

HOUSE OF COMMONS
ORAL EVIDENCE
TAKEN BEFORE THE
TREASURY COMMITTEE

PROJECT VERDE

TUESDAY 11 FEBRUARY 2014

ANDREW BAILEY

Evidence heard in Public

Questions 1916 - 1999

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Oral Evidence

Taken before the Treasury Committee

on Tuesday 11 February 2014

Members present:

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

Examination of Witness

Witness: **Andrew Bailey**, Deputy Governor of the Bank of England for Prudential Regulation and Chief Executive Officer of the Prudential Regulation Authority, and former Managing Director of the Prudential Business Unit of the Financial Services Authority, gave evidence.

Q1916 Chair: Thank you very much for coming to give evidence to us this morning, Mr Bailey. We have a lot of ground to cover on Verde. Before we do that, I have two initial questions and it is possible that one or two colleagues may want to cover similar ground coming in straight after me.

First of all, on the bonus cap, we are in the bonus season. I want to be clear on whether you agree with what the Banking Commission concluded on this issue, which it did after looking at it in great depth. It opposed the bonus cap, not on the grounds that it might make the UK less competitive nor because it might be easy to avoid, although those may or may not be true, but because it would not tackle the key problem of bonuses, which is that they were incentivising the wrong kind of behaviour. Do you agree with those conclusions?

Andrew Bailey: I do.

Q1917 Chair: The second question is, do you think that the bonus cap effect on the current bonus round is bearing out that concern?

Andrew Bailey: I do. I should say, of course, it is looking forward to the next bonus round. This bonus round is the last of the old regime in that sense, but banks have to put in place what they are going to do in the next round. To be strictly true, that is an important distinction to make. I do detect, as we have discussed before, a pressure to increase the fixed element of remuneration at the expense of the variable bonus element of remuneration, and that has two concerns for us. One is that it risks reducing the flexibility for banks to adjust remuneration and therefore build capital. Secondly, to the point that you specifically raise, it has the risk that it creates the wrong incentives.

We have done a lot of work in the last three or four years to adjust the remuneration structure to improve the incentives; to create greater deferral of remuneration, a point that the

commission that you chaired put emphasis on and I agree with that; a pressure to reduce the amount of what I call cash out of the door, because that is directly relevant to capital retention; and a pressure, in the context of that deferral, to use the tools subsequently in the period of deferral of malice and also—and we are going to consult on this very shortly—claw-back, which is the bringing back of remuneration that has been paid out. Malice is where it is deferred but not paid out. I agree with you on all of these.

There is a question that you have seen covered, which is: are banks seeking to evade the rules, these so-called allowances? My view on that is that is all about the fact that the bonus cap then forces a definition of what is fixed remuneration and, therefore, where the boundary is. These allowances are not things that can vary as a result of the performance of the bank or the performance of the individual—that is strictly not allowed under the CRD IV regulations—but they are being used and I think this is sensible, going back to my two points about why we care about this. For instance, in a situation where the bank suffers a shock to its capital position, we want to be able to get them to adjust future remuneration downwards. That must be the right answer.

Chair: Therefore, it makes the task of keeping the banking system secure more difficult.

Andrew Bailey: Yes.

Chair: Making the job of prudential supervision more difficult.

Andrew Bailey: Yes.

Q1918 Chair: Unless other colleagues want to come in on this point, it might be helpful to have clarification on one other point. Do you therefore want to see the bonus cap overturned in the courts?

Andrew Bailey: I have supported the UK legal action. I have provided a so-called witness statement, which is largely drawn from things I have said to this Committee in the past because they are on the record. So, yes, my position is clear.

Q1919 Chair: Unless colleagues have other points they want to raise on that, I would like to move on to one other issue that has put the Bank of England as a whole in the news, which is that the bank might have condoned manipulation of foreign exchange benchmarks as a result of the way the market shares customer information. Are you investigating this? What is going on?

Andrew Bailey: Yes. The Bank of England does not condone any form of market manipulation in any context whatsoever. We are supporting the FCA's investigation. We have done so from the outset. We are also playing a leading role in work, which of course goes much more broadly than the FX benchmarks, into the reform of the process of setting benchmarks in financial markets; something that Mark Carney is leading in his capacity as Chairman of the Financial Stability Board. The governors, in the plural, of the bank have taken the claims about the meeting with bank officials extremely seriously since we first heard about these allegations. Just so you know, we first heard about them in October. We have released a minute of that meeting, but there are now allegations that there are different versions of what happened at that meeting.

What I can tell you is that the governors immediately initiated a full review into it. That is being led by the Bank of England's legal counsel, but also supported by external legal counsel and it is working in close co-operation with the FCA. On the evidence that we have currently, we have no evidence to substantiate the claim that bank officials in any sense condoned or were informed of price manipulation or the sharing of confidential client information but, like the investigation that the FCA is doing and obviously bearing in mind what has been said in the last week, we do not regard that review as over. We will take into

account any information that we get. The review is not over until the information has all appeared, and we do not know what is yet to appear.

Q1920 Mr McFadden: As part of this investigation, Mr Bailey, you are investigating yourselves because the allegation in the Bloomberg report from a few days ago is that the meeting of the Bank of England's Foreign Exchange Joint Standing Committee with traders in April 2012 condoned information sharing before they are fixed and that report says they even said it could be a positive thing.

Andrew Bailey: Just to be clear, it was a sub-committee of the standing committee, but that is obviously a technicality. We are investigating it because, as I said, we take that very seriously. I should say we have no evidence yet and we have not seen the evidence that was in the Bloomberg report. It has not been submitted.

Mr McFadden: Have you spoken to the person who wrote the Bloomberg report?

Andrew Bailey: No. We have spoken to the FCA because they are conducting the investigation, including the investigation into the individual. They have not seen that evidence, but we have said to them that we take it extremely seriously and if that evidence does materialise or if the individual would now like to provide that evidence, if they have not already done so, that will be part of our investigation.

Q1921 Mr McFadden: You understand the context of this. The bank has just taken over greatly increased regulatory responsibilities. After LIBOR, people now have doubts about the honesty of the foreign exchange fixings, and indeed other benchmarks that we asked Mr Wheatley about last week. If there was corroboration that the bank had somehow turned a blind eye to that kind of activity, it would be enormously damaging to confidence in the bank in this new regulatory environment, wouldn't it?

Andrew Bailey: That is one of the reasons why we take it so seriously. I agree with you on that. That is why we have set up this investigation and this process. You are right; in a way I would say it does not turn on the issue of whether the bank is a regulator or not. It turns on the issue of the central bank's position. Obviously becoming the regulator adds to that, and I agree with you on that, but you can be assured that the governors take the whole question of the reputation and the integrity of the central bank extremely seriously. It is the most important thing we have, so I can't emphasise to you enough how much, first, I agree with you on this point but, secondly, we take this seriously.

Mr McFadden: I suspect it is an issue we will return to.

Andrew Bailey: I am sure we will.

Q1922 Chair: Can we turn to the main subject of the hearing this morning and begin by asking you, with respect to the Co-op, who among the senior people, who we have all heard from now, do you think is primarily responsible for the collapse of the Co-op? I don't want to exclude anybody but just to include four names: Peter Marks, Barry Tootell, Neville Richardson or Paul Flowers.

Andrew Bailey: I think the answer to this question has to go to the root cause of the problem and that, in my view, is not the Verde transaction. We can come on to the Verde transaction because it is important, but it is not the root cause of the problem. The root cause of the problem goes further back. In my view, there are two root causes that relate to the two parties that created the Co-op out of the Britannia merger and they are different root causes.

I have written to you on this question because there was a disagreement between myself and Neville Richardson on this after my previous evidence here and his evidence here. I think the root cause in Britannia was the problem of the loan book and obviously I wrote to you on that. I think the work that has been done more recently on that loan book, and

particularly the commercial loan book, has tended to reinforce that. What that has tended to reveal is that more of the book is difficult to refinance in the sense that when the loans come up to maturity, unless the commercial property can be refinanced, there is a problem with the loan. More of the loans are structurally subordinated in ways that do not seem to be appreciated.

I have been all the way through the records of the supervision of these institutions, going back at least to the immediate pre-merger, and you see comments from very senior people in Britannia. Indeed the then chairman of Britannia was saying that he did not understand why the bank had gone into the commercial lending business, but it was quite clear that this was a set position within the board before he became chairman. Secondly, you had a mortgage book that had a very low proportion of prime mortgage lending with high impairments, a point that I think has come out in your previous hearings. So that was an embedded problem.

I think the root cause with Co-op is quite different and does not have the same what one might call culpability, because the problem with Co-op was that it was a full-service retail bank but very small. Prior to the merger with Britannia, I think it had a balance sheet of just over £16 billion. For a full-service retail bank, that is extremely small.

Chair: Just give us an idea of the size of a full-service retail bank.

Andrew Bailey: If I am right, Lloyds, pre-merger with HBOS, had a balance sheet of about £350 billion. Lloyds was probably at the smaller end of the big banks. Nationwide today has a balance sheet of just under £200 billion. This is one of the issues in the whole competition debate. Being in the personal current account market has expensive overheads attached to it. Obviously there is debate about whether some of those are justified or not. I think you have had it said to you, and it is very clear in the records, that there was a view in the Co-op that this was not sustainable and I think they were right. The costs were too high to sustain that sort of business.

They felt they had to do something. That led, in a sense, to the merger, but the problem was that Britannia was one of the building societies in 2008-09 that was in trouble. There was a group of them. Bear in mind that this merger happened over a year between summer 2008 and summer 2009, the most febrile period in the whole of the financial crisis and in those days I was responsible for resolution. I was not a supervisor in those days. I had to resolve the Dunfermline Building Society that failed end of March 2009. It was much smaller.

Bear in mind that Britannia was the second largest building society, although there is a huge gap between Nationwide and the others but it was still the second largest. If I remember rightly, it had a balance sheet of just over £35 billion. The merger happened during this febrile period. The Dunfermline had to be resolved. The West Bromwich Building Society had what these days we would call a bail-in of subordinated debt; a little bit like what has happened with Co-op, but it was much simpler in that case because there were a relatively small number of holders of it. Today it has a new management team that I think is doing a very good job to bring it slowly out of that problem.

The big question, which we keep going back to, was that the Co-op merger took Britannia out of the spotlight, but it did not solve the problem because obviously it did not deal with the underlying problem. The question is, was that the right thing to do in 2009? I think it would have been very difficult to have done a full resolution of Britannia at that point were it necessary—frankly, I think it would have risked undermining more building societies because it was so much bigger—but it left the problem unresolved. The problem could have been dealt with, and I think these were assumptions that underlie the business model, had the economy recovered, particularly had interest rates risen and therefore the squeeze on net interest margins been alleviated. That has not happened and, therefore, the problem was there.

Verde was a further attempt to build up the Co-op into something that was sustainable and larger. Putting the Co-op and Verde together met the independent commission's test on a challenger bank. If you remember, there are recommendations on Verde in the independent commission report that the Government accepted. Ultimately, Verde could not be done anyway without solving the underlying problem. The underlying problem went back to capital and the other things that we discussed when I was last here in answer to Mr Norman's questions, but the other things were more capable of being dealt with. Risk management and governance could be dealt with and they were dealt with progressively. There are two things: the capital question and whether they could generate a business model that could generate earnings to sustain the position of the bank and build it out of these problems ultimately defeated it. Sorry, that is a long answer.

