HOUSE OF LORDS

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The Select Committee on Economic Affairs

Inquiry on

BANKING STANDARDS AND CULTURE

Evidence Session No. 1 *Heard in Public* *Questions 1 - 17*

TUESDAY 14 JULY 2015

3.35 pm

Witnesses: Lord Green of Hurstpierpoint and Sir Winfried Bischoff

Members present

Lord Hollick (Chairman)
Baroness Blackstone
Lord Forsyth of Drumlean
Lord Griffiths of Fforestfach
Lord Kerr of Kinlochard
Lord Layard
Lord May of Oxford
Lord Monks
Lord Sharkey
Lord Teverson
Lord Turnbull
Baroness Wheatcroft

Examination of Witnesses

Lord Green of Hurstpierpoint, and **Sir Winfried Bischoff**, Chairman, Financial Reporting Council

Q1 The Chairman: Lord Green, Sir Win Bischoff, welcome to this one-off hearing on the culture of banking and particularly its impact on risk management, operations, the treatment of customers, remuneration and the integration of acquisitions. We shall want to discuss these points during today's session. Perhaps I can start off with acquisitions. Both of you have worked at the highest level in organisations that have been active in buying other businesses and that in some cases have been bought by other businesses. It would be of particular interest to us to hear from you both about the process of due diligence—the process of inquiry before you have made those acquisitions to satisfy yourself that the businesses are indeed in good shape and are going to be good acquisitions. Sir Win, would you like to start?

Sir Winfried Bischoff: Thank you, Chairman. You are asking me not as chairman of the FRC but as a former banker.

The Chairman: I am not asking you as chairman of the FRC.

Sir Winfried Bischoff: Thank you very much. In terms of acquisition in relation to banks, there is quite a lot of inquiry that you have to make, particularly, I happen to believe, in terms of the business model rather than just the risks. Does the business model, for example of an investment bank, fit in very well in relation to the acquisition if the purchaser is a retail bank?

Secondly, there is only so much due diligence that one can do, by the very nature of it if it is a publicly listed company, so there is a limitation. That in my view therefore calls into play the judgment: should this in fact be done at all, particularly at a time when perhaps the economy is not in great shape or there is some volatility in the economy and so on? Taking all these things together, it is very unlikely that you are ever going to be able to do all the kinds of things that you might want to do in terms of due diligence and therefore judgment. Acquiring the right kind of company, with the right kind of business model, with the right kind of culture, et cetera is very important.

Lord Green of Hurstpierpoint: HSBC did a series of acquisitions over many years. It is worth reflecting that there are different strategic backgrounds to why you do an acquisition. You have, for example, the case where you are acquiring a bank in market because that bank is distressed, sometimes even more or less at the invitation of the authorities to take it over. There are three examples of that in HSBC's history, the famous one being quite a while ago, which was Hang Seng Bank in Hong Kong. Then you have the in-market acquisition that is designed not to help out a distressed bank but to build out your own network. Again, we did a few of those. We bought Republic New York as a means of building out our branch network in Manhattan. You then have acquisitions that take you into a new geography, and they can be either distressed situations or normally functioning banks. In the case of the former example, we bought a bank in Brazil and one in Turkey. In both cases that was a move into a new market, and in both cases they were distressed institutions. We also bought a bank in France, CCF, and one in Mexico, where the bank itself was not distressed. It took us into a new market, because strategically we wanted to do it.

I mention that because the nature of the due diligence will somewhat vary. If you have a distressed situation where you are more or less being asked to take it over by the authorities, you can do a lot of due diligence and, indeed, you need to do a lot of due diligence, particularly on the state of the book and the state of the liabilities. You have the opportunity to see a great deal about the institution you are being asked to acquire. If you are buying a fully functioning bank, particularly in a mature market, you do not have that opportunity, and the risks and the limitations of due diligence, to which Sir Win has already referred, come into play. You can review the book, you can look at their filings, you can listen around in the markets as to what people have to say about the standing of the bank, but you cannot see its innards. In particular, you cannot see its systems environment, which is an extremely important question for banks, until you have done the deal.

