I am very specifically talking about how the chairman was performing rather than maybe routine discussions with mid-ranking FSA individuals.

David Davies: That is why I am clarifying that I had meetings.

Q1823 Mr Ruffley: That is very helpful indeed. Now, Mr Baker-Bates, when you were in these discussions with the chair—you said you met him before board meetings—could you give an example, if any, of where you disagreed with the Reverend Flowers on any of Project Transformation, Project Unity or Project Mars, now known as Project Verde? Were there any fallouts or conflicts where after a long discussion you were convinced he was wrong and he was convinced he was right—any examples?

Rodney Baker-Bates: Well, there were discussions at two levels. The meetings we had before the board were generally around specific papers. We would be discussing an issue maybe in the bank; whatever papers were presented to the board we would go through them in detail, add our views and give context to them. Paul Flowers, Len and Peter Marks were well aware of my opposition both to Unity and Verde because that was expressed much more overall. It may come down on a specific paper where I would say, "I believe there are these risks in this and we should not be doing it," but my opposition to Verde was known and expressed to the board and was overarching, so we did not have a specific argument about Verde at any point.

Q1824 Mr Ruffley: Final question: on something as important as that, you, as a very experienced financial player and as deputy chairman, clearly saw yourself as having a responsibility to look closely at what this chairman was doing. How often did you consider resigning when you had these disagreements that you have just referred to?

Rodney Baker-Bates: I think I have already said—maybe I have not—I went to see Paul and Len privately in October 2010 saying I wished to resign because of my opposition to Verde.

Chair: We are going to come on to that right now.

Rodney Baker-Bates: If you are on a board that is what you have to do.

Q1825 Mark Garnier: My question is addressed to both of you so feel free to chip in, whichever is more appropriate. What I want to concentrate on specifically is Project Verde and what was happening within the board. My first question is: when was this first discussed? When was the germination of the idea to bid for Verde?

Rodney Baker-Bates: My understanding was that there was an approach to the Co-operative Group in February 2011, it would have been, and that it came to the board I think for the first time in April.

David Davies: I would put it just a month later, but Rodney may have inside knowledge of that.

Rodney Baker-Bates: It was spring.

David Davies: Yes, spring of 2011.

Q1826 Mark Garnier: Who was that approach from?

Rodney Baker-Bates: It was from Credit Suisse.

Q1827 Mark Garnier: They were acting as corporate broker, touting around, and presumably that was part of a general salesman expedition where they were going around presumably seeing potential other bidders?

Rodney Baker-Bates: Well, it was public knowledge that this was going to take place, and I think they brought the idea to group, who then brought it to the board.

Q1828 Mark Garnier: Do you think you were particularly picked or do you think there were a number of other people they were talking to as well?

Rodney Baker-Bates: I cannot answer.

Mark Garnier: You do not know?

Rodney Baker-Bates: No.

Q1829 Mark Garnier: That is fine. Neville Richardson and Gary Hoffman have both said that Peter Marks, the group CEO of Co-op, was the key driver behind the Verde deal. Would you agree that that was the case?

Rodney Baker-Bates: Yes.

David Davies: Yes.

Q1830 Mark Garnier: Absolutely. Do you think he was doing this as group CEO or as a Co-op Bank board member?

David Davies: I think it was as group CEO.

Rodney Baker-Bates: CEO, yes.

Mark Garnier: He wanted to see the group that he was ultimately in control of become even bigger and more magnificent?

David Davies: This was very clearly a group matter. Clearly, he would want bank support because if he did not have bank support it would not have happened. Ultimately, the decision was going to rest with group. This was such a significant transaction.

Rodney Baker-Bates: With the change in reporting line from Neville Richardson at the beginning of the year, he clearly had become an executive. He was no longer a non-executive, at least in my eyes.

Q1831 Mark Garnier: Yes, sure. It is quite an important thing. Because of his position as group CEO on the board of the bank, did his opinions carry more weight than anybody else's because of that position he held?

David Davies: I cannot go back and look at a single instance. There is no doubt it carried weight. Whether it carried more weight than Rodney's or mine? I don't think I could answer that. I suspect within the group directors, yes.

Q1832 Mark Garnier: Your hesitation is quite interesting because I am trying to visualise the dynamic that is going on at a board meeting of the bank. You have one individual there who is a non-executive but he is also group CEO. He is talking about doing something that you know has support of the group. He is effectively speaking on behalf of the entire organisation, isn't he, in the context of the board?

David Davies: Yes. The dynamics of the meetings, the format of the layout, was Paul, Barry, chief executive, Peter Marks. He was close to the centre of the action. As we were immediately post-Britannia, we were a board of 22 and we came down to 15 not quite by the time of the Verde discussions. The more central you are, clearly the more influence you seem to carry.

Q1833 Mark Garnier: Neville Richardson has also said that Paul Flowers was pushing for the Co-op bid. Is that the case?

Rodney Baker-Bates: I am less clear on that.

David Davies: Yes, I would concur with that. I think Paul was very good at not nailing his colours to the mast. As chairman, I thought he deliberately avoided trying to push people in a certain direction. He let the arguments develop.

Q1834 Mark Garnier: That is very interesting and I think that is quite an important point. Your view is that—and this is almost in his favour, if you like—he was absolutely a neutral chairman; he was not necessarily trying to lead the board. As Mr Norman so openly pointed out, it was not the Charge of the Light Brigade. He was not leading that charge.

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

Rodney Baker-Bates: Yes, I would agree with that.

Q1835 Mark Garnier: That is very interesting and very helpful. Neville Richardson has also said that Len Wardle, the Co-op Group chairman, was pushing for the deal. Again, is that fair?

David Davies: Again, I would characterise Len as being more in favour than Paul initially, but I think by the time we got to heads of terms, they were all very much ad idem. Certainly to start with, it was a slow burn.

Q1836 Mark Garnier: Yes, okay. How about anybody else within the Co-op or the Co-op Bank pushing for it? Was there anybody else who was a significant player in this?