Chair: I am going to pass the question to David Ruffley but, before I do, the question was, which of these individuals was responsible?

Andrew Bailey: I know I am unpopular in some quarters for saying this, but I think more of the responsibility for the embedded problems goes back to Britannia.

Chair: Meaning?

Andrew Bailey: The management of Britannia.

Q1923 Mr Ruffley: Mr Bailey, I find your arguments very compelling. I think this is the first time this Committee has had such an unambiguous statement on the prime cause for the Co-op's difficulties. Just to clarify this, it seems you have launched an Exocet at the chief executive, the chairman and the former board of Britannia. Are you saying that the Britannia assets were the prime cause of the Co-op's difficulties?

Andrew Bailey: The root cause, yes. The second thing that came along—

Mr Ruffley: But is the root cause the same as the prime cause?

Andrew Bailey: Yes, I think it is. The second thing, which is a point I probably should have mentioned and I apologise, is that the losses on the write-off of the information technology transformation programme—I think there was some confusion in one of your hearings on this—which I think are now about £598 million, are hugely larger than anybody could have expected. How this came about is one of the stories that needs to be revealed by the investigations because, I will be honest with you on that, I still do not understand how it is possible to have ended up in situation.

Q1924 Mr Ruffley: The question of write-offs must have been foreseeable by the Co-op management.

Andrew Bailey: Foreseen?

Mr Ruffley: Foreseeable, if they were acquiring Verde with all the Lloyds' IT infrastructure.

Andrew Bailey: Yes. I think the question here goes to another issue that has come up in the hearings, which is the letter that we sent to all banks in December 2010 following an FPC recommendation concerning the interpretation by banks of the provisioning standards. I think Barry Tootell has referred to this as the shock. Bear in mind that this letter went to all the banks. As you know, there is a huge debate in the accounting standard-setting profession about the question of incurred versus expected loss provisioning.

As regulators we think the standard needs to be forward looking and, therefore, more in the expected loss world, but that was not the issue with this letter. The issue was we felt that within the existing standards there were practices that were leaning towards underproviding, i.e. not looking at questions on a more forward-looking basis, such as refinancing risk. Bear in mind that we sent this to all banks, and Co-op was the only bank that was seriously affected by this. The others may have made some adjustments at the margins,

and I know they did, but that was not a big issue for them. Co-op was the one that was affected by this.

The reason I raise this in the context of your question is that I think it goes exactly to the point you make. What this tended to reveal was an attitude towards impairment that was out of line not just with what we felt but with what other parts of the industry felt.

Q1925 Mr Ruffley: Understood. I want to come back to a letter you wrote to this Committee on 10 September regarding Neville Richardson's evidence. You talk about your concern was "not just that the former Britannia assets had contributed a significant proportion of the Co-op Bank's loan losses"—we knew that—"but that the nature of those assets meant that they were likely to lead to further impairment. The former Britannia assets were those on the bank's balance sheet that were most vulnerable to further stress." Just so I am clear about this: were you saying and thinking what I have just read out? Was this on the 12 July 2011 away day with the Co-op?

Andrew Bailey: No. I must be clear on this.

Mr Ruffley: I want to pin down, when were you saying that the Britannia assets were vulnerable to further stress?

Andrew Bailey: To be honest, July 2011 was very early in my time in this role. I had a view—and the supervisors had sympathy with the view—that there was an inherited problem in Britannia. The reason for me holding that view, going back to what I said a few minutes ago, was my view of the problem we saw in 2008-09 and how near it got to a very difficult situation, but we had not done the detailed asset quality review work in July 2011 that has been done subsequently or indeed the stress test.

The reason I made the comment in the letter was the two things I mentioned earlier as examples. One was that the asset quality review work has revealed the problems of refinancing these loans. To give you a metric, the share of these loans—bear in mind that these are commercial property loans, but you can use similar metrics—that have loan to value ratios of over 100% are going to be inherently very difficult to refinance. Secondly, we felt, as a result of the asset quality review work, that the degree of structural subordination in these loans, because these loans typically have more than one bank providing the loans, or the structure of the lending was not appreciated. The reason that I stress structural subordination is it is just more likely that these loans are going to be impaired if they are structurally subordinated.

The final point I would make, and I think this is a point that Co-op executives have made, is that Britannia had a policy of taking more concentrated loan positions in single loan exposures than, say, Co-op did. When you had Barry Tootell here, I think he made the point in answer to a question that he now realised that there were far more problems in that loan book than they did at the point when they did the fair value adjustments in the context of the merger.

Q1926 Mr Ruffley: You have said now very clearly why you thought the Britannia assets were vulnerable to future impairments in your opening answers to Mr Tyrie and to me. The shortfall exercise revealed Co-op's £1.5 billion capital black hole. Do you think it is likely that there are more Britannia asset-related losses to come or do you think we have seen the worst of them?

Andrew Bailey: We have no evidence to suggest there are more to come. I should say, because who knows what the future will hold, it is possible that the future will turn out better. If we see a sustained recovery of the economy and the commercial property market—and we are seeing the beginnings of some signs of that, although the commercial property market in this country is very tiered so you have to be very careful what bit of commercial property and

what particular type and area of the country you are looking at—it is possible, because this is a probability assessment, that the outcome will turn out to be better. I can't rule that out if there is a sustained recovery.

Q1927 Mr Ruffley: A final question, because I know lots of colleagues want to get in on what I think is incredibly powerful testimony that you are giving to us. Would Britannia have failed had it not been for the merger with Co-op? Let me tell you why I ask that question. It seems to me that there were some real systemic structural problems with their loan book, and you have articulated that very clearly. Do you think they were incompetent in missing this? I am talking about the board and management of Britannia in the run-up to merger. Were they incompetent or do you think that it was a desperate throw of the dice to avoid Britannia itself collapsing? Is that why they did the merger?

Andrew Bailey: Going back to 2008-09, Britannia was one of a small group of building societies that stood out when the work was done by the tripartite authorities looking across the board. The others that stood out have also had to have some form of either resolution or remedial measures taken on them. Why did that come about? I think this is very important in the context of thinking about mutuals. The common feature of those societies was that they had expanded their lending activities into outside the traditional prime mortgage market that building societies occupied. Why had they done that? I think the reason they had done that—and this is a theme that runs through a number of the failures—is that, during the period of five to seven years prior to 2007, lending margins in the mortgage market had been squeezed very heavily. One of the reasons for that was the activities of institutions like Northern Rock.

This was a model in which there was a severe squeeze on lending margins, particularly in the prime mortgage market because it tends to happen more there. What that had led to was institutions that were not the strongest and largest players in the market—I will come back to one of the largest players—therefore looking to diversify their lending activities to earn larger returns. To simplify it, they were doing one of two things. They were either going into what you might call the fringes of mortgage lending, so into the self-certify non-conforming market, or they were going into commercial property lending. Dunfermline, which I had to resolve, had gone into both of those and Britannia had. The problem was that they did not have the risk management skills to manage those sorts of loan books and, as mutuals, they do not have the same flexibility to raise capital to manage those sorts of lumpier risks.

By the way, the same is also somewhat true of the HBOS story. HBOS moved out of their traditional prime mortgage lending market because the returns on it were being squeezed and, disastrously, moved into other lending markets that they did not have the skills to manage. The long answer to your question is there is a common theme there.

Q1928 Mr Ruffley: That is a very useful response, but I just want to repeat the question. In the run-up to merger, were the Britannia board and management incompetent in taking the course of action you have described? Did they miss it through incompetence or do you think they pressed ahead with the merger with Co-op because they thought this was the only way to stop their own implosion? Which was it?

Andrew Bailey: They deny the second.

Mr Ruffley: What about the first?

Andrew Bailey: I think they were completely convinced of the rightness of their business model. Some of the evidence you have had before you is that they still are, to a degree. It is quite interesting. Rodney Baker-Bates, who I think became chairman of Britannia in its last two years and joined the board for about the last three years, said to the supervisors

at the time, “I don’t understand why Britannia has gone into commercial lending. It doesn’t look like a good thing to have been done, but the board is clearly convinced that it is right and doesn’t seem to be shaken of that judgment.” He also described the loan book as “racier”; I think that was the word he used.

Chair: To be clear, you said that they are still convinced of their business model. Just translating that a little, do you mean they are in denial?

Andrew Bailey: I have read all the transcripts of your hearings and I have to say that was one of the conclusions I drew from it, yes.

Q1929 Jesse Norman: Thank you very much indeed, Mr Bailey, for what is proving to be a gripping session. You have drawn a picture in which, in the middle of the first decade of this century, Northern Rock and other institutions were putting a squeeze on traditional margins.

Andrew Bailey: Yes.

Jesse Norman: These institutions are hunting for returns and they are therefore diversifying outside their traditional areas. Might it be fair to add that some of them have been carried away by great dreams of investment banking-type glory and potential remuneration?

Andrew Bailey: There was probably some of that as well. Not on the same scale but some of that, yes.

Jesse Norman: It is hard to imagine anything being on quite the same scale. You can comment on that if you like, Mr Bailey. When you said that, it seems to be an implication of that that the mutual model is not broken. It has simply been very badly abused in the context of these unusual market conditions.

Andrew Bailey: I think the mutuals were put under stress particularly by what was happening in the institutions that had demutualised.

Jesse Norman: My colleagues will come on to that. I just wanted to be clear, briefly that is the kind of implication that you are gesturing towards?

Andrew Bailey: Yes. To be clear, of course, we should not tar all building societies with this brush because some of them took actions that have stood them in good stead. Some of them essentially hunkered down—a phrase they tend to use—in this market and said, “This is really not a business that we can prosper in, but we are here for the long run because we are mutuals”. I think they can do this because a mutual can exist on a lower rate of return than an institution in the commercial sector. It is shielded in that sense. They took that strategy, and they are here today and doing pretty well.

Q1930 Jesse Norman: Good. You did not address the specific question, as far as I understood it. Would Britannia have failed had it not been for the merger?

Andrew Bailey: Bear in mind I was responsible for resolution at the time and bear in mind the febrile conditions at that time, my view at the time was, yes, it would.

Jesse Norman: It would have failed?

Andrew Bailey: Yes. I think the merger essentially took it out of the limelight, and that was the key. In that sense, of course, it achieved its objective.

Chair: Britannia was rescued.

Q1931 Jesse Norman: I just wanted to be perfectly clear. That is helpful. The second thing about that is you also said that, based on your considerable understanding of resolution—I doubt if anyone knows more about the issue than you do, Mr Bailey—it would have been difficult to do a full resolution of Britannia. To me, that implies liquidation or nationalisation.

Andrew Bailey: I agree. This is a key point. Had we had to do the same thing for the Britannia that we did for the Dunfermline Building Society, which was, in your term, liquidation—a transfer of deposits to another institution and the rest goes into an insolvency process essentially; some assets went over but not that many—bear in mind that Dunfermline had a balance sheet of about £4 billion, if I remember rightly, and Britannia had a balance sheet of about £35 billion to £37 billion—

Jesse Norman: Yes, it is nine times the size.