Sir Winfried Bischoff: I would just say in relation to that that if you are asked to do this on behalf of the Government in a distressed situation—and I was involved in two of those—you do not have all that much time. You usually get rung up on the Friday afternoon—I saw it in America with the FDIC—and you have to have a decision one way or the other by Monday morning. You know it is distressed; you do not necessarily get indemnities from the Government; and you have to act and to exercise your judgment over a relatively short period of time. You may know something about the bank, but you do not know its exact state at that particular time.

The Chairman: It follows from those remarks that in fact you are only partially sighted in quite a lot of acquisitions, particularly those that are public companies, because you can only look at what is available on the public record, although is it not the case that if you are paying a handsome premium, you should have the right to look behind the screen and look into the books?

Sir Winfried Bischoff: Of course. It is possible that you agree with the other side. On the whole, these banking transactions are not done on a hostile basis. It is very unlikely that they are done on a hostile basis—very few are—so you might be able to arrange with the other side that you do make it public that you are looking at it. The other side—the acquiree company—would say, "I need to have certainty, my shareholders need to have certainty, my depositors need to have certainty". There are limitations to it.

The Chairman: Lord Green, you mentioned buying a bank in Mexico, which subsequently turned out to be rather a difficult acquisition, to put it mildly—rather an expensive acquisition. Were you not given the opportunity to look into the bank and its activities to understand how it managed risk, to understand how it managed money laundering and to understand possibly that its client base might not be totally above board?

Lord Green of Hurstpierpoint: I do not have personal knowledge of exactly what we were allowed to look into in that particular situation at that time, but your earlier summary is right: you are only partially sighted in most acquisitions. You take an element of risk in making an acquisition in almost any circumstances, it is true.

The Chairman: Let us take the Republic bank, where you were involved as head of private banking at the time. The Swiss subsidiary clearly was going to be a major part of the acquisition. To what extent were you able to investigate the basis of its business, its business model and whether its business model was in fact fully compliant with the laws of the land? We have now discovered that was not the case.

Lord Green of Hurstpierpoint: In fact, I was not involved in the acquisition of the private bank, but I do know from conversations with my colleagues at the time that quite detailed conversations took place. They were very aware, in the case of that bank, that it was a distinctive business. It was actually a new business—at least the scale of it was a new business for us—and it was a business with distinctive characteristics, in many ways a community institution. I know that a lot of conversation was had with the owner of the business and that in many ways there was a good strategic rationale for that bank. It was a perfectly reasonable proposition for a bank like HSBC, with its global footprint and its development ambitions, to take the view that the way the world was going there would be more and more businesses and people around the world who would have need of private banking-type services, and in many cases that would mean Swiss-based private banking services. On the analogy of aircraft cabins, you have a first class, a business class and various other grades of service, and it was felt—I think rightly—that there was a growing number of people who would be wanting that kind of extremely intensive private banking support. There was a good strategic rationale for it, but it was a very unusual acquisition, no question. It was a privately owned business, or at least strongly dominated by its previous owner, with a very distinctive client base. I think it would be right to say of me but also of my other senior colleagues who were closely involved at the time that we were very conscious that there were going to be issues in the private bank: that there would be a considerable need for work on, for example, politically exposed persons and, again, the systems question that always comes up in banks. You do not know, until you really get into the detail, what the systems are like.

The Chairman: Did you have an opportunity to look into that business to see whether in fact it was operating above the law and to what extent the products were non-compliant? It subsequently came to light that it was running a sort of industrial-scale tax evasion business on behalf of its customers.

Lord Green of Hurstpierpoint: I am not sure to what extent the due diligence at the time revealed issues of non-compliance. I do not believe that anybody was aware of the—to use your phrase—"industrial-scale" systems of tax evasion. What is true is that on acquisition, HSBC Group put in place a series of policies, one of which was absolutely clear. We had a thing called the private banking instruction manual, just as we had instruction manuals for every other part of the bank. It is rather characteristic of HSBC that they were not guidance notes or anything; they were instruction manuals. Very prominent in that was an assertion that account managers were forbidden from aiding and abetting, or advising on, tax evasion.

In some senses this is not so dissimilar from other acquisitions. You go into most acquisitions knowing that there will be areas of remediation that you have to undertake in order to bring it up to the standards that the group wants, and to be honest knowing that this will take some time. The newer the product range, the newer the market, the more complex the market, the longer that time would realistically be. It is a journey, if you will. We are kind of moving off due diligence into implementation, but in a way that is the appropriate thing to do, because it is in implementation where the hard work really begins. As I say—and I think Sir Win has echoed it too—in almost no acquisitions that I can think of do you go in fully sighted.