David Davies: My recollection is initially the banking board were more in favour of it than the group board because the group board I thought took a view that this was a very stressing, stretching acquisition for the group, and it was not necessarily financially that well placed to take advantage of it.

Q1837 Mark Garnier: So the bank was more enthusiastic than the group?

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

Q1838 Mark Garnier: This is quite interesting because the bank was at this point trying to increase its size, ultimately in a three-year period tenfold. We obviously know about the stresses that were going on in terms of the integration of the IT systems and all the rest of it. It is interesting that the bank was trying to drive this forward. It must have been well aware of this.

David Davies: Drive is the wrong word: I said support. Peter was driving it. The bank supported it because they could see that this was going to be a step change.

Q1839 Mark Garnier: They were persuaded?

David Davies: This was early in the piece. As we got in the subsequent months the heads of terms, doubts began to surface. The nature of the deal changed shape from being

plan A through to plan C—in other words, we reversed the system strategy here. As it got more complex, I think the banking board certainly started to get less sure. We got to the heads of terms. We had the vote; two voted against. In the subsequent months after the heads of terms vote, I am convinced that more and more directors saw the folly of this.

Mark Garnier: Directors of the bank?

David Davies: Yes, sorry. I am speaking personally of the bank now because I did not have sight of the group at this stage.

Q1840 Mark Garnier: Just to be clear, though, Peter Marks was very enthusiastic about this and he was effectively pushing it forward?

David Davies: Peter was leading the negotiations and he was dealing with Lloyds.

Q1841 Mark Garnier: He was leading the negotiations, but the board that he was the chairman of, the group board, was not as enthusiastic about it as the bank board, is that right?

David Davies: To begin with. I think as we got to heads of terms, it changed. The bank board got more nervous because of the financial position of the bank and the financial deal. The group board were more persuaded by Peter in the sense of the strategy for the group should support this acquisition.

Q1842 Mark Garnier: The group does not know much about banking. Okay. Then we get to the stage where we are still pushing forward and the bank is, presumably led by you two, trying to wind back a little bit on this. Yet there is this momentum that has gathered behind it.

David Davies: Again, heads of terms vote is crucial here. Up until the heads of terms vote there was not a great deal of dissension within the banking board. That brought matters to a head, particularly the change in strategy from plan A to plan C, which occurred in April of 2012 and then the heads of terms vote in July 2012. I certainly became more opposed to it in those three months. Rodney will speak for himself, but I am pretty sure he was more opposed to it before me. Post the vote in July of 2012, I saw more wavering among my colleagues on the board and I believe more of the banking board directors joined my view and would have, if it had come to a vote, changed their vote.

Q1843 Mark Garnier: Why did it not come to a vote? Why wasn't it pushed for?

David Davies: Because we had yet to get to the signing of the SPA. The SPA was going to be the crunch point and that was being—

Q1844 Mark Garnier: When was that due?

David Davies: This is one of the problems of Project Verde. If you start from the beginning in November 2011 when we became preferred bidder, optimism was abounding and it was suggested SPA would be signed in March of 2012. That was clearly undoable. We got to July of 2012. We signed heads of terms. At that stage it was confidently expected SPA would be signed in December of 2012 and that required us to submit to the regulator by the beginning of December 2012 our paper asking for his support.

Mark Garnier: Sorry, SPA stands for?

David Davies: Sale and purchase agreement. We got to December. We were well short of having an SPA ready to be signed. It then was forecast for March and gradually, as we know, things were beginning to get worse within the organisation. In the end, we got to April and Peter pulled the plug and said it cannot be done.

Q1845 Mark Garnier: Just a couple more questions. Did Paul Flowers or Peter Marks share with the board the impression given by Lloyds of the bid? What were Lloyds thinking about how things were moving along? Because, of course, as we know, Lloyds was in November 2012 starting to—

Chair: Clearly, that is quite a big question, but if you have something specific to say, please say it. If not, speculation will not help.

Rodney Baker-Bates: I have nothing to say. I was not on the board.

David Davies: Shared with the banking board? All I can say is that Lloyds thought that our offer was the best offer. That is why we got preferred bidder.

Q1846 Mark Garnier: As far as you were concerned, all the way through the process you were given the impression by Peter Marks and Paul Flowers, where he got involved, that Lloyds were fully behind all of this? There were no problems; there was nothing going wrong; no doubts; it was all tickety-boo?

David Davies: That is a slightly different question. Peter Marks was the main conduit of information from Lloyds. Peter gave us the impression that we were preferred bidder. We knew we were preferred bidder and that Lloyds was supportive of our bid. We got to the end of 2012 and Rod Bulmer rather than Peter Marks, I believe, said to the risk committee, of which I was a member, that Lloyds had ceased engaging with us on capital and conduct issues. That is quite a fundamental statement.

Mark Garnier: Yes, it is.

David Davies: You get the impression, therefore, that Lloyds had said, “Guys, this is not going to happen.” We were at that stage unable to get a satisfactory explanation from Rod as to why Lloyds had done that, and it became pretty clear that basically Lloyds now had misgivings about the capital strength of the Co-op Bank and the deal was in jeopardy. That came to me and the risk committee from Rod Bulmer—I do not think from Peter. Paul certainly gave no indication that he had been in touch with Lloyds.

Q1847 Mark Garnier: That was before Christmas 2012 because I believe that it was delivered—

David Davies: No. I understand your question. To my knowledge, it was post-Christmas 2012. It was in January when Lloyds said to us—this is information to the risk committee, not to the Co-operative team. I do not know when the Lloyds team said to the Co-operative team, “We are not engaging.”

Q1848 Mark Garnier: There is a bit of ambiguity about this, but as I understand it Lloyds gave the indication in early December but it was not notified to the board until the board meeting in January. That sounds pertinent.

Chair: But you do not know about that?

David Davies: I can’t speculate on what happened before the January board meeting.

Q1849 Mark Garnier: But in the January board meeting that was the first you officially heard about it?