Andrew Bailey: —you are talking about a wholly different order of magnitude. The other thing I would say, and this is an issue that remains to this day, is that, had we done that with Britannia, we would have increased the burden on the Financial Services Compensation Scheme. That is relevant because today one of the statistics that is important in the competition context is that, if I remember rightly, about 25% of the earnings of the building societies collectively go to the FSCS to pay the legacy costs of Bradford & Bingley, Dunfermline and some Icelandics.

Jesse Norman: So this might have sunk the FSCS?

Andrew Bailey: Yes, and that is a burden on the building societies. When I quote that 25% figure, it is important to remember that earnings in the building societies are low because of the squeeze on net interest margins because of low interest rates. It is 25% of a smaller number. The point I am making is, had we put Britannia in there, I think you would have had a much larger number than 25% and you would have seen more building societies disappear because they would have found it unsustainable.

Q1932 Jesse Norman: Anyone looking at the situation of Britannia in a fairly cool-eyed way in 2008-09 would have concluded that, from a political standpoint, there was a compelling incentive to tidy away or somehow prevent either the liquidation or nationalisation of Britannia because it might well have taken out the general scheme and therefore the wider industry.

Andrew Bailey: The only point I would disagree with you on that is the word “political” judgment. I don’t think you should tar politicians with this brush. I think there was a broader reason for this. I don’t want in any sense to think this was a judgment made by particular politicians with which later they disagreed. I still think today, if we faced that situation again, it would not necessarily be the wrong thing to do, bearing in mind the tools we had available to us at that time.

Jesse Norman: Just to be clear then, not merely political but public interest?

Andrew Bailey: Yes.

Q1933 Jesse Norman: That is very helpful. When you talked about responsibility for the catastrophe of the current circumstances surrounding the Co-op you said that the responsibility for the embedded problems, the main cause, lay with Britannia. I want to suggest to you that the embedded problems are only part of the general problem and that there does seem to me, from what you have been saying, to be very clear culpability on the Co-op side on two grounds. One is because they took over the Britannia with its embedded problems in a way that, in retrospect, looks extraordinarily reckless at a time when the market was febrile. Would you agree with that?

Andrew Bailey: Yes.

Jesse Norman: The second is because they themselves did so at a time when they were looking down the barrel of a gun on a whole series of other sources of loss within their own operations and businesses, notably the IT losses that you have mentioned.

Andrew Bailey: The IT losses predominantly emerged from the bringing together of Co-op and Britannia.

Jesse Norman: That was a collateral cost that they should have anticipated with the merger.

Andrew Bailey: Yes, but if you go back and replay history—I set out these two problems—I think the Co-op’s problems were slower burn. Because of this point about being a full-scale retail bank with a very small balance sheet compared to others, the Co-op would have had to deal with that issue eventually. I am not saying, however, that they had to deal with that issue in 2008 or 2009. I suspect they could have gone along relatively out of the limelight, earning fairly low returns but not critically low returns from the point of view of the business model they had. Eventually, as I think a number of people from the Co-op have said in these hearings, they had to deal with that issue but I don’t think they had to deal with it at that time.

Jesse Norman: Just to be clear, this has been a total disaster for the mutual members of the Co-op. They have gone from having a small high-cost bank to having at least a £1 billion hole in the balance sheet, of which half would be from the Britannia under-performing assets that we know so far and half from the IT costs associated with the merger.

Andrew Bailey: You are right and also, to pick up your point, they have gone from being a small high-cost bank to being a larger high-cost bank. They have never solved the cost problem.

Q1934 Jesse Norman: Good. Then I want to ask you another question. There is another person, who I am sad that we have not had a chance to call to this Committee but who ought to be put in the frame for responsibility, and that is Len Wardle, the chairman of the Co-op itself. We know that the Co-op Group was driving the merger on Verde, as well as some of the other changes in the bank. Of course he was the chairman of the group and he will undoubtedly, as such, have taken a close interest in the appointment of Paul Flowers as bank chairman and so on. Do you think he bears a degree of responsibility and, if so, how much?

Andrew Bailey: I think the Co-op Group do. My reading of this and my evidence on this would suggest that Peter Marks was the driving force behind the Verde thing.

Jesse Norman: He said that himself.

Andrew Bailey: Of course, to your point, you can say that Len Wardle was the chairman of the Co-op Group. The role of the chairman is to rein in the chief executive when the chief executive is going beyond the limits of what the business should sustain. So in that sense, yes.

Jesse Norman: After all, the situation with Britannia was hardly hidden in 2008-09 and the wider circumstances with institutions getting into difficulty all around the marketplace was hardly hidden.

Andrew Bailey: Yes. I have to confess to you I can’t remember the date when Len Wardle became chairman of the Co-op Group.

Jesse Norman: No, but the general point about group responsibility must be perfectly clear.

Andrew Bailey: Yes.

Jesse Norman: You must have been amazed, in retrospect, that they consummated that, given what people knew about the Britannia.

Andrew Bailey: I think it is and you have had evidence, particularly from Barry Tootell, that indicates that it was a mistake.

Q1935 Jesse Norman: You have said that in your judgment Peter Marks was the driving force, as well as him having identified himself as that. Students of history will recall that the Co-op made a previous large acquisition, which was Somerfield; a completely

different kind of business, a retail business. That has turned out to be a disaster for the Co-op. Some of the evidence that we have had suggests that Peter Marks thought running a bank was like selling groceries, like running a retail chain, and that all retailing was automatically *sui generis* even though the differences existed. Do you think that contributed to part of the catastrophe of merging with the Britannia?

Andrew Bailey: I think we have to be a bit careful here. I have no evidence about Peter Marks' involvement in the Britannia transaction. By the way, it is all before my time as supervisor so I can only tell you from what I have read in the files on that point. I don't have any evidence to point to Peter Marks in the context of the Britannia transaction.

Jesse Norman: Thank you for that. It is the wider point about the association of banking and retail that I wanted to get to.

Q1936 Stewart Hosie: Mr Bailey, could you describe your view on how the Co-op's capital position developed over the period between 2011 and 2013? How did you see that deterioration and how did you see the capital position move?

Andrew Bailey: I would say that in the summer of 2011, when we quite clearly put the board on notice on the capital position, the evidence for that was two things. One was that we were pointing out to them that they were relatively less well-capitalised than the other major UK banks. I have to be clear that Neville Richardson's response was, "That is because the others have all raised capital. We used to be at the top of the heap and now we have gone down to the bottom." We said, "Yes, but you know that, with the introduction of Basel III, you have the period of time; you are going to have to add capital", and I think at that time we put that number at a bit under £1 billion. That is the first thing.

Q1937 Stewart Hosie: I will come back to the regulatory changes in just a moment. When did the regulator's view change from the general concern that the Co-op might have to strengthen its capital position, which you have described, to a very serious concern that they had a significant capital shortfall?

Andrew Bailey: Let me quickly accelerate through the story. The second thing we said to them was that, "If you want to do the Verde transaction, you are going to have to be in a position to support the capital that will be needed for it". The Verde transaction was then reconstructed because the bigger version of the Verde transaction fell apart and Co-op pulled out as the exclusive bidder in March-April 2012. The Verde transaction was then reconstructed in a smaller form, which was more beneficial to the Co-op in terms of capital. The Verde transaction, for which I think I am right in saying the heads of terms were signed in late June or early July 2012, was a more favourable transaction. As I think I said last time I was here, we then did the stress test of the Co-op. Bear in mind, as I was saying earlier, alongside that stress test we were also doing quality review work. It was at that point that the scale of the capital issue within the Co-op, separate to the Verde issue, became much clearer.

Q1938 Stewart Hosie: The cause of the change, in the regulator's mind, from having a problem to having a serious problem was at the period when you undertook the stress test and thought, "Goodness, something isn't right". Co-op say, and you alluded to this in the last answer, that it was the change to the regulation, the additional burden of holding more capital in relation to Basel III. Is the truth somewhere in between or is the Basel III capital requirement just an excuse?

Andrew Bailey: No, it is not a Basel III point. It goes back to what I was saying earlier and it goes back particularly to this question about the interpretation of the letter we sent out to all the banks on provisioning. We reached the view that Co-op were taking a much—I will

use this word carefully—looser approach towards that than others, and indeed looser than the standards we felt they should have taken. That is one of the key moments.

Q1939 Stewart Hosie: That is helpful. In July 2011 you warned the Co-op that it might need to raise an additional £900 million of capital. That figure rose to £2 billion in the event of a successful Verde acquisition. First, how do those figures relate to the £1.5 billion capital shortfall ultimately announced in 2013? Secondly, why did the hole in the Co-op's balance sheet, the level of distressed assets, come to light much later than the other banks or other financial institutions?

Andrew Bailey: Let me say that the £900 million and the £1.5 billion are different. The £1.5 billion is added to it in that sense.

Stewart Hosie: Sorry, the £1.5 billion was added?

Andrew Bailey: Yes, because the £900 million is the Basel III requirement. The £1.5 billion is recognising the issues within the Co-op balance sheet, which, by the way, the IT issue becomes part, as you understand. Why did it come out later? There are two things I would say there. First of all, it does reveal a different approach by Co-op management to the treatment of provisions and impairments than had been the case in other institutions. Secondly—and I will be quite honest with you, we have to hold our hand up on this, and I have said this to other people—if we had had the system and engineering that we are currently designing to implement concurrent annual stress testing across the major UK banks earlier we would have arrived at the £1.5 billion earlier, but we didn't have that.

We intend to come out of this approach this year. The FSA had built, following 2008, the ability to do sequential stress testing of the major banks so that, essentially, every major UK bank could be stress tested about every two or two and a half years, because they did not have the technology and the capacity to do it. Had that capacity existed, I think the £1.5 billion would undoubtedly have come out sooner.

Stewart Hosie: I hope at some point in the next few years we will be asking you why it has been such a great success.

Andrew Bailey: We will see, but it is a big point for us.

Q1940 Stewart Hosie: One final question. You said that the second iteration of Verde was much more favourable for the Co-op. Did you take the view at that point that Verde was a means of filling the Co-op's capital gap?

Andrew Bailey: I think Verde had the potential to do three things. It would have helped with the capital gap because Lloyds, under the reconstructed Verde for instance, were going to underwrite the IT cost, bearing in mind that it is now just under £300 million. Lloyds had also entered into a commitment to ensure that Verde met the capital requirements on day one, but I don't think you should interpret that as Lloyds saying they will fill any hole the Co-op find in the transaction that is important. The second thing is that Verde reconstructed meant that in essence Lloyds were providing a management team for Co-op, so the core of the team that is going to be managing TSB today under the IPO in essence would have become the Co-op's team.

Stewart Hosie: Does that imply that the regulators were much happier with a Lloyds' management team than what was being proposed previously by Co-op?

Andrew Bailey: This is what you might call a version of planning blight. The problem that Co-op faced was that they were increasingly relying on a management team that was interim. The third thing was IT. The reconstructed Verde transaction meant that the Co-op Verde bank would have run on Lloyds IT systems not Co-op IT systems.