Q2 The Chairman: It would seem to me a fairly basic question, given that it is located in Switzerland, that its transactions on behalf of its private client customers would need to be scrutinised very carefully to make sure that they were acceptable to the laws not only of Switzerland but of other countries. You make the point that you have a very rigorous process of looking into these accounts to make sure that they comply with all relevant legal and other matters, yet this somehow slipped underneath the radar screen. How did that come about?

Lord Green of Hurstpierpoint: I do not know, because we became aware of this situation and the extent of it only in around 2010. Indeed, the kinds of activity that were described in the media reports earlier this year I was certainly not aware of before we read about them in the media reports, and I do not think any other member of the senior management of the group was either. There was an audit process, of course, and it did not reveal these, so far as I am aware. There are lessons to be learnt from that.

The systems environment is an important issue. This is a general truth, not only about private banks. It is always the case in banks that systems are a complex feature of integration. I guess it would be true to say that we have become more conscious as the years have gone on of the importance of culture. I am sure my successors would say that they are even more conscious of it. Programmes to work on the culture, to understand what it is, to understand where the problems are and the relevant remediation, through training, development and incentivisation are all part of the integration challenge, there is no doubt.

The Chairman: When you took over as chairman of Lloyds after it had purchased HBOS, your chief executive at the time, Eric Daniels, was on the record as saying that the due diligence that was done on HBOS, no doubt over a weekend or however long it was between the opportunity arising and it being completed, was between one-third and 20% of the level of due diligence that he would normally expect to have happened. Is that a situation where, bluntly, Lloyds was bounced into doing something in the public interest?

Sir Winfried Bischoff: I do not know the circumstances that pertain to that particular acquisition. I do know that Eric Daniels did say that he would have liked, in normal circumstances, to have done more due diligence. It is very difficult to do more due diligence when you have to announce that due diligence is being done, because it leaks. Due diligence of a big bank needs quite a lot of people, so inherently it is very difficult to do a lot of due diligence in relation to a very large financial institution because of the likely publicity that will attach to it. What would I say in relation to that? I come back to my point that I made at the beginning. You have to use judgment. Is this the right time to buy it? You will not be able to do as much due diligence as you would have liked to. Is this, from an economic point of view, the right time to buy it? Does it fit the business model that you have for yourself? Governments, as Stephen mentioned, will speak to major financial institutions to see whether something can be saved, and you just have to decide whether that is the right thing for you to do or not.

The Chairman: Governments will bounce you into it but not be prepared to underwrite the risk.

Sir Winfried Bischoff: Indeed, as one has seen, yes.

Lord Sharkey: Lord Green, back to Switzerland for a moment, what kind of processes do you think might have revealed the true situation in the bank?

Lord Green of Hurstpierpoint: I am not sure that I know the honest answer to that, nor do I know how extensive the issue was within the bank. A lot of investigation has been done by HSBC Group since I left. As I say, the data theft and the extent of the client data theft became apparent, I think, only around 2010, and the nature of the contents of some of that became apparent to senior management of the group even later than that. I am not sure that I know the honest answer to that. But—as we always did with acquisitions, so far as I know—group internal audit went in after the acquisition had completed and did a thorough analysis of the condition of the institution that had been acquired. I do not know what that uncovered in the case of the private bank, but I do know that there were a lot of areas of remediation. I mentioned, because I remember it, the politically exposed persons situation. There were issues like that that were being addressed very proactively in the early years of that acquisition. It was complicated by Swiss law, which, as it stood, prevented a London parent company from seeing the details of clients. With the benefit of hindsight, it would be right to acknowledge that it would have been good to have drilled into this much more systematically earlier. We did not get everything right.

Q3 Lord Forsyth of Drumlean: I should declare an interest as the director of a challenger bank, which is in the register of interests. Can I just bring you back to the issue in February 2009, when Eric Daniels said that Lloyds had carried out "three to five" times less due diligence than normal on HBOS's balance sheet before agreeing to the deal? You said in response to the Chairman that you did not know what the circumstances were, but you were appointed chairman in July, after Eric made these remarks, and the newspapers were full of coverage that the Prime Minister had leant on your predecessor as chairman to do this deal. Did you not inquire as to what had happened? Was Eric Daniels keen to make the acquisition and do less due diligence because of the carrot that was offered to reduce competition limitations, which would otherwise have prevented the bank from being able to take out one of its competitors?