David Davies: I think it was the risk committee first, because I was not at the January board meeting.

Q1850 Chair: Can I clarify whether at any point you had a sense or were told of any political preference or pressure on this deal?

David Davies: No. Personally, I was aware that there was—

Chair: The answer is no?

David Davies: No.

Chair: Okay. If the answer is, “No, but” something substantial, please say.

David Davies: I was aware there was contact but no pressure.

Q1851 Teresa Pearce: Good morning. Mr Baker-Bates, Neville Richardson resigned in July 2011. He said that he spoke to you about his concerns on the telephone shortly before that departure. Do you recall that?

Rodney Baker-Bates: Yes.

Q1852 Teresa Pearce: Do you recall what he said?

Rodney Baker-Bates: Yes, or reasonably. It is a long time ago.

Q1853 Teresa Pearce: Reasonably, yes. What reasons did he give primarily for stepping down?

Rodney Baker-Bates: He was particularly worried about Unity and the intrusion for group into the operations of the bank, the changes of reporting line on key functions, and his ability to manage the bank in the way that he wanted to. He was chief executive; I can understand that.

Q1854 Teresa Pearce: Primarily, his concerns were about Project Unity rather than Project Verde?

Rodney Baker-Bates: Verde was relatively young at that stage. He and I both agreed it was a giant step and too far given that we had not yet integrated Co-op and Britannia.

Q1855 Teresa Pearce: You shared his concerns?

Rodney Baker-Bates: Yes.

Q1856 Teresa Pearce: You did. Did you attempt to persuade him to stay?

Rodney Baker-Bates: Yes, and failed.

Q1857 Teresa Pearce: You did, unsuccessfully. Neville Richardson prepared a script for his conversation with you. In it, he spoke about Project Verde and said, “If Project Verde, which involves the acquisition of 600 banks, is to succeed, you need me to stay within the group. Verde is one of the biggest opportunities the group has had in a long time. I will only stay to ensure its progression if you negotiate with me regarding Unity.” Do you think that was genuinely his position, that if Unity had been pushed to one side he would have stayed? Was it singly about that one issue?

Rodney Baker-Bates: I do not recall those exact words, but he had been a chief executive for getting on for 10 years. He had been chief executive of a major financial institution, Britannia. He had, bluntly, been cut off at the knees.

Q1858 Teresa Pearce: Do you think Unity was important to the group? Do you think it was necessary?

Rodney Baker-Bates: No.

Teresa Pearce: You don’t.

Rodney Baker-Bates: Unity was born out of a fundamental misunderstanding about the shape of a banking balance sheet. It was primarily to reduce costs and I fully accept that costs were too high. Peter Marks said in his evidence that it saved £80 million, but if your risk asset ratio on your risk assets moves by 1% in a bank with £40 billion, you lose £400 million. This was one of the key failures I could not get across, to understand the impact of leverage in

a bank's balance sheet. If Verde had gone ahead, you would have had a small food business attached to an enormous bank.

Q1859 Teresa Pearce: Mr Richardson to this Committee intimated that he resigned because of Project Verde. What you are telling us now is that you do not think that is correct. You think he had major concerns about his own position?

Rodney Baker-Bates: No, not about his own. What he had concerns about was we were embarking on a project that he was equipped for if we were to carry it out, but he was not going to be allowed to carry it out, in his mind—that was the Unity project—but both of us, I think, shared the view that it was a huge step, so there were a lot of risks.

Q1860 Teresa Pearce: Reverend Flowers told us that he believed that Mr Richardson resigned because he did not want to report to Peter Marks. Is that a fair assessment?

Rodney Baker-Bates: That is his judgment.

Q1861 Teresa Pearce: Is it your judgment?

Rodney Baker-Bates: Oh, it is much more complicated than that.

Q1862 Mr McFadden: Mr Baker-Bates, you have made clear this morning—you both have but I will begin with you—that you thought Verde was the wrong thing to do and that you were consistently opposed to it. You described it to my colleague, Mrs Pearce, as a huge step and a step too far. Why were you so opposed?

Rodney Baker-Bates: You have to look at it at two levels. You have to look at it at a group level and at the bank level. At the time of the Britannia merger—in fact almost when the merger was completed—the group announced the acquisition of Somerfield. Previous to that, the group had had a pretty strong balance sheet, low current ratios, strong capital ratios. One of the most important things in Britannia for me was the strength of the group. In order to complete that transaction, they geared up the balance sheet to the point of about £1.3 billion, so they significantly weakened or used the availability in the group balance sheet. The group was pursuing two parallel strategies: to invest heavily in food and to invest heavily in finance. My fundamental question around Verde was simply: did the Co-operative Group have the capital and the competence to compete in two parallel industries that are highly capital intensive and when they had already merged with Britannia, which was a threefold increase in the bank at the same time? That is the overarching point and when Verde came along, if you have that as your overall view, it is an enormous risk to take.

Q1863 Mr McFadden: It was really that limited capital was the heart of your concern?

Rodney Baker-Bates: Yes, and competence.

Q1864 Mr McFadden: Capital and competence, okay. You said your opposition came a little bit later, Mr Davies, but was it for the same reasons?

David Davies: In essence, yes. In November 2011, when the concept was debated for the first time among us all, I voted in favour. I sent an email to Paul, “I am voting in favour of this from a Co-operative Bank Group position as a director. If I was a member of the Co-operative board I would have significant misgivings because of affordability and capital.” I was in favour of it from a strategic sense.

As I have said, we got to April when we changed our systems strategy. Instead of suggesting that we would migrate all the Lloyds business that we acquired on to Co-

operative's new platform, we discovered a significant error in the costing of that platform such that it made the Verde deal basically not worth what we were suggesting.

Q1865 Mr McFadden: What kind of error? How much money are we talking?

David Davies: We are talking hundreds of millions of pounds.

Q1866 Mr McFadden: Your estimates of the IT costs were out by hundreds of millions of pounds?