Stewart Hosie: It would have been more akin to TSB—

Andrew Bailey: It would, yes.

Q1941 Andrea Leadsom: Good morning. I would like to ask you a few more questions about the capital, some fairly specific ones. When Barry Tootell was before this Committee he said that you did not raise capital as an area of concern with the Co-op Bank in December 2011 but as an area that Co-op Bank would have to specifically address in order to proceed with the transaction. Is that a fair characterisation?

Andrew Bailey: I wrote to Co-op in June 2011 and December 2011. They are pretty similar letters and, on both occasions, capital was raised as one of the five issues that they would have to address to convince us on Verde. I don't think there is any question around that. But I think it goes back to the line of questioning we have just had, which is that the very specific impairment issues, and of course the IT issue that only emerged later, were yet to emerge at that point. The answer is that we put the capital issue on the table because we saw that they were going to have to work hard to meet the Verde capital needs. The specific work that followed made that task more difficult.

Q1942 Andrea Leadsom: Mr Tootell said that the capital shortfall only emerged in 2013. As you will realise, what I am trying to get to is, was he being deliberately obtuse about the capital issue prior to that? He claims, therefore, that he should not have been able to reasonably foresee the capital problem ahead of 2013. Do you think that that is right?

Andrew Bailey: Let me say two things on that. In fact, our records indicate that the first time he was informed that the stress test was going to lead to a quite markedly larger capital requirement was in November 2012. To be fair, we had not put the exact number on it but he was put on notice at that point. The second thing—and I think he said this to you in his hearing—is that he, certainly when this capital requirement came out, was realising the misjudgments they had made on the Britannia assets.

Andrea Leadsom: When was that? About when was he realising?

Andrew Bailey: I don't think he put a specific date on it, but I would guess it was during the period December, January, February, going over 2012-13.

Andrea Leadsom: To be very specific, is it reasonable for the board of Co-op to suggest that they had no real awareness of the extent of the capital problem before 2012? Is it reasonable for them to say that or not?

Andrew Bailey: The difficulty with this is that a number of them are now saying, "Now we look at it, we realise there was a problem".

Q1943 Andrea Leadsom: The issue here is that an awful lot of entirely innocent investors have lost an awful lot of money and we still seem to go round the houses as to who should have known, who did what and who in fact did do what. It is enormously frustrating for this Committee to constantly find that nobody was responsible and everybody did what they should have done and made the right decision at the time, but clearly it has all had catastrophic results. I will just ask you again: is it reasonable for the members of the Co-op board who have appeared before this Committee to suggest that their account of the regulator's concerns about capital over the period between 2011 and 2013 is accurate? Are you comfortable with their testimony?

Andrew Bailey: The problem with that is that if you strip that comment down they are essentially outsourcing risk management to the regulators.

Andrea Leadsom: Exactly. Is that reasonable?

Andrew Bailey: What they are saying is, "You can't really expect us to have spotted the problem until you come along and tell us there is a problem". I reject that as a proposition.

Q1944 Andrea Leadsom: Yes. In many ways now, with the responsibility that you have under the new environment, arguably a failing bank in the future could put that point even more strongly, couldn't they? As you have just said, now you do have the ability to carry out more accurate stress testing within a shorter period of time. Arguably, are we creating a problem for the future where a future failing bank will say, "Andrew Bailey didn't tell me my capital risk"?

Andrew Bailey: It is a very good point. Out of what you might call bitter experience, we are certainly having to create a regime where we are much more activist on asset quality reviews and stress testing. If you sit in my chair, you would think, "Well, you would be mad not to do that because otherwise you are a bit defenceless". I think you raise a very good point. Are you then setting up a system that is almost outsourcing the identification problem, because the regulator is going to come along once a year and work you over and tell you what the results are? Of course, this is a problem that exists in other countries. The US has this issue with its stress testing regime, which is a black box regime, as well.

Q1945 Andrea Leadsom: What are you doing about that? If you are aware of that risk then it is for you to be able to write to boards and say, "Guys, it is absolutely on your shoulders. Don't wait for us to come and tell you what the problems are". Are you doing any of that?

Andrew Bailey: The answer to that is we have to be much more engaged with boards. We don't have to be distant in that sense. I think you are absolutely right that we have to go to boards and say, "Look, this is what we see" and, in the nicest sense of the word, "why aren't you on to this?"

Andrea Leadsom: Yes, exactly. Notwithstanding that you are the backstop, you have to make sure that it is very clear to them that they are where the buck stops and that they have to be on to it.

Andrew Bailey: Yes, absolutely. We can't have a world where it is outsourced to us.

Q1946 Andrea Leadsom: By the same token, therefore, the other completely horrendous thing about this whole Co-op debacle is the clear and apparent lack of expertise of those who should have been looking after the interests of investors and clearly were not, because they had no expertise in the banking sector. Again, while your regime of approving directors may have improved dramatically, are there some kind of red lines where you would say, "If you have no banking experience there is absolutely no way you could ever in future be the chairman of a bank"?

Andrew Bailey: Yes. We would not approve somebody today. First of all, even in advance of the senior managers regime being introduced, of which I am a very strong supporter, we have changed the approach towards approval of senior persons. We would not have somebody in the role of chairman of a large bank who had no financial services experience. Moreover, the process for all senior appointments at major institutions, chairmen and chief executives being a typical case in point, involves a much more senior level of interaction from us. To be clear, I do the interviewing with a very senior adviser, typically, and that is a very big contrast to the arrangements that were in place when the Reverend Flowers was approved.

Q1947 Andrea Leadsom: Again then, is the balance right? Are you now being responsible for the next chairman who appears to be allegedly taking bribes and so on, or is the board of the bank that is responsible ultimately for the behaviour and capability of that chairman? Where does that balance sit?

Andrew Bailey: The first line has to be the board but, again you raise a very big question and important issue for us as we go forwards. I am acutely aware that there is a real danger that we become effectively the people who appoint and select chairmen—

Andrea Leadsom: Who are running the banks, yes.

Andrew Bailey: —who run banks. Sometimes institutions approach me and say, “We have two candidates for this position. Can we send them along to see you?” I say, “I am sorry, I am not going to choose between the last two. That is not what we do.” We have to watch this. The other thing we have to watch, because it is not only a very high profile area but it is an area of intense personal interest—we do not reject people, because they withdraw. You may know, because this has appeared in newspapers, when people do withdraw and sometimes these names get out—often they don’t but sometimes they do—we have come under quite heavy criticism. There was one particular case about a year ago: what right is it of ours to exercise that function when the person has failed to clear our bar of what we think the competence to do the job is. I am very acutely aware that in the public eye this is a controversial area and one where we walk a fine line between rejecting and accepting people. You are right, it is not an easy area.

Q1948 Andrea Leadsom: On that point, it has been put to me by people in the industry that in fact you are inadvertently discouraging people from applying for jobs, particularly senior risk jobs in banking, because of the implications for their entire career, family, reputation and so on if they are found to be wanting. I would appreciate your comments on that.

Andrew Bailey: I think it is true of more than just senior risk jobs. It is true of being on boards of banks, frankly. We do have to watch that we do not create a regime where these jobs are so unwelcome that no right-minded person would do them. I would say that there are still people, certainly in executive jobs, whose technical skills and expectations and ambitions are lacking. It is true; it can sometimes be quite hard to recruit for these jobs. I am also concerned about the pool of people who are willing to be non-executive directors. It is a much more demanding role nowadays than it was before the crisis, and rightly so. As some of them rightly say to me, there is not a lot of upside in that role.

Chair: But they are still coming forward?

Andrew Bailey: They are, but I think if you talk to most of the chairmen and senior independent directors they would say it is harder than it used to be.

Q1949 Chair: You touched on one point a moment ago where you said you need to be much more engaged with banks and that you are attending board meetings to do the interviews. Do you attend the annual report of the regulator to the major banks?

Andrew Bailey: I do. The boards, yes.

Chair: I was surprised when I asked Martin Wheatley whether he attended and he said no. Do you think it would be helpful if the two regulators worked together more to ensure that you are both reporting at the highest level?

Andrew Bailey: I saw your exchange with Martin. As he said, he chooses to do it a different way. We have adopted a particular approach; I have adopted a particular approach. I think it works quite well for us. I don’t want to criticise Martin. I think that is unfair. We have a different approach.

Q1950 Mr Love: Could I go back to the issue of the two letters that you sent to the Co-op Bank and Barry Tootell’s interpretation of them? We also heard evidence from other members of the board who similarly misinterpreted the message that was coming through from them. Do you accept that there was ambiguity there and would you accept that perhaps

the letters needed to be a bit more robust according to the lights now that are put on these responsibilities?

Andrew Bailey: No, I am afraid I don't. I think the letters were direct. I think you now have a document, among the ones we sent you, that records a meeting with Neville Richardson after the July board. Funnily enough, I was at the meeting with Neville, but it was a discussion that happened after I left the meeting where Neville essentially said to the supervisor, "I wish you had told me that Andrew was going to be so direct and so blunt with them because I would have warned the board". So, no, I am afraid I don't accept that proposition.

Q1951 John Mann: When did you first hear of the Co-op's intention to bid for Verde?

Andrew Bailey: I first heard about it when I came into the role in supervision. I came into that role at the end of March 2011. To be honest with you, I can't remember the exact date but it was some time between then and the middle of May, because I first met the Co-op in the middle of May.

Q1952 John Mann: Neville Richardson says that you never raised the issue of Britannia with the Co-op.

Andrew Bailey: Bear in mind that Neville stepped down not that long afterwards. I think there was only one meeting with Neville, because he stepped down in July.

John Mann: Yes, but you addressed the Co-op Bank's strategy away day.

Andrew Bailey: Yes, I did.

John Mann: Did you raise Britannia then?

Andrew Bailey: I didn't raise Britannia on that occasion but we did raise the capital issue.

John Mann: Why didn't you raise Britannia then?

Andrew Bailey: I think for the reason that I gave earlier, which was that the full extent of our assessment of the problems in the Britannia loan book has come out subsequently.

John Mann: Are you saying that the regulator did not know that there was a problem with the Britannia three years after the Britannia had merged with the Co-op?

Andrew Bailey: No. I think you have a record of a meeting—and if not I will repeat it now—that I held with Peter Marks, Paul Flowers and Barry Tootell at the end of July 2011 when I said that, in my estimation, Britannia would have failed and there was a problem. The point is that Neville had stepped down. Neville stepped down very quickly. I don't think these things are related, by the way, but the point is that Neville was off the scene at that point.

Q1953 John Mann: What I am asking you about is that it seems rather surprising that the issue of the impaired Britannia assets was raised so weakly by the regulator, and yourself specifically, during this whole period when the Co-op was considering bidding for Verde.

Andrew Bailey: We had raised the issue of the capital need but, as I have said before, at that time we did not have the extent of the evidence that we subsequently had. Just to go back, I said earlier that I hold my hand up on this point. If we had had the technology that we are building today—and will have in place, I expect, later this year—at that point, we would have had a much better body of evidence, but we did not.

John Mann: The reason we do not have proper regulation then is because we did not have the technology. Is that is what you are saying to us.