Sir Winfried Bischoff: When I was asked to become chairman, I inquired as to the circumstances, to the extent I could, of the HBOS acquisition. The HBOS acquisition was not done, from what I learnt, purely because the then Prime Minister had encouraged the board of the bank. There had been discussions from a strategic point of view that this might in fact suit Lloyds very well. It was not just one factor; there were a number of factors that came together and that from a strategic point of view suited the board and the circumstances at the time, with HBOS being in some difficulties.

Lord Forsyth of Drumlean: What do you mean by "a strategic point of view"? Do you mean less competition?

Sir Winfried Bischoff: No, a larger market share.

Lord Forsyth of Drumlean: Is that not the same thing?

Sir Winfried Bischoff: I do not think it is necessarily the same thing, but you could say that it is the same thing, yes. Lloyds would in fact have a market share that was close to 30% at the time.

Lord Forsyth of Drumlean: Could I just ask Lord Green, briefly, about the acquisitions that were made in Mexico and in Switzerland—the private bank—where you indicated that you and the senior management did not know what was going on? Is it not a bit surprising that the senior management and the board should not be concerned about reputational risk to the bank? For anyone looking at a country like Mexico, surely there should be some alarm bells going off, given the nature of the situation in Mexico at that time.

Lord Green of Hurstpierpoint: We were certainly concerned about the reputational issue. We are concerned about the reputational issue in the case of any acquisition. In any new venture into a new product or market, which may or may not involve an acquisition necessarily—we built up our own investment banking business without an acquisition—you have reputational risk. Of course, in the case of Mexico you could hardly ignore the fact that this was a large emerging market, but the business case was also clear. This is part of NAFTA. It is a population now of well over 100 million people. It was and is quite a strong grower. There were plenty of good reasons to believe that this was the kind of emerging market that HSBC has flourished in in so many other parts of the world. It was an extension, because we had already moved into Latin America via the acquisitions in Brazil and Argentina earlier. If you like, this was building up our presence in Latin America, which was not a traditional stronghold of HSBC, unlike Asia and the Middle East. It is emerging-market territory. I do not think there was anything quixotic about the business strategy that took us into Mexico.

Lord Forsyth of Drumlean: I do not want to pursue this, but given the violence, the drugs and the gangs in Mexico at that time, what I find difficult to understand is why the senior people at the board did not say, "Hang on a second. This is not a normal acquisition. What have you done by way of due diligence?", and were not very concerned about doing a deal of that kind.

Lord Green of Hurstpierpoint: I do not want to convey the impression that no due diligence was done and that nobody cared about the nature of the client base. As I mentioned, we put in an internal audit. I go back to the point that there is a limited amount of due diligence that you can do pre completing a deal, but we did look at Mexico and, yes, we were aware of some of the difficulties of the Mexican market as well as the opportunities within the Mexican market. We put in a very thorough internal audit review, which made a whole series of recommendations. With the benefit of hindsight, again, yes, we should have worked harder on getting those findings from the internal audit implemented properly in the Mexican business. One of the things from this whole experience that HSBC has derived and taken the benefit of under my successors is a much stronger investment in compliance and a much stronger control line for compliance through to the centre. We did operate with a more federal model. They have specifically changed that in the last couple of years, and the strength of that decision to change it means that you have much stronger control over the control functions. Yes, I wish we had done that earlier.

Q4 Lord Griffiths of Fforestfach: Chairman, I must declare my interest, which is in the members' register, as a director of an investment bank. It is natural, I suppose, if you are running a bank to want to see the bank growing. In the extreme, you have two choices: you can either grow organically or you can grow through acquisition. You have said that if you are going to grow through acquisition, you will inevitably have a situation where you can only partially sight the institution you wish to acquire. The question is: if you know that that brings such risks with it—and, with the benefit of hindsight, we have seen that the risks have really been enormous—is there not a case for public policy to put some restrictions on how much acquisition international banks should be involved in?