David Davies: Yes. As I say, we were creating a new platform, which we had been doing for some years. It was not the platform that was the problem. It was the peripheral systems that interfaced with the platform. There was an error of some hundreds of millions of pounds of integrating Lloyds on to our platform. Within a matter of weeks, we did a U-turn and instead of integrating on to Co-operative platforms we were going to integrate Britannia and Co-op on to Lloyds platforms, which was then going to be split for Co-operative use. This came on very late in the day and further undermined my confidence in the doability of the management of being able to do this. I did not believe that our management, which had not been successful in the integration of the Britannia branches on to the Co-op systems, could do something of this nature.

There was a worrying subplot that management now were saying that Verde was the least-risk option for the bank—that if we did not do this deal the bank would not survive. I found that a statement that I could not possibly agree with and something I took up with the chief risk officer. I did not think it was the least-risk option. In fact, I thought it was quite high risk.

My points of concern were, first, the economic environment that we were still in and the future. Success depended on base rate increases and we were predicting base rate increases in 2014. I was worrying that base rate increases would not be there until 2017, in which case the viability of the whole thing suffered. Secondly was the doability argument, which Rodney has mentioned and I have mentioned. I did not think that management could do this integration process even though we were getting Paul Pester and management from Lloyds. This was such an enormous scale thing that I was concerned. The third aspect was capital. It seemed to me that storm clouds were gathering all around us. The regulator was, it seemed to me, mindful to keep adding capital to us until we broke, frankly. You could see that in the life fund release, where we had built into our plans £200 million from moving the life fund out to Royal London. It took us an age to get approval for that and the £200 million was not going to be available at least until 2014. I could see that the regulator was going to increase our capital guidance numbers and gradually capital was going to get tighter and shorter. All of that convinced me that we should not do this deal. That is in July of 2012.

Q1867 Mr McFadden: That is a very full and helpful answer. Now, the regulator shared these concerns about capital. We have heard that Mr Bailey shared his concerns about a number of aspects of this deal, including capital, in 2011. Do either of you recall a presentation given by Mr Bailey and his team in July 2011 citing capital as a potential problem with the deal?

David Davies: I will take that. July 2011 we were offsite in Nantwich. Remember, there is a backcloth here that Neville was having his discussions with Rodney, Paul and Peter about Unity and Verde and leaving. I do not think we had a presentation—well, presentation implies slides and things like that. I think it was more like a fireside chat in an environment rather like this. Mr Bailey sat over there and we sat—I am trying to think whether it was auditorium style. Anyway, he did indicate five areas. I do not have notes and I do not have board minutes of those things, but the five points that you have picked up in previous

evidence were areas that he wanted us to demonstrate to him that we could get on top of, and capital was one of those items.

Q1868 Mr McFadden: Did he mention the figure of £2 billion?

David Davies: No—well, not in my hearing. One of the things that was quite difficult to get was the scale of the issues of capital. That was the problem. The Co-op Bank had always run on a relatively thin capital base. We were a wholly owned subsidiary; capital resided in the parent. We always knew that we had to keep capital under very tight scrutiny and we did that. How much capital Mr Bailey thought we needed to do this deal, I do not think was ever spelt out to me.

Q1869 Mr McFadden: We are limited in time so I want to go to one further area. You have this vote where the two of you vote against the deal. You then at different times leave the board of the bank. When you leave, Mr Baker-Bates, am I right in saying you go and see the regulator and you share your concerns?

Rodney Baker-Bates: Yes, I had two meetings with the regulator. I went to see Clive Adamson at the end of July. I chose Clive because the group was splitting but I knew him and I wanted to talk to a senior member of the regulator to express my concerns. Clive has referred in that to the meeting. What I was trying to convey was that I had come to the conclusion, probably some time before, that the Co-op Bank and the Co-op Group would be unable to meet those criteria. That is what that meeting was about.

Then I had a meeting at the end of August with Andy Cope, who was the senior case officer for the Co-op Bank, which was my formal exit interview.

Q1870 Mr McFadden: Do you think the regulator should have done more or should have acted earlier to stop this deal given that you, as directors with significant financial expertise, had, first, voted against it and then, secondly, gone out of your way to raise your concerns directly with the regulator?

Rodney Baker-Bates: Well, I am not the regulator and I do not know the range of information that he had, but I think the regulator does have the power to stop a deal if they wish to.

David Davies: That is quite a hard question. In July, when we had the vote, information was put to the board that the regulator did not have enough evidence at that stage to say, “Do not do this deal.” Therefore, he was not going to intervene. That point was made very clear to the board at the time we had the vote. My own view was that the regulator was sufficiently uncomfortable with the deal that he would keep pushing at the capital position and keep gradually, a bit like the lobster in the pot, turning up the heat to the point at which we cracked. When I look back now, I think in a sense that is what happened. Whether it was deliberate or whether it was just the regulator responding to the economic conditions, I do not know.

Q1871 Mr McFadden: There is a curious thing here. When the chairman of the bank is appointed, there is a deal struck that there will be two deputy chairs with significant financial experience who will, if you like, ride shotgun to help the chairman because of his lack of financial experience. You are those two people, but you are not told about this deal, although that is specifically your role. Yet, despite that, you then go and see the regulator to tell him your worries about the Verde deal and it trundles on for a significant number of months after that before the plug is pulled. It is a curious situation, isn't it?

Rodney Baker-Bates: One thing I should say is that David and I, following the vote, were intending to go together at a date on which we could fix it, so we had a shared view. I

said to David that I advised Clive that David had wanted to be there but could not and had voted against it. As I said, I do not know what other information. I rather agree with David that they were just pushing and pushing and pushing until the terms. There is a concept called “no objection,” isn’t there, David?

David Davies: Yes. It is very difficult to speak on behalf of the regulator here. On the basis that two people voted against this deal, I cannot see that that is justification for the regulator intervening there. He probably had formed his own impression that there were severe stresses on this deal at that stage, but he wanted a bit more evidence, I suppose, and he would want more opposition, if you like. That was emerging—gradually, as we got to the end of the year, more and more directors were beginning to question it—and I am sure if there was any interaction with the regulator they would have picked that message up.