Andrew Bailey: We have been on a path to deliver better regulation, as you know, and a big part of that has been to improve the capacity and the technology to conduct things like stress tests. I do not hold back from that at all.

Q1954 John Mann: Whatever technology is used, you have a building society in huge problems with a dodgy loan book that merges with another institution and takes it over and that itself has problems. You are informed they are going to bid for another part of an institution and you sit on your hands for the following 18 months. That is what happened, isn't it?

Andrew Bailey: No. I am sorry, I do not accept that. Let me say why. First of all, the letters made clear what the issues were. Secondly, we set about making and requiring the firm to make changes in respect of the issues we raised on that. Let me give you two examples. First, immediately after the July board meeting, we raised explicitly with the Co-op the fact that we did not believe that their risk function and their chief risk officer was up to the job. I raised that with Paul Flowers, and Paul Flowers said to me, "I understand the point you are making. He will be replaced", and he was. They overhauled their risk. Between mid-2011 and the end of 2011, they did that.

Secondly, we said that we were not happy with the constitution of the board. I think some of the changes were already in train, but between then and sometime during 2012—I cannot remember exactly when—there was an overhaul of the board. It shrank the number of members of the board, it replaced the so-called democratic Co-op members to a greater extent. It also replaced the former Britannia directors and it brought on people who had banking expertise. I am sorry, I do not accept the point that we were doing nothing. Moreover, there was capital put into the business by the Co-op Group and there were plans, as you know from previous hearings, I think, to effect the sale of the insurance companies, which would put further capital into the group. I am sorry, I do not accept that proposition.

John Mann: The Co-op Bank's debt has been downgraded to junk status.

Andrew Bailey: Yes.

Q1955 John Mann: Did you put any hierarchy in those five issues that you raised with them and what criticality did you stress of any one of those five issues?

Andrew Bailey: I wanted them all dealt with. They were all critical issues. It goes exactly back to the conversation we were having a few minutes ago. It is no good having capital if you do not have proper governance and it is no good having capital if you do not have proper risk management. You have to deal with those issues.

John Mann: What you are saying to us now is there were five critical fault lines, five, and you allowed their bid for Verde to carry on regardless.

Andrew Bailey: Let me take that in two parts. First of all, we did not sit on our hands. As I have just said to you, we set about requiring the firm to take actions. Secondly, let us look at the question of Verde. It was not obvious at that point that undertaking the Verde transaction would have been bad for the Co-op—not obvious. What would have been bad for the Co-op is had they undertaken that transaction and not dealt with the issues that we had highlighted. Moreover, as you will be aware, the Independent Commission on Banking had highlighted that a challenger bank would be more successful if it had a larger share of the personal current account market, and Co-op-Verde took it into that position. The answer to that question is by no means obvious, I would suggest.

Q1956 John Mann: What assessment method did you use for judging the Co-op's ability to overcome the five critical hurdles that you identified?

Andrew Bailey: We undertook a risk assessment of each of them individually, because they each require different methods. They are quite different issues in that sense.

John Mann: Can we get copies of those risk assessments?

Andrew Bailey: They are now subject to the enforcement investigation and I am pre-constrained by the legal advice that I had on what documents we can share while that process is going on, but after that process is done, of course you can, yes. I have no desire to withhold information from you.

Q1957 John Mann: Why didn't you intervene and make clear that this bid was doomed to failure?

Andrew Bailey: Because it was not necessarily doomed to failure. In my judgment, that is the wrong assumption to make. Had they raised the capital and had they continued, as they were starting to do, to deal with the other issues, then it is not obvious that it was doomed to failure. I do not think that is a true proposition whatsoever, I am afraid.

Q1958 John Mann: Did anyone lean on you at any stage in relation to this?

Andrew Bailey: No.

John Mann: Nobody leaned on you?

Andrew Bailey: No.

John Mann: Did anyone lean on anybody?

Andrew Bailey: Sorry, did I lean on people?

John Mann: Did anyone lean on anyone in the process that you are aware of?

Andrew Bailey: If you are going to the question of political involvement, if that is the point that underlies this question—and this is a comment on the course of the first half of 2012—I come back to my point about the Independent Commission. The Independent Commission on Banking, chaired by Sir John Vickers, had come up with specific recommendations on Verde in the context of competition and challenger banks. The Government had accepted those recommendations. Therefore, I do not think it is unreasonable for the Government to say, “We do have a public interest in this transaction”, but nobody leant on me. I can tell you that.

Q1959 John Mann: Others may come back to that, but this is my final question. I put to you regulation in this country is not fit for purpose if you can now tell us that this bid for Verde all the way through was perfectly valid, acceptable and doable, and still maintain that now. How can we have trust in regulation in this country and the new regime when you are maintaining that it was viable?

Andrew Bailey: No, I am sorry, you have misinterpreted what I was saying. What I was saying was that we set out conditions. Those conditions had to be met. By the way, that was a very big change from the system of regulation that pertained when the RBS-ABN transaction went through. We set out the conditions. We set out quite clearly that we would have to approve that transaction, which we would, and we have the powers to block it, which we do, but in my view it was reasonable to say, “If you can meet these conditions, then there is a case for the transaction going ahead”. I do not think that is at all unreasonable. We have to be very conscious of how we use our powers as regulators. If we just pile in early on and say, “We don't like that”, we will be having different discussions in this room.

John Mann: So we are back to light-touch regulation.

Andrew Bailey: No, we are not back to light-touch regulation. I am afraid that is quite wrong, in my estimation. If you compare the intervention that we made on Verde and the conditions we set with what did not happen on RBS-ABN, you will see a difference.

Q1960 Chair: Just a couple of points I want to pick up from those exchanges with John Mann. The first is, why was the full extent, or at least a roughly accurate estimate, of the impairments on Britannia's balance sheet not picked up much earlier? Why does it surface so much later than the impairments on other bank balance sheets?

Andrew Bailey: Two things. First of all, perhaps the management of Co-op were not scrutinising their balance sheet and their asset quality in the way that we would assess others were, by virtue of the fact that, when we intervened, others did not have to make the same sort of adjustment. Secondly, as I have said a couple of times, we have developed a much more rigorous approach and we are still developing it—back to my point about stress testing in terms of asset quality review work—and that is what we have done.

Chair: That is the second point that John listed.

Andrew Bailey: Yes. That is what we have done since the middle of 2011 and, although you may say, "Here we are in early 2014", it has been a very substantial investment on our part.

Chair: The basic answer is, "The Co-op management were not up to it and we did not have the technical capacity to do the stress testing".

Andrew Bailey: At that time.

Chair: So we have been quite exposed a long time on the regulatory front?

Andrew Bailey: Oh, it is legacy, I am afraid. When we—

Q1961 Chair: You are saying we are still not yet in a position where we can have sufficient confidence in these sequential stress tests because you do not have yet the technology in place. Isn't that what you have just told us?

Andrew Bailey: Two things. We are in a much better place on asset quality review work and that is already showing. I fully expect that we will have the first set of sequential stress tests done by the end of this year. In fact, the process has begun. The banks are now engaged on it.

Chair: I will not open it up now, but a very big issue is whether the continental European banks are anywhere near—

Andrew Bailey: That is a very different issue.

Chair: That we might raise on another occasion.

Q1962 Mark Garnier: Can I turn specifically to corporate governance, possibly drawing in some of the conversations we have had with other members and trying to summarise it, in fact? First of all, David Davies and Rodney Baker-Bates made some comments when they came in that, while there was there was some financial services expertise on the board, it was pretty thinly spread. Did you agree with that with regard to the bank board?

Andrew Bailey: Yes.

Mark Garnier: Do you see that as a problem?

Andrew Bailey: Going back to the point I made to Mr Mann, one of the things that we insisted on after the summer of 2011 was the restructuring of the board to achieve that end. There was not adequate experience on the board.

Q1963 Mark Garnier: Prior to that you felt there was a problem. Again, I appreciate that some of these questions refer back to a time before you were the regulator, but I am very interested in your opinion on this. We have heard, I think in answer to Mr Norman's questions, that you rated that Mr Peter Marks was kind of the dominant member of the board. In comparison, how did you rate Barry Tootell's performance?

Andrew Bailey: I do not think Barry Tootell was at all dominant. He was, of course, appointed as interim CEO when Neville Richardson left for the reason that the outcome of the future of the chief executive of Co-op would depend on Verde. I think Barry was perfectly competent, but I do not think he was in any sense a strong chief executive. No, I do not.

Mark Garnier: Although he had financial services experience and he was an accountant—

Andrew Bailey: He had a lot, yes.

Mark Garnier: Yes. He knew what he was talking about and Peter Marks was a retailer. The dominant factor was the bloke who liked to open shops, if you like.

Andrew Bailey: Yes, but let me be clear that we were very clear and they were very clear—and this is a point that Paul Flowers was very clear on—that the Co-op Bank board had to take the decision to recommend the Verde transaction to the group. Peter Marks could not take that decision on his own.

Mark Garnier: No, but he could influence it.

Andrew Bailey: He could seek to influence it but, of course, in the end the bank board did not agree with him.

Q1964 Mark Garnier: How do you rate Paul Flowers?

Andrew Bailey: I will give you my personal view on Paul Flowers. I think I met him probably six or seven times. I thought he was pompous, to be honest. I thought that he, as we know, had no financial background, but let me give the other side of the coin: I have been through the records and I have looked at the comments made by all the members of the board that we interviewed, both old and new, and none of them criticised Paul Flowers, interestingly. They generally say that he was an effective chairman. To be frank with you, I was as surprised as you were when he made the errors in the hearing with the Committee, because it was not my experience with Paul Flowers. My experience with Paul Flowers was that he seemed, to use a phrase, well-briefed. On the whole, he did not display ignorance.

To go back to my exchange with Mr Mann, when I put to him, “The chief risk officer is not up to it”, he said, “Yes, I will deal with that”. The only point he made to me was, “Look, in the Co-op we do these things with dignity. Let me do it with dignity”. I said, “Fine”, and the person was out within a few months. I was as shocked as anybody else when the whole thing came out, but the Paul Flowers scorecard is distinctly mixed, frankly, in that sense, more mixed than you obviously get from the popular camps.

Q1965 Mark Garnier: It is quite interesting, because one of the things that made this Committee slightly speechless was the revelation from Rodney Baker-Bates, I think it was, that, of the four candidates to be the chairman of Co-op Bank, three of them with financial expertise were discounted in favour of Paul Flowers, who did best on the psychometric testing scores. What did you make of that?

Andrew Bailey: It goes back before my time, so I can only offer an observation.

Mark Garnier: No, sure.

Andrew Bailey: It is a sign of the times. I think my reading of it is that the reason Paul Flowers was chosen was to do with what one might call sort of the internal workings of the Co-op, but I think also they wanted a chairman who could manage the relationship with the group and I think Paul Flowers saw that as one of his roles. To be honest with you, he said to me he saw one of his roles as managing the group chief executive.

Q1966 Mark Garnier: I think all of us have probably had lots of people volunteering information from one form or another, but one of the pieces of information that was volunteered to me was that Paul Flowers was given the chairmanship of the bank in order to

stop the confrontation with Len Wardle in terms of being chairman of the group; that Len Wardle was given a second shot, a second three-year period, and Paul Flowers was given the second-best by way of compensation for not being group chairman. Does that sound plausible to you?