Lord Green of Hurstpierpoint: There is a case for the onus of proof being on the case for acquisition, if you will. You have summarised the risks and we became very conscious of them. We did a lot of acquisitions that went just fine. Nonetheless, you cannot help becoming conscious of the risks. HSBC, over the period of about six or seven years starting from about 1997 onwards, did quite a lot of acquisitions. One of the reflections, looking back as a learning experience, was that we may have been stretching ourselves quite quickly. One might reflect, with the benefit of hindsight, on the wisdom of some of that. Nevertheless, it is also important to point out that there are risks in the organic growth of business, too. We also took a decision to grow our corporate investment banking markets business without making an acquisition. One of the reasons for doing that was because we absolutely did believe that trying to acquire an investment banking business was a very dangerous game, so we grew our own. Of course, growing your own means recruiting a lot of people from the market, and that carries risks with it and threats to the culture that have to be carefully managed. I do not think this is risk-free either way, unless you reach the extremely conservative conclusion that we just should not seek growth. That would be a big policy shift.

The one other point I would make in respect of my time at HSBC is that an enormous number of acquisitions were put to us that we stood away from. It would be wrong for me to comment on examples. There were a number that we publicly walked away from, where it was known that we were in discussion. We walked away from an acquisition in South Africa and one in Korea. I would like the Committee to recognise that we thought quite carefully about these things.

Sir Winfried Bischoff: I agree with you entirely, Lord Griffiths, that organic growth on the whole is less risky, even if you have to hire people from the outside. It depends, of course, on the extent. Is it a very large extent, or are you hiring some people, particularly in the investment banking area, who you can integrate very well? At the same time, a public policy that there should be no large acquisitions would be going too far. The regulator will look at the capital side of it, which is very important. Boards and shareholders should also look at the culture and so on and ask, “Does this really fit?”. You have seen relatively few acquisitions, other than those encouraged by Governments—perhaps in the United States—that were large acquisitions. Regulators are probably very much against large acquisitions at the moment.

Lord Green of Hurstpierpoint: Just to quickly add to that, the HSBC experience is of almost nothing since the mid-2000s, because of the crisis for one thing but also because of this growing appreciation of the cultural stretch and the risk involved.

Baroness Blackstone: Just continuing on the issue and thinking about culture for a little bit longer, when did you discover that the Mexican bank that you purchased in 2002 did not have adequate money-laundering controls in place?

Lord Green of Hurstpierpoint: I do not know the answer to that question. To repeat, I know that a detailed internal audit was done. I do not know what that came up with.

Baroness Blackstone: Is that not a question that you ought to know the answer to, given the issues that have been in the public domain since then? Can I follow up? Having discovered it, why did you then allow the bank to continue operating when you knew that it was not meeting your group standards?

Lord Green of Hurstpierpoint: It is always true with acquisitions that there will be group standards that are not met on day one, and some of them will take a long time before you are in a position when you can meet them. It is a journey, just to be realistic about this. I have mentioned systems a couple of times. Systems are an intractable thing; they take a long time to fix, but the systems are critical to the information on which compliance will often depend.

Baroness Blackstone: Given the reputational damage that this did to you, surely this is an example where you should have intervened much earlier.

Lord Green of Hurstpierpoint: There is no question that, given the experience, we should have focused and drilled down on this much earlier. There is no question; we did not get it right.

Baroness Wheatcroft: I should declare an interest as a former director of a bank. I have a quick point of clarification, if I may, Sir Win. You indicated that in a time of economic downturn you would be particularly wary about making acquisitions, that pressure from government would be an influence, and, indeed, that as far as you understood it it had not been the only influence in the Lloyds HBOs decision. Could you give us some indication of how much pressure there was from government to do that deal?

Sir Winfried Bischoff: I really do not know. I was not there. I have read newspaper reports, of course. I do know that one of the requirements was that if that acquisition were to go ahead, there should not be a reference to the OFT, because otherwise it would have to be unravelled. That is the only thing that I know about it. On the proportion of strategic as against government influence, I just do not know. I know from all that I have heard that the government influence was not the only one; there was a strategic intent there too.