Q1872 Chair: In any case, it is the regulator’s job not to save a particular institution but to save the system?

David Davies: Absolutely, yes.

Q1873 Chair: It is not their job to take your decisions. Speaking of those decisions just for a moment, it does strike me as somewhat odd, which is a related point to the one that Pat McFadden made, you two were brought in specifically because more banking experience was needed, or at least you were elevated to the role of deputy chairmen with that function in mind. But then, through this crucial deal, it seems that you were briefed as a board member but you did not seem to be intimately involved in the discussions as they rolled forward at every stage. Or do I have the wrong impression of the basis—

David Davies: Discussions with whom, Lloyds or the regulator?

Chair: For every aspect of the Verde deal and, of course, the Lloyds negotiations would be the most important.

David Davies: It is a valid point, but the discussions with Lloyds were principally Peter and the group team. With the regulator, there were continuous weekly meetings, every Friday, between the team and the regulator. You are right that it is surprising, bearing in mind that—

Q1874 Chair: You did not raise it or raise concerns that you were not in that loop?

David Davies: No, because I did not—

Chair: This is a major transaction. When transactions are on, the atmosphere on boards is completely different. The non-execs become extremely active to the point where they are thinking about the deal every day, aren’t they? They are not sitting waiting for the next monthly board pack.

David Davies: We were. You will see by the meeting notes there were meetings after meetings after meetings between the board and the risk committee on this subject. Am I surprised that the regulator did not talk to me and Rodney? I am a bit surprised, given that he apparently suggested that we should be deputy chairmen, but I was not—

Q1875 Chair: Even within the corporate governance structure that you were working, did you feel you were fully in the loop, as much in the loop as in retrospect you should have been, in those negotiations?

Rodney Baker-Bates: Certainly not in the negotiations. Absolutely not in the negotiations.

David Davies: Yes, because this was a group-led project.

Rodney Baker-Bates: We were very clear it was a group-led project.

David Davies: I think the risk committee were briefed very thoroughly on the progress of agreeing the parameters of the integration and all the nuts and bolts and the risks involved.

Q1876 Chair: There are many things that are puzzling me about this whole story still, but I will just throw out one more and see if I get an answer to this. You were joint senior independent directors, were you not?

David Davies: Yes.

Rodney Baker-Bates: Yes.

Q1877 Chair: Have you ever been on another board where there are two SIDs?

Rodney Baker-Bates: No.

David Davies: No.

Q1878 Chair: Did that strike you as an unusual arrangement bearing in mind the combined code provides for a chairman and a SID? Or whatever it is now called; I cannot remember.

David Davies: The Co-operative Bank is a strange animal. It is a wholly owned subsidiary. The SID concept and talking to the shareholders is not so straightforward.

Q1879 Chair: Perhaps it might have helped if there was one man on point as the SID who should have been more intimately involved in these negotiations?

David Davies: Yes, but it would have been quite heroic for one man to have covered insurance and banking. I was very clear that I was covering insurance and if anything went wrong with the insurance part of the business I would be pretty much in the dock.

Q1880 Chair: I do not want to prolong this but this is quite an important question. We have a chairman here who we now know was not up to snuff. The primary role of a SID is to do something about it, but here we had two SIDs so we had divided responsibility for blowing that whistle.

Rodney Baker-Bates: There is no doubt in my mind that the shareholder was aware of my deep concerns about Unity, Verde and the transformation.

Q1881 Chair: You went to the shareholder to explain that?

Rodney Baker-Bates: Because they sat in the board.

Chair: But you said individually—

Rodney Baker-Bates: Yes, I wrote to them.

Chair: —and you had meetings lest they had not got the message, which was the key point in your earlier evidence.

Q1882 Andrea Leadsom: I would just like to clarify some timing. Andrew Bailey attended a Co-op Bank strategy awayday in July 2011 and at that meeting he gave some stark messages about the FSA's view of Co-op Bank, its capital position and risk management. In particular, he questioned the ability to bid for Verde. At the time, did his views come as a surprise to you?

David Davies: Expressed in that way, yes. He expressed concern about our ability to do the deal. He linked it with the notion that it might be a good idea if we linked up with another institution. That was the strength of that. My impression was that he did not think that we could not do this deal. He wanted to be persuaded that we would address the issues that he raised as part of his giving approval—the issues about risk framework, capital, liquidity and stretch. I do not think he had formed a judgment at that stage that we could not do this deal.

He was identifying for us things that we needed to work on to demonstrate to him that we could do that, and I think that was very fair.

Q1883 Andrea Leadsom: Okay. Had the board been sufficiently briefed by the chairman and chief executive prior to Andrew Bailey coming to that strategy awayday on the questions that Andrew Bailey might have about the deal?

David Davies: No, because at this stage it was still quite a gleam in the eye that this was a worthwhile thing to put in an indicative offer for, so that we could see just what the nature of this potential animal was that we might want to develop. At that stage, we had only had the gleam of an idea. I would not say that Neville had objected to it because I do not think he had. This is when we started to think seriously about whether we should do this, and it was not until we got to October/November that we had the joint discussions with the group board about capability and the size of our offer.

Q1884 Andrea Leadsom: When you say, “We started to think if we should do it,” are you talking about you and Mr Baker-Bates?

David Davies: No, I am sorry, I am talking about the organisation.

Rodney Baker-Bates: The organisation, the bank board.

David Davies: At this stage, speaking personally, I did not have a view as to whether we could do this deal or not. The deal on the face of it sounded attractive and sounded a positive thing that we should be thinking about and certainly tossing our hat in the ring.

Q1885 Andrea Leadsom: Would it be true to say, then, that Mr Bailey’s concerns sparked concerns in the minds of board members? Which came first, the chicken or the egg? Was it his concerns or their concerns?