Andrew Bailey: Look, others are much more expert on the workings of the Co-op Group than I am. What I could detect was there is a lot of internal politics.

Mark Garnier: So it is not an unreasonable assumption?

Andrew Bailey: It is not an implausible proposition, but I cannot substantiate it because it is before my time.

Mark Garnier: No, I would not expect you to, but from what you know, it does not sound way out?

Andrew Bailey: Yes.

Q1967 Mark Garnier: I know one of my colleagues wants to come forward particularly on governance in general in this type of area, but specifically on the Co-op governance model has this been a perfect example of a failure in a governance model when it comes to a financial services institution?

Andrew Bailey: I think it is an example of a governance model that does not work for a bank because, in its earlier form, it has relied far too much on too heavy a weighting towards what I think is called the democratic members, who are the Co-op Group members. My reading of it is that you had two groups on the board post the Britannia merger. You had the sort of democratic members, who were the Co-op people, and then you had the ex-Britannia people. Some people have said that they were quite distinct in terms of groups. We have also had the observations made by one or two of the current board members who were brought on later of two things. First, the whole discussion in the board of the Britannia assets changed once the ex-Britannia directors left the board. That has been said by a number of people who straddled that period.

Mark Garnier: Is that a suggestion that, while the Britannia members were still there, there was a will to say, “No, no, it could not have possibly have been anything to do with us”, and after that it was—

Andrew Bailey: Yes, it was a defensive thing.

Mark Garnier: So they confronted the problem essentially.

Andrew Bailey: Yes, I think that is right.

Q1968 Mark Garnier: That is very interesting. Just one sort of final question, if I may, following on from Andrea Leadsom’s question, and this is the role of the regulator when it comes to the construction of the board. I was very struck by what you were saying to her in terms of delivering accountability to board members and how you strike that balance. Clearly there is a possibility that you could be accused of being a shadow director as the regulator if you start intervening and throwing your weight around, but how on earth do you find the balance between not being a shadow director and yet exercising sufficient oversight to make sure that we do not see a repeat of this type of cock-up?

Andrew Bailey: It is not easy. I have written to you on the question of shadow director status because it was a point made by the Parliamentary Commission, where you requested it. In many respects, the letter is a legal argument as to why we do not believe that we are in the position of shadow directors, given our status as a public authority. That is fine, but you are right; in the real world we have to walk very carefully because it would be dangerous, but in some contexts quite easy, for us to get ourselves into the position where, whatever the legal position about shadow directorship, we are exercising more control and more influence than

we should be in our position. I think the earlier line of questioning went to that. I am very conscious of this. It is something that we have to watch very carefully.

Q1969 Teresa Pearce: Could I just take you back to something I think you said earlier? You talked about the Britannia and you said you think that Britannia would have failed without the merger. Is that correct?

Andrew Bailey: Yes.

Teresa Pearce: Yet you say that it was reckless for the Co-op to take them on. Is that correct?

Andrew Bailey: I think that it was a mistake, because I do not think the Co-op had the balance sheet strength and the ability to generate earnings to support the Verde—

Teresa Pearce: Yet you seem to intimate, even with hindsight, that it was the least worst option.

Andrew Bailey: Yes. That may sound a contradictory thing to say, I agree with you. You have to put yourself back in the position in late 2008, which was a very bad time from the point of view of—

Teresa Pearce: The Co-op took the risk that would have fallen elsewhere?

Andrew Bailey: Yes. If you follow that line of argument through, then yes, of course it would.

Teresa Pearce: Yes. It was the least worst option as far as the rest of the industry is concerned?

Andrew Bailey: It is a very hard thing to say because obviously the bondholders were saying, “That is outrageous”, and I would have some sympathy with them (several inaudible words 06:42 file 9 - 11:36:49 PTV) provided a very good service in this whole exercise in terms of making clear the views of bondholders. How can you reach that decision? Of course, if you put yourself back into the problem, if you put yourself back into 2008 and knew everything that would happen subsequently, you would find it very difficult to make the judgment that was made then, but we did not know, of course.

Q1970 Teresa Pearce: When you talked about the Britannia, you said that they had moved themselves into the fringes of a mortgage market with self-certification and you also said they did not have the risk management in place and they did not have the skills to manage, particularly in that febrile environment; yet from 2005, the FSA were meant to regulate the mortgage market. Do you think they failed in the case of the Britannia?

Andrew Bailey: I think you have to say that it must follow from that and, of course, Britannia is not the only institution. There are things that went on in that period in terms of financial institutions and the regulation and, yes, there were big shortcomings.

Q1971 Teresa Pearce: Do you think that the resulting problems with the Co-op are caused by it being a mutual or by it being just the Co-op itself? Do you think that it is exceptional circumstances in one bank?

Andrew Bailey: I think you have to pick that apart a bit. As we were just discussing a few minutes ago, there were particular issues around the governance of the Co-op that you do not see in building societies. The governance issues you see in building societies tend to be a bit different. There is the question of the appointment of board members and the relationship between the group and the bank: that is not a feature. I think that is particular to the Co-op. Yes, you are right; there are more generic issues around the position of mutuals and the generic issues, in many ways, are all to do with the constraints on raising what we call core tier 1 capital, because they cannot go out and raise equity in the way that a bank can. Nationwide has now done an issue of a new core tier 1 instrument, which is encouraging, but

they are restricted. This comes back to the risks that Britannia and a few others were taking. This restriction on the ability to raise core tier 1 capital inevitably must have an effect on what risks they take and the way in which they manage risk. Those two things must be related.

Teresa Pearce: Are you saying that what happened in the Co-op was unique to the Co-op and is not the same issue with mutual? Mutuals have a problem with raising capital, as you say, but the governance issues are particular to the Co-op?

Andrew Bailey: I think the governance issues were particular to the Co-op, yes. I do not see those sorts of issues in building societies.

Teresa Pearce: Would you say that the issues with Britannia were not an issue of a mutual acting like a mutual; it was a mutual acting like a bank that caused its issues?

Andrew Bailey: The traditional building society is a prime mortgage lending model. Obviously that was their rationale for existing. The pressure that was being put on to that caused a number of them to diversify the risks they were taking, but in ways that they found very difficult to manage.

Q1972 Teresa Pearce: You have mentioned the problems for mutuals. What are the problems for the regulator in regulating mutuals? Clearly you have to regulate the whole industry. Do you have to have different ways of dealing with them or different risk management? Do you have to have different expertise? Is it a challenge for the regulator?

Andrew Bailey: It can be a different challenge. We have a team of supervisors on the building society side who are specialist building society regulators. They do not, on the whole, do commercial banks in the broader sense. What that means is that they do understand many of the particular challenges. We also have what we call a building society source book, which is a somewhat bespoke approach towards supervising building societies. In that sense, yes.

Teresa Pearce: Have you made changes to that in the last—

Andrew Bailey: It is new. It did not exist if you go back to the period that we are talking about—

Teresa Pearce: Right.

Andrew Bailey: Yes, absolutely.

Teresa Pearce: Since when has that existed?

Andrew Bailey: The source book is entirely new. It was brought in after all these experiences.

Chair: It is public?

Andrew Bailey: I am pretty sure. You have me there. I will confirm that one. All our books are—

Chair: If we could have it, we would like to look at it.

Andrew Bailey: Yes, of course.

Q1973 Teresa Pearce: Can I just ask one final question? Clearly you regulate the banks and then you have the Co-op, which is different, and then you have mutuals that are different. You also regulate 600 credit unions.

Andrew Bailey: We do.

Teresa Pearce: Is that a risk and how do you do that? Some of the poorest members of society have small amounts of money.

Andrew Bailey: Yes. They too are very different as well.

Teresa Pearce: Do you have a source book for them?

Andrew Bailey: I am not sure if we call it a source book, but we have a particular credit union supervisory approach. You are absolutely right, and it is set down. They are

different in that sense, yes. Of course, the thing about credit unions is that they are quite restricted by their own articles and by law as to what they can do.

Teresa Pearce: But they are also, in the general, run by people who are not experts.

Andrew Bailey: Absolutely they are, and they do, by the way, fail. I am trying to think off the top of my head, it not unusual for probably for eight or 10 credit unions to fail every year.

Teresa Pearce: Could you get that number down, possibly?

Andrew Bailey: You might do—

Teresa Pearce: Did you try?

Andrew Bailey: —but you might find you have fewer credit unions as a result, because there is a sort of trade-off between—

Teresa Pearce: But when people in credit unions lose their money it is a disaster.

Andrew Bailey: No, but they do not because the restriction on the business model means that they cannot take deposits in excess of the FSCS limits.

Teresa Pearce: Right.

Andrew Bailey: That is one of the protections.

Q1974 Chair: In summary, the Co-op governance model was a disaster for trying to run a bank, and the mutual model can be made to work but only with quite a radical re-engineering of the way you regulate it. Is that a summary of what you have said?

Andrew Bailey: We have had to do quite a lot of work on building society and mutual regulation and, of course, over this period you have seen a continued shrinkage in the number of building societies, because we have been talking about some of the bigger ones. I can send it to you, if you like. I cannot remember how many building societies there were in 2007 but it is quite markedly lower, because we have lost a number of small ones. Usually they go through arranged mergers, big and small.

Q1975 Mark Garnier: Carrying on from where I was talking about the appointment of Paul Flowers, Clive Adamson gave us some evidence about how he interviewed Paul Flowers, an hour and a half of general chit-chat. Given what we know about Paul Flowers, given what has happened, given all the kind of revelations, does Clive Adamson still have your confidence?

Andrew Bailey: Clive is a close colleague. I think Clive would say to you that, like a lot of people—and I put myself in the same category—he has learnt a lot during the crisis. He has had a lot of experiences, some of them very difficult. I regard Clive as a very wise counsel on these issues. He is an effective supervisor and I think he would say to you he has learnt a lot.

Mr McFadden: A simpler answer to Mr Garnier would have been “yes”, but you did not use the word “yes”.

Andrew Bailey: That is because I wanted to say a bit about Clive, but if you want me to say yes, I will say yes.

Q1976 Mr McFadden: I want to change tack a little bit.

Andrew Bailey: Sure.

Mr McFadden: Most of the questions for the last hour and a half have understandably been about the Co-op and their strengths and weaknesses in relation to the Verde bid. I would like to ask you about their rivals, NBNK. What discussions did you have with NBNK about their bid and do you think they were viable alternatives to the Co-op?

Andrew Bailey: We had quite a continuous discussion with NBNK and it came and went because NBNK were in the bidding in late 2011, early 2012. Of course, then the Co-op

was settled on and then the Co-op withdrew and NBNK came back in. During both periods we were involved with them. I think Lord Levene said to you when he came here that he was satisfied with its engagement with us.

“Were they viable?” is an interesting question. First of all, going back to my point about the Independent Commission on Banking, of course, the NBNK proposition did not meet the test of challenger bank that the Vickers Commission had set up. I think Peter Levene would say to you, “Oh, but we would have done. Give us time and we would have got there”, and it is true that that is a matter of judgment. I think the issue with NBNK—and this goes back to what seems like a very long time ago, when you had António Horta-Osório and Win Bischoff here—is that we said to NBNK clearly, “Look, if you emerge as the preferred bidder”—I did not say in these words, obviously—“you will get a letter. You will not get the same letter as the Co-op, but you will get a letter because there is a lot that we do not know about you, obviously. You do not have the capital at this time”. I do not think they could have sustained the Verde mark 1 proposition that the Government had agreed with the European Commission under the state aid rules any better than Co-op could, which is why it had to be restructured.

I should say Verde mark 1 always struck me as a bizarre arrangement, because it involved selling of a £16.5 billion funding gap. I remember saying to Eric Daniels in 2009, “I do not know who you think will be out there that could buy a £16.5 billion funding gap”. It had to be restructured. I think the big questions were obviously around, “Is the capital going to be there? Is the funding there? How are you going to run the bank?” We went some of the way down that track with NBNK, but I would not want to over-exaggerate that. We did not get that far with them, because obviously they dropped off the scene.

Q1977 Mr McFadden: The engagement with NBNK was not as detailed and direct because they were not in pole position for most of this time. They never received a list of five things that they had to satisfy in the way that the Co-op did?

Andrew Bailey: No. I can tell you the major point of engagement with NBNK. Lloyds today enjoys, under the Basel regime, what they call advance models treatment for its capital adequacy and risk asset ratio. Broadly speaking, there are two regimes. There is the so-called standardised regime, which tends to have high-risk assets, and then there is the models regime, which tends to generate lower risk assets and therefore a lower capital requirement. It depends how you measure risk. NBNK were very concerned as to how they, as a de novo institution, would get that models treatment and we worked with them quite a bit to explain to them what they would have to do to prove to us that they could manage that. That was the major point of engagement they wanted to have with us.

Q1978 Mr McFadden: Lloyds said in their evidence to us, and I am quoting, “NBNK had no platform or infrastructure. NBNK’s bid was supported by letters of intent from investors, but there were explicitly not guaranteed commitments of finance and, although the board contained members well-known in the City, their bid was dependent on raising the full purchase price in the public market at a time when the public equity markets were effectively closed”. Would you have shared some of those worries?

Andrew Bailey: That is all correct. I think Peter Levene would say to you that he would have dealt with all of those issues, but I think they are all correct as observations.

Mr McFadden: Does this explain why, despite your warnings to the Co-op and despite those warnings at some point being passed on to Lloyds, Lloyds continued to want to stick with the Co-op because of their doubts listed there about the NBNK—

Andrew Bailey: You have to ask Lloyds, but I suspect the answer is yes, it does.

Q1979 Mr McFadden: Do you think this series of questions about Co-op governance, the lack of financial experience for Reverend Flowers and so on has been convenient for NBNK; it has meant that their alternative bid has gone relatively unexamined because of the obvious problems that have been exposed in the Co-op?

Andrew Bailey: I think the NBNK bid has always been subject to far less scrutiny, as you say, because they were not in pole position. I think that is broadly true, but that is a comment obviously on the period. I do not know whether the Reverend Flowers is relevant to that because that obviously postdates all of that, but yes, it was subject to a lot less scrutiny in that sense.

Q1980 Mr McFadden: We have also heard that the two deputy chairmen of the Co-op Bank, who did not have faith in the Co-op going forward with the Verde transaction, made quite exceptional efforts to alert Mr Adamson and the regulators; not just normal exit interviews, but specifically. Did any of them come to see you?

Andrew Bailey: This is in the period after I had come on the scene. I did not conduct the two exit interviews, but I have the records.

Mr McFadden: But they went over and above the exit interviews, did they not, to try to impress upon you certain views?

Andrew Bailey: I think Rodney Baker-Bates saw Clive Adamson, yes.

Q1981 Mr McFadden: Yet the transaction trundled on for some months after that. Have you considered whether at that point you, as the regulators, should have done more to step in?

Andrew Bailey: Yes. Can I tell you what was said to us in those two separate meetings, because I think this puts it into some perspective? I will start with Rodney Baker-Bates. There is no question that he voted against the Verde transaction. There is no question that the reasons that he raised were capital management and governance. Indeed, he said they were essentially the same issues that were in our letter. Here we are talking about the restructured Verde—the summer of 2012 version of Verde. He said, “Actually, I welcome this new plan. It is more attractive. It makes Verde more feasible”. What he said to our supervisors was, “I recommend that, as it approaches the signing of the sale and purchase agreement”—and that would have happened in the spring of 2013—“the FSA should exert leverage on the Co-op to force changes in governance and management”. He did not say, “Stop now”. Indeed, he said something quite different, in my view.

Let me move on to David Davies. David Davies, too, no question he voted against the Verde transaction. Bear in mind Rodney was a Britannia board member, David Davies was a Co-op board member by background. David Davies said, “The Co-op Bank is struggling for its identity. Verde is a massive opportunity”, but he had concerns. He had concerns particularly about the sustainability of the business model in the low-interest rate environment and the capital question. He also said that the Co-op’s history of acquisitions and reaping the benefits, particularly Britannia, is not good. But then he said, as our record records—and, as I said, I was not there—“I do not want the FSA to reject the deal, given that it has to happen. Co-op are the best show in town. I hope that I will no longer be on the board at the time of signing”. So you have to take from that a rather different message that they were giving us. I should say for the record he also said he did not see eye-to-eye with Peter Marks; he would be worried if Peter Marks was solely in control of the Co-op Bank, but he felt that the new board structure had enough checks and balances. He also said at the end of the day he thought that Peter Marks would not put the Co-op Group at risk.

Q1982 Mr McFadden: Thank you. Can I just ask you one final thing? Was this reported discussion between Lord Levene and Mervyn King about collective pressure ever reported to you? Do you remember that?

Andrew Bailey: The discussion itself was not, but I had a discussion with Mervyn, prior—as I now know—to him having a discussion with Peter Levene, because I was obviously responsible for supervision at the time. Although I was formally in the FSA reporting line in terms of day-to-day supervision at that point, I was still a director of the Bank of England. We did have a discussion and I did say to him, if we go back to the point about the Independent Commission on Banking and the Government's views, "There obviously is a lot of political interest in this transaction and, obviously bearing in mind what the Commission has said and what the Government's response to it is, the Co-op bid passes the test in terms of the share of the personal current account market that it would have had, which is the 6% threshold, and NBNK does not".

Mr McFadden: That is a slightly different point from saying Ministers specifically—

Andrew Bailey: It is putting a bit of context on it, which I hope is helpful.

Mr McFadden: Okay, thank you.

Chair: That was exceedingly interesting evidence, which you are telling us is supported by written material that I suspect you are going to argue, too, should remain in the hands of the regulators while the enforcement action continues.

Andrew Bailey: I am afraid that is the injunction I am under from the lawyers at the moment.

Chair: No, I understand.

Q1983 Mr Love: Can I refer the Committee to my designation as a Labour and Co-operative Member of Parliament, as normal?

Can I come back again to this issue of Lord Levene and the meeting with Lord King? Were you aware of that meeting and are you aware of the contents of the discussion?

Andrew Bailey: I am aware of the contents of the discussion. I was not aware of it at the time, but I am aware of the contents of the discussion, yes.

Q1984 Mr Love: You have indicated the view that you took, and I suspect that Lord King took at the time, related to the Independent Commission's recommendation. Was that the sole basis on which you agreed that there was political—

Andrew Bailey: That was the point I made. I cannot speak for Lord King on this. I think you are going to ask him some questions in writing. I think he is in New Zealand at the moment. I obviously cannot—

Mr Love: I think we have written to him, but I am not sure we have received any reply as of yet.

Andrew Bailey: No, he is on the other side of the world, I think. I can only relate to you my own sort of interpretation of that and what was said, but I think it is consistent with the record of this conversation with Peter Levene.

Q1985 Mr Love: Peter Levene was very bold in his assertions about political involvement and it would seem that if the discussion merely referred to the Independent Commission report and the need to create challenger banks there were clearly strong banking reasons for supporting the measure, but he chose to focus on the political involvement.

Andrew Bailey: Yes.

Mr Love: Why would he have done that?

Andrew Bailey: Because it is interesting to do, I think if you go back to that time and you look at the reaction to the announcement of the revised Co-op bid and the acceptance of

that bid by Lloyds at that time, you see some pretty strong statements by senior politicians about how welcome this is, in public. They are on the record. I do not think it is unreasonable to conclude, therefore, that there was a view that there was some quite strong endorsement of that approach.

Q1986 Mr Love: Lord Levene indicated the commitment in the document prepared by the Coalition at the time of the 2010—

Andrew Bailey: Yes, the coalition agreement.

Mr Love: —to supporting mutuals and co-operatives. Do you think that that was an important consideration in regard to this merger?

Andrew Bailey: I think it featured in that. Yes, I think it did. I was aware certainly, because I have read the coalition agreement, that one of the clauses—there are a lot of clauses in it—was the encouragement of mutuals and yes, I think it did feature somewhere. Not quite as explicitly probably as the Independent Commission, but, yes.

Q1987 Mr Love: Can I ask you about Paul Flowers? It has to be said we have heard mixed evidence on this. Most people have said there was no political involvement whatsoever. Lord Levene was very robust. Paul Flowers was a little more subtle, if that is the correct word. He indicated that there had been a private conversation between you and him. I am sure you have read the record where you indicated that there was considerable political support. Was that related to the Independent Commission recommendations or—

Andrew Bailey: I did not use those words to him. He is absolutely right in recording the conversation. It was as we were leaving a room after we had had a meeting on the Co-op and his recollection was correct. I do not think I raised the Independent Commission with him at the time, but that is what was in my mind, yes.

Q1988 Mr Love: Can I ask you, looking at it almost the opposite way around, did the fact that you believed there was support through the Independent Commission recommendations at a political level have any influence on the way that you treated the Co-op Verde merger?

Andrew Bailey: It did not cause any change to the conditions that we set out in the letter, to be clear. We would not have compromised on any of that list of issues, but I am acutely aware that in those days we had a “have regards to competition” and these days we have a secondary objective in terms of competition. If you do not mind me saying so, I am aware that we have been criticised for not having taken that particularly as seriously as some people think we should have done. We could debate that, but possibly not now. The fact is we now have the objective. We are content with that, but yes, we were conscious of that and we were conscious that we had to balance our primary objective of safety and soundness with our secondary, in those days, “have regards to” to say, “We should not stand in the way of a challenger bank emerging if it can be done consistent with our primary objective”. I think that is a reasonable interpretation.

Q1989 Mr Love: Did you have any discussions to try to and clarify these matters with the Treasury in relation to the—

Andrew Bailey: Yes.

Mr Love: To what extent did that discussion go? Did you seek clarification as to whether there was support at the Treasury level and get an interpretation from them of the coalition agreement and the Commission report?

Andrew Bailey: Yes.

Mr Love: What did you do to strengthen your opinion as to how the Treasury felt about the merger?