Rodney Baker-Bates: Let me answer. I think he listed out five perfectly sensible and clear criteria, which I already had in my mind because I was looking at the transaction in the same way as he was. To make this work, particularly as you are integrating, you have to be very sure about a whole series of key risk parameters. He was expressing something that I felt was perfectly natural and saying we needed to convince him—that was early days—that we could do that.

Q1886 Andrea Leadsom: Okay. Then Andrew Bailey sent a letter to Paul Flowers in December 2011 reiterating his concerns over the Verde deal. Was this letter shared with the board? Were you privy to that letter?

Rodney Baker-Bates: Personally, no.

Q1887 Andrea Leadsom: Were you aware of it?

David Davies: No.

Rodney Baker-Bates: No.

David Davies: I was not aware of it until I saw the evidence. I have asked the Co-operative Group to provide me with a copy and so far nothing has emerged.

Q1888 Andrea Leadsom: So you still have not seen it.

David Davies: No, and it was not registered. I have tracked the board papers and I can find nothing in the board papers to show it was shared with the board.

Q1889 Andrea Leadsom: A letter was sent to Reverend Flowers, who had no banking experience, expressing grave concerns over this banking transaction. Neither he nor

the regulator shared it with anybody else in the board and you were not even made aware of the existence of that letter?

David Davies: There were some statements in there that I do not know if I can answer because I am not aware of them. All I can tell you is that I did not see a letter and I do not know whether anybody saw it.

Rodney Baker-Bates: I certainly did not see it.

David Davies: From memory, I have a feeling that Barry Tootell said the letter had gone to him, but I have not checked the evidence. It is from memory.

Q1890 Andrea Leadsom: Okay. Just coming back again, would you say that Andrew Bailey's concerns about the Verde deal affected both of your individual concerns about the deal or just confirmed what you already feared?

David Davies: Personally, no. As Rodney says, these were issues that I think were things that you would think about. We had thought about them—and forgive me opening up another can of worms—in the Britannia deal. These were not new issues. Capital, liquidity, risk management and capability of doing a deal was something that we thought through when we merged with Britannia. It was natural that we would continue to think through them. They cropped up at pretty well every discussion we had on doing the Verde deal—quite clearly in the November discussions when we made our indicative bid and from then in every meeting thereafter.

Q1891 Andrea Leadsom: After the December 2011 letter that you were not aware of and never saw, were you aware of any other contact from Andrew Bailey? Did you get the impression that he was warming to the deal at all between December 2011 and June 2012, or did you have the impression that he was cooling even more, expressing even more concerns, or did you just have no contact with him?

David Davies: The feedback that we got was that the FSA were engaged and I use the phrase “supportive and positive.” That does not mean to say that they were in favour of doing the deal, but they were genuinely trying to help us get to the end point to reach a decision. I am aware that Paul Flowers had some meetings with Andrew Bailey. I cannot tell you how many. All I know is that there were occasions when Paul said, “I am meeting Andrew Bailey. Give me your advice, please.”

Q1892 Andrea Leadsom: Is it not odd that since he was expressly aware of his own lack of knowledge and experience as a banker and that you were both expressly taken on to be that expertise and knowledge, you were not part of those meetings or at least involved in what was being discussed at those meetings?

David Davies: It is odd if the FSA's requirement was that two deputies be appointed to help Paul with the technical aspects. As I say, that was news to me and I was not aware of that. I did not really feel put out that I was not part of the team with the FSA because I had no belief that I was—I am going to say it—a valued member of the team. The contact was between the chief executive, the chairman and the group chief executive. I do not even know whether his chairman met the FSA.

Q1893 Andrea Leadsom: At your respective exit interviews, what did you say to the FSA? Did you both individually at your exit interview make very clear the fact that you were gravely concerned about the Verde deal?

Rodney Baker-Bates: Absolutely, and I ran down the criteria. As I have already explained, I thought the group simply did not have the capital and the competence. You could go through those headings and you could talk about the risks in systems; you could talk about

the risks in integration. Something that has not come up is that, in the mergers and acquisitions I have done, normally the institution you are acquiring or merging with has a track record—you can look at its performance over five years; you can look at how the management performs. In this transaction, it was a carve-out. By the time I resigned I did not even know who the management were that were coming across, except for Paul Pester. To me, that is the sort of questions I was saying needed answers. I am afraid I felt that I could not continue on something that I thought was just a slope to disaster.

Q1894 Andrea Leadsom: You made it very clear to Clive Adamson that you thought this was an absolute disaster waiting to happen?

Rodney Baker-Bates: I would not use those terms; I was a bit more subtle than that. As he said, I did not tell him anything he did not know, but I thought I was trying to tell him that here is somebody who is a deputy chairman telling you this deal is not going to work.

Q1895 Andrea Leadsom: Your appointment as deputy chairs was part of Mr Flowers' arrangement with the FSA for being approved as chair, and yet when you both offered your resignations as a result of your grave concerns about a banking transaction that the FSA recognised he did not have the experience to understand, the FSA did nothing to take into account your concerns? Are you aware that they did anything differently or responded in any way whatsoever following your very clear—

Rodney Baker-Bates: Well, I had obviously no further involvement. I had resigned from the board so I have no knowledge of what they did.

David Davies: I had my interview as part of an Arrow interview in October and I laid it out very clearly. Frankly, I was certainly given the impression that they understood my problems and why I voted against. Andy Cope, who did my interview, knew of my concerns. I presume that was because I was three months after Rodney had spoken to Clive Adamson. They were very well aware of my concerns. I do not know whether directly they did anything different as a consequence of our votes. I suspect it confirmed or reaffirmed their concerns—

Rodney Baker-Bates: Hardened their views.

David Davies: —and they would just let the scenario play out to the point in time when it became clear that this was not going to happen.

Q1896 Andrea Leadsom: Is that, in your opinion, what a regulator should do? To hear absolutely overwhelming evidence from people of experience and then do nothing with it, is that the right way to defend the taxpayer?