Andrew Bailey: We had many conversations with the Treasury, and I will come on to a particular issue that was the subject of conversations. We did have conversations around those issues. They were clear on the challenger bank point as well, because obviously they were the Department responsible for that. They always made it clear to me though that the judgments on safety and soundness were for us to make and they would not interfere in those judgments and they did not. There was one particular issue, and I think this has been covered a little bit in the outside coverage. It is a bit technical, but I know it has been taken up, and that is on the question whether the Co-op group, under European law, would be a financial holding company and we did have quite intense discussions. They took a somewhat different view from us on some occasions on that. In the end, of course, the issue never came to a head because the bid did not go forward, but we did, and we also had a discussion around ring-fencing, as to whether that was a way to take into account the European law point.

Q1990 Mr Love: Comment has been made by previous witnesses on the role particularly of Mark Hoban. Lord Levene said that he asked Mark Hoban, who denied it, but indications seem to be that there was contact. Whether that stretched into support or lobbying on behalf, we are not absolutely clear. What role did Mark Hoban play in relation to the regulator?

Andrew Bailey: Mark Hoban was the junior Minister at that time responsible for financial services, so it naturally fell into his patch. When I took over from Hector Sants—so this is around about April 2012—I met with Mark Hoban at least once a month, as I do with the junior Minister responsible for financial services. Yes, we did discuss it, but I can assure you that Mark Hoban never put me under any pressure in respect of our primary obligations.

Mr Love: Were you aware of his contact with the parties concerned?

Andrew Bailey: I was aware that he was in contact with Co-op. I have to say that the number of contacts that have been quoted in some of these hearings strikes me as quite large, but I think you would have to ask him whether that is a true recollection. I cannot substantiate that. He will know.

Q1991 Mr Love: Just for the record, I presume you never had a conversation with him as to what the conversations and the contacts were about?

Andrew Bailey: I never asked him explicitly to tell me what he had discussed, but he gave me the sense as to the issues that he was interested in, which are competition and then this particularly technical issue about the financial holding company status under European law.

Mr Love: But you would not have stretched that into whether he had explicit support for a Co-op merger; he was merely interested from the point of view of creating a challenger bank?

Andrew Bailey: That, and I think he did have an interest, as you say, in the fact within the coalition agreement there is a clause on mutuals.

Mr Love: So you can kill two birds with one stone, you get a challenger bank and get promoted to—

Q1992 Andrew Bailey: Yes, I think that is a reasonable point to make, yes.

Q1993 Chair: Can I just go back a moment to the evidence that you have just given with respect to the meeting between Rodney Baker-Bates and Clive Adamson? I have the transcript of what Rodney Baker-Bates said in front of me here. He said, and I am paraphrasing because it is in two adjacent places, that his meeting was about pretty much

explaining the need to get across to the regulator that the deal was “just a slope to disaster”. That does not seem to square with the note of the meeting.

Andrew Bailey: No, it does not, and the problem is it is not the same meeting. This is the issue. We are now talking about two different meetings. There was a meeting with Clive Adamson and then there was an exit interview with Rodney Baker-Bates with our supervision team, which I have the record of.

Chair: Okay. In a nutshell, having read the evidence that we have had from Mr Davies and Mr Baker-Bates, is that evidence consistent with the notes that you have read, which we will see eventually, or not?

Andrew Bailey: I think what did not come out in that hearing was their view that, first, Verde had merit as a transaction for the Co-op if the conditions could be satisfied and, as far as I can see—and they said it—they shared our view on what those conditions were, and as I say, I think the interesting twist to it is that they did not advocate calling it off immediately. You have to remember I was not at that meeting. I am reading from the record.

Chair: No, I am only asking for your opinion.

Andrew Bailey: I have no reason to believe it is an inaccurate record at all.

Q1994 John Thurso: Can I just come back to the points that were being raised by Andy Love about the political pressure? The central thrust of what Lord Levene has been saying to us all along is that there was sufficient political interference that NBNK were denied the opportunity to bid for Verde and Co-op were preferred, and that that was as a result of political pressure. Is there anything at all that you have seen or heard to substantiate that allegation?

Andrew Bailey: No and, honestly, I do not think Peter Levene has direct evidence. I think the comments are somewhat indirect. No is the answer.

Q1995 John Thurso: You would concur that it would be perfectly proper, where a Government has decided that it would like to see a mutual flourish, for it or indeed, any Opposition politician to express that publicly and this would be quite normal and not construed as being pressure?

Andrew Bailey: Yes. As I say, I draw the line when, if you do not mind me saying so, politicians seek to try to influence our statutory objectives, but for people to express preferences without doing that I think is what you do.

John Thurso: Thank you. Yes, that is what I think.

Andrew Bailey: I am not a politician, but it is my interpretation of what you do.

Q1996 John Thurso: Can I go back to the very early evidence that you gave this morning where you talked about the root causes, the first one of which was that, frankly, the Britannia was pretty well holed below the waterline and would almost certainly have found itself—had it not gone ahead—in trouble? I think that is a very quick but accurate summary of what you were saying.

Andrew Bailey: Yes. I will perhaps just expand on that in one respect. In a sense of course you say, “Well, if it was holed below the waterline, it was a slow leak”, but the point is that—and I perhaps should have said this—in the febrile funding conditions of 2008-09, it was precisely these institutions that were perceived to have these weaknesses in their balance sheets that put themselves in a situation where they could not fund themselves.

John Thurso: You then went on to say that, of course, the Co-op itself, the other root cause, was a very small but full service with too high costs.

Andrew Bailey: Yes.

John Thurso: This was two cars looking for a crash, wasn't it?

Andrew Bailey: I suppose the logic would be that if you could have put them together, if you could have had a number of things fallen into line, a very strong management that could have brought costs down, a very strong management that could have delivered new systems and a recovery in the economy such that we would have had a normalisation of interest rates and a normalisation of interest margins, it was a scenario in which it could have worked. The problem is none of those things came to pass.

John Thurso: But it was a sensible strategy, if both sides understood the predicament they were in, to come together to—

Andrew Bailey: If they thought they had the wherewithal to get themselves out of it.

Q1997 John Thurso: You have two groups that have quite serious problems and have come together with a chance of winning through, but with very significant headwinds. If you then add in a substantial takeover, which is the Verde, doesn't common sense tell one that that was doomed to stress the organisation to the point where it could not possibly do it?

Andrew Bailey: In a way, that is exactly why we put the five conditions down, "You are going to have tackle and address these five conditions", to get over exactly the hurdle that you identify.

John Thurso: Therefore, from the moment you put the five conditions down, this was doomed not to go ahead because nobody seriously in the FSA or later the FCA could have thought that those conditions could have been met.

Andrew Bailey: I did not think the probability was very high, frankly, but—

John Thurso: So the putting down of the conditions was the handbrake?

Andrew Bailey: I think that comes back to a discussion we had much earlier in this hearing and it goes back to sort of the role of the regulator. I was not involved, but in the RBS-ABN case the regulator basically took their hands off. At the other end of the spectrum the regulator can live in a sort of—it is sort of pejorative terms—central planet world, where we take views and it follows and, frankly, we will get some right and we will get some wrong, and that's life. What we did instead—and I was in a sense responsible for this—was to say, "We cannot have the ABN world. We will set the conditions. We will give them a reasonable chance to meet those conditions and that is an appropriate approach to take". As I say, I am very much trying to balance here the role of the regulator and the fact that we have a market economy.

Q1998 John Thurso: I completely accept that point—it would be quite wrong if the natural operation of a good market became whether or not you would say yes or no to something. You are there to see the market function, not to tell it what to do. I completely understand that, but you have two entities that have problems. They come together. They have a chance, but you then add in a highly complex, large takeover—

Andrew Bailey: You are referring to Britannia and Co-op or Co-op Verde?

John Thurso: We will start with Britannia and Co-op. You have some inherent faults to start with, which everybody has recognised, at least with hindsight. You then add in a massively substantial takeover, which has to be reconfigured in iteration 2 to include capital to make it all work, and every time you are just going further and further away from something that might be realistic. The question therefore is did that time pressure, effort and money distract from the possibility of a different outcome, which was at the point of the five conditions saying, "If you cannot demonstrate you can meet those pretty sharpish, then stop doing this and concentrate on your own"? That is the question.

Andrew Bailey: Yes, that is a very fair point. As I think I said when Mr Mann was questioning, we did not take our hands off the Co-op and say, "We will come back to you when you have determined whether you do Verde or not". We dealt with risk management

and board governance. By the way, capital was put in during this period; in retrospect, not enough. It was during that period that the group put, I think, around £350 million of core tier 1 capital into the bank between 2010 and 2012. Moreover, they committed to the sale of the two insurance businesses, which I think is estimated to be worth about £500 million in terms of core tier 1.

Q1999 John Thurso: The final point, if I may. One of the very first hearings we had was with Sir Win Bischoff and António Horta-Osório, at the end of which Sir Win produced a marvellous chart demonstrating the market's view of Co-op.

Andrew Bailey: I have never seen this chart, but I have read about it.

John Thurso: It was on the TV. Basically they did that to say, "How could we have known what was going on in Co-op? Look at what the market thought. This is only just appeared". Since then, all of the evidence that we have had regarding particularly the regulator shows very serious and growing concern between 2011 and 2013. The question therefore is, did you or any of the regulatory team share any of those concerns at any time with Lloyds?

Andrew Bailey: I think I alluded to this in the hearing last summer. When I wrote the second letter to Co-op in December 2011, I was concerned about the situation with Lloyds and also, by inference, obviously in terms of the position of NBNK in terms of them having a fair chance. I can't go to one bank and say, "Let me tell you what you do not know about another institution that I regulate". That is obviously legally out of order, but I did take the step of saying to Co-op, "You have to show this letter to Lloyds. Lloyds needs to understand the reservations that we have, because I do not want this thing to end in a crash and for Lloyds, quite reasonably, to come to us and say, 'If only you had told us, we would have obviously done something different'".

It was a requirement of Co-op that they show the letter to Lloyds. I have written evidence, that Co-op did that, so there is no question. I have written evidence. I have also had evidence from Lloyds executives. I have to say to you what was a surprise in your hearing was that Win Bischoff did not know. When I heard about your hearing, I said, "Well, that is odd", and that is obviously an issue within Lloyds, but I have written evidence that Lloyds executives have seen it.

John Thurso: If I just have it absolutely straight, you are testifying that Lloyds knew.

Andrew Bailey: Yes.

John Thurso: But it would appear from the evidence we have gathered that Win Bischoff did not?

Andrew Bailey: That is exactly what he told you, yes.

John Thurso: Therefore, that there was a gap in communication between the team that was receiving information from Co-op and the top level. That would be the logical—

Andrew Bailey: You would have to ask them, but I think that is the logical conclusion, yes. You would have to ask Lloyds that question.

John Thurso: Okay, thank you very much.

Chair: We have no other questions. You can tell that there was a good deal of interest in this session from my colleagues and, no doubt, beyond this room. Thank you very much for the evidence, which has run on over two hours and which has been both informative and detailed. This will be the last of our public hearings on this, given that we now have half a dozen inquiries or at least the fact that we have been looking at this seems to have contributed to the spawning of a good number of investigations, both internal and external, in what is going on in the Co-op. We are very grateful to you for the detailed evidence you have provided.