David Davies: I think it is slightly over the top to say “overwhelming evidence” because do not forget that a number of directors—the majority of the directors in the Co-operative Bank—voted in favour of doing this deal, or at least going on to the next step. Therefore, they were convinced that things could be done, things could improve; changes might happen that would make this deal doable. The heads of terms was not a clear break. When you got to the SPA, that would have been a clear break when, if you like, any doubts would have had to have been surfaced. We chose heads of terms because certainly in my case I thought this had now got to the point when I could not carry on with this. I thought we had to stop because it was beginning to, in my view, hurt the organisation. But it was not a natural breakpoint because it was still open for negotiations after heads of terms, and that was one of the problems—that there were a number of details still remaining to be negotiated post heads of terms, before SPA, that could have changed the nature of the deal.

Q1897 Andrea Leadsom: Just one last point: I certainly recall with various of the witnesses that we have had here an overwhelming sense that they all felt that on the board of

Co-op there was a lack of experience and a lack of accountability. In effect, what the FSA did was appoint you two gentlemen to provide the expertise and then they disregarded your explicit concerns. Do you think that was a reasonable action for them to take in hindsight?

David Davies: Well, I do not think they appointed us. I think they pressed upon Paul it would be a good point in his favour to appoint some expertise. I think Paul seized on that and did exactly that, but I do not think they made it—well, I do not know. I am speaking of something here I am only speculating on. I do not know if they did make it part of the deal.

Q1898 Chair: Sorry to interrupt but just on that point, Clive Adamson said in his oral evidence, “It was not the Co-op Bank’s idea. In recollection, it came from Mr Flowers’ idea, because he recognised that he did not have sufficient technical experience. I think, as he has disclosed to the Committee, he put that agreement into practice afterwards. He viewed it as an agreement that would be necessary.” Is that consistent with what you know?

David Davies: All I can say is the paper that went to the board asking for volunteers made it look as if it was Paul’s idea. There was no mention of the FSA’s involvement.

Chair: Okay. Is there anything else, Andrea?

Andrea Leadsom: That’s it.

Chair: Andy, do you have any quick things you want to add?

Q1899 Mr Love: Yes, I want to go back on a few issues. Let me, first of all, as usual, draw the attention of the Committee to my designation as a Labour and Co-operative Member of Parliament.

Can I just be absolutely clear about this signal that the regulator, Andrew Bailey, was sending to the board? It has been characterised by them as being a stark message: grave concerns have been raised. How do you remember Andrew Bailey’s intervention? I do not know exactly when the letter was drawn to your attention, if it was. Did you get the impression that this was a stark message from the regulator?

Rodney Baker-Bates: We never saw the letter so I presume you are referring to July. To me, the regulator was raising five key issues, which, as an experienced banker, I would have raised and I had raised already in my own mind, so what he was raising matched with my concerns. I would not have described it as a stark warning.

Q1900 Mr Love: Mr Davies, it seems to have had little impact. People were already convinced of what the regulator was saying in his five points, but it did not seem to convince much of the rest of the board. Would you agree with that?

David Davies: Convince is not the right word. There were a number of activities that were launched on the back of that: risk framework design; liquidity management, trying to tighten it up—although I think that is one area where we would disagree with the regulator; our liquidity management was not that bad—capital we were clearly very much aware of and it was under the microscope, with a regular review on a month by month basis; management actions to raise more capital; the sale of the life fund; the potential sale of the general insurance business; the deleveraging of the balance sheet. Things like that were all there on the table to be considered—even the potential for group to provide a capital injection, albeit the last resort.

On management stretch, the risk committee in particular had a number of meetings both with Paul and Peter Marks to say that we were concerned with the number of resignations and the way the organisation was stretched. We kept management stretch as a regular item on the risk committee and on the boards and got reports from human resources about how we were coping. Things on that front seemed to be improving towards the end of 2012 when we were recruiting into the organisation some very good, experienced individuals.

Governance was an issue that was ongoing. There were meetings between Paul and the regulator on improving the governance, slimming down the size of the board, bringing on to the board specific skills. We were aware that we had a balance issue of being more banking expertise. We did not have any treasury expertise on the banking board. We did not have any large systems expertise on the board. We were looking to recruit people on to the board that covered both those positions and that was due to happen around about the end of 2012, although it did not actually happen until much later on.

Q1901 Mr Love: I want to come back to that in a second. You mentioned earlier on when asked about political involvement in this whole process that there had been contact. I think that was the word you used. Could you elaborate on that for us? Where did this information arise?

David Davies: I can only do it from memory and it is in the board papers. The board papers refer to Peter Marks having contact with a Treasury Minister. There was a phrase used in the board papers that referred to “goodwill” from the Government towards the deal.

Q1902 Mr Love: But you had no board discussion about that?

David Davies: No.

Q1903 Mr Love: You accepted the report as given in the board papers?

David Davies: I would have expected there to have been interaction between the group board and the Government or the Ministers.

Q1904 Mr Love: Mr Baker-Bates, let me go back to the issue of the chairmanship of the merged entity. It is a fact that Neville Richardson was appointed as the chief executive officer. In your experience, would that normally mean that automatically the other partner to the merger would choose the chairman? Would that be normal?

Rodney Baker-Bates: Well, normally the chairman is appointed by the board, that is how it works, and then confirmed by the shareholder when he is re-elected as a director. It is customary sometimes to do that, but I would not say it was normal. You have to look at the individuals involved.

Q1905 Mr Love: I understand that, but the point I was trying to make was it would be, I think, normal practice in order to meld the merged organisation together for one of the two most senior people on the board to be from each of the organisations, wouldn't it?

Rodney Baker-Bates: It seemed to me perfectly natural, given it was a wholly owned subsidiary of the Co-operative Group and it was a merger. That seemed to me like a perfectly sensible division.

Q1906 Mr Love: You also mentioned a shareholder appointment—the chairman should reflect the shareholder—which is rather unusual, as you both commented, in this regard. Would it be unusual in the selection of a chairman to ask questions that related to knowledge and experience of who the shareholder was? You mentioned earlier on in your comments that you had been asked a lot of questions about the Co-op Group and the wider Co-operative movement. Wouldn't that be normal that there would be an expectation that if you were to represent the shareholder, you would have some understanding of the shareholder and who the shareholder was?

Rodney Baker-Bates: Yes, absolutely. Obviously, I come from a plc background and it is slightly different. In a wholly owned subsidiary it was clearly an important skill, which was not my strong suit, I absolutely acknowledge that.

Q1907 Mr Love: Can I ask you, Mr Davies, how independent, in your view, was the bank board? After all, it is a plc within a wider co-operative governance arrangement. It had its own executive, its own chief executive, and its own board with many non-executive directors. How independent was it? You were on the board for quite some time through various mergers and changes and, indeed, a slimming down of the board as you mentioned earlier on. How would you characterise it as an independent board?

David Davies: I would regard it as independent. I do not think we were instructed to do anything that we would not have wished to do. My only caveat on that is Project Unity and the overlap that was created. Some functions that were bank and insurance ended up being merged with group functions and so we lost an element of independence there. I am also sorry to say that I think the requirement for Neville to report into Peter also damaged the relationship between the chief executive and the board, because he had basically two masters to report to. I have worked in a situation like that as a chief executive and it can work. It is not comfortable if the group chief executive you are reporting to does not see things in the same way that your board does and then you find yourself getting squeezed. In hindsight, I wish I had thought more deeply about that and tried to somehow accommodate Neville because—a personal opinion—I think that was the major reason that Neville gave in and gave up: he did not like the reporting lines.

Chair: One more question.

Mr Love: I thought we had until 11.15 am.

Chair: Yes. I have one rejoinder I want to come back to.

Q1908 Mr Love: Okay. I will try to be brief. I want to ask two more questions if that is possible. Mr Baker-Bates, could you foresee any circumstances where Project Verde would have gone ahead without the approval of the bank board?

Rodney Baker-Bates: No, I am absolutely clear. Otherwise I would have resigned earlier. I stayed on because I wanted to make the argument and persuade the bank board not to proceed with Verde. If I believed that the group board would override that decision, I would not have stayed on.

Q1909 Mr Love: Even though the executive and the people that were doing the negotiation were primarily from the group board, they would have sought and it would have been necessary to have approval of the bank board before they could be given the green light?

Rodney Baker-Bates: I cannot imagine that any independent would have remained on the board if the bank board had voted against it.

Q1910 Mr Love: Can I ask you one final question? This is posed to both of you. The board slimmed down from 22 to 14. On my estimation, nine of those board members had either financial banking experience or insurance experience. Was that your view? I am turning to you first, Mr Davies. You mentioned the whole issue of balance on the board. Did they have enough financial expertise on the board to take these decisions? Were you confident, even accepting the shortcomings of the chairman, that the board was adequately experienced and knowledgeable in these matters to take these decisions?

David Davies: Yes, I would be happy to confirm that. My only concern was that they were spread thinly across all the committees. The same people were getting put on to more than one committee and it was asking a tremendous amount of workload. It is not as if all 14 of them had financial services expertise, so that was part of the problem. Another issue about governance is we covered three separate organisations: life company, general insurance company and the bank. Therefore, expertise was being more thinly spread because of that. We

improved the situation when we started to create dedicated boards for the general company and for the life company, but we were too late in doing that—well, we were late in doing it, not too late.

Q1911 Mr Love: Do you wish to add anything, Mr Baker-Bates?

Rodney Baker-Bates: No, I would share David's view. There was enough expertise but it was too thinly spread.

Q1912 Mr Love: On your basis, Mr Davies, they were taking action at the time you came off the board to address those issues?

David Davies: Yes. My test is: are there any decisions in hindsight that we took that I would not have taken? The Verde decision is one that I would not have taken, but I would have got there earlier than I did. I think we were right in pursuing it so far. I only wish we had stopped it sooner.

Q1913 Chair: That is very helpful. There is one further issue that comes out of that to some degree—many, actually, but one that I want to ask you about that I am still puzzled by. It is clear that the bank board was not the key driver of this transaction at key points. This was being done through the group board and your evidence has been unequivocal on that point. Correct me if I am wrong.

Rodney Baker-Bates: No, you are right.

Chair: The bank board could have stood up for itself, couldn't it? The bank board could have said, "Look, this just will not do and we want to be much more closely involved in this deal. This is, after all, a financial transaction and it is absolutely essential that we have a bigger role." Why didn't the bank board do that?

David Davies: I would question where you think it did not have a big role. The risk committee and the bank board were meeting every month on the Mars subject and were heavily engaged. Where we were not engaged was the financial terms of the offer.

Q1914 Chair: That is the key issue, isn't it, of any deal? That is the heart of the matter.

David Davies: In a sense, I could look at that and say the financial deal was a very good deal. Here we were providing £350 million financed by the vendor, so we were not dipping into our own pockets. It was when we got to capital that the banking board—

Q1915 Chair: I can ask this question many different ways but it amounts to the same question, which is, as you have said, the main board was driving the deal, not the bank board. I am saying why didn't the bank board say, "We should be"—

Rodney Baker-Bates: I think the bank board did stand up. That assumes that there was unanimity of opposition and I think the Committee needs to understand that there were six, seven, eight NEDs; there was a range of views there. I was at one end, being trenchantly opposed to it for reasons that we have discussed; there were other colleagues at the other end who were, in fact, strongly in favour of it. You are trying to convey the concept of a united board on this particular issue and the fact is there was a wide range of views.

Chair: That is very helpful. We are very grateful to you for giving evidence this afternoon. It has been extremely interesting, enlightening and, in one or two places, surprising, as it always is when we take evidence on this subject. We now have Treasury questions on the floor of the House so we will bring the meeting to a close. Thank you very much.

Rodney Baker-Bates: Thank you.

David Davies: Thank you.