Lord May of Oxford: I should declare an interest. I was, for several years, a member of the corporate social responsibility committee that Lord Green created when he came to HSBC. I would just like to make a couple of remarks about it, because it takes us wider than what we normally focus on but at the same time it is important. That committee was his creation and it did a lot of very socially responsible things. It had very strict rules on lending that might be for not funding forests that should not be logged, for example, which is not in the bank's best financial interest but is the sort of thing that, if you are thinking of banking in a larger sense, is important. Also around that time—not under Lord Green's aegis originally, but when he came—it was a bank that essentially had no women in high positions at all. That was turned around. There were, in short, quite a lot of things like that. Once he had left, his successor very quickly got rid of the committee and the stroppy people who were on it. In some sense, maybe on another occasion, we ought to think more generally about corporate values. We are focusing on one particular corporate value, but there are others that ultimately are equally important.

Q5 Lord Sharkey: I should have declared an interest earlier as a director of a financial services think tank. Lord Green, how did you make an assessment of the culture of your acquisition targets?

Lord Green of Hurstpierpoint: In the earlier years that we have been talking about, we did this more intuitively and instinctively rather than systematically. I suspect that the company, going into an acquisition process now, would be much more systematic about it. I do not know how systematic you can be about assessing culture. Some parts of it are measurable; you can indirectly measure the culture by things like absenteeism, late report filings and so forth, but you do not really get at the values in the company that way. You can clearly look at the mission statements and value statements that most boards have these days, and you can talk around and try to get a sense of the extent to which people take those seriously, but again, if we are talking about the due diligence phase, this is very limited. Once you have completed that and the acquisition is complete, there is clear scope to be reasonably systematic about assessing culture. Surveys are increasingly frequent. They were not so frequent in the period we have been talking about, but they are much more frequent now. Asking managers questions like, "If you needed to cut a few corners to meet this profit target, would you be tempted to do so?", and measuring the percentage responses, and then asking the people who they manage what they think the answer is to the same question posed to their manager is the kind of targeted survey that starts to unearth real cultural attitudes. By the nature of the case, you cannot do that in due diligence.

Lord Sharkey: No, but it is curious, since the cultural fit—or the potential cultural fit—is surely a key aspect when you make an assessment of any acquisition, that you seem to be saying that there is no systematic, rigorous or even evidenced way of making an assessment of these cultures in advance of purchase.

Lord Green of Hurstpierpoint: The evidence is limited. You can do a certain amount of systematic work in advance, but the honest answer is that you are going to have to take a risk there, yes.

Q6 Lord Kerr of Kinlochard: Can I take you further into why that might be, Lord Green? You referred to the federal model. It was suggested by Stuart Gulliver in evidence to the Parliamentary Commission on Banking Standards two years ago that some of the problems at HSBC arose because, "We were reliant as a board, on the information coming from … a single pair of eyes on the country; the country head was omnipotent". He went on to say, "Our structure was not fit for purpose for a modern world, where, to be honest, our geographical footprint became very attractive to transnational criminal organisations, whether they are terrorist or criminal in origin". That structure pertained throughout your time as chairman. Do you think that the Gulliver criticism of it is a fair criticism?

Lord Green of Hurstpierpoint: What is certainly true is that the old HSBC, if I could use that phrase—meaning going back pre-1990, so pre the Midland Bank acquisition—was a very cohesive Asian and Middle Eastern-based business, which was run by those famous international officers, all of whom were Brits and none of whom were women by the way. It was very cohesive and you could rely on the person on the spot, because you knew them and you had probably been to school with them. You can see how that model worked. The bank then grew, and not just incrementally: Midland Bank doubled the size of HSBC and then, subsequent to about 1993, the workforce of HSBC as a whole went up by about two and a half times until about 2005 or 2006, which is where it peaked, roughly speaking. This was done by a series of acquisitions in a lot of different places, which were newer territories. You can see why a formula that had worked extremely well down the decades for the bank became less and less fit for purpose as time went by. Indeed, Stuart Gulliver made that announcement a couple of years ago on the shift, which he described as the biggest shift in management of HSBC since it was founded in 1865. It would be wrong for me to make too many comments on it, because anything I say is likely to be overinterpreted, but the comment I would make is that there is a difference between centralising risk-management and control functions, so that the compliance function, the audit function and the finance function have clear, strong lines into the centre, and the lines of business. Win will bear with me if I mention an organisation that he once chaired where the line of business was the strong model, so that the different lines of business were the controlling driver of business and the country manager was kind of an administrative connector. That has risks to it, too. The truth is that you are, in any such complex business consisting both of geographies and products, or lines of business, going to have to find some way of getting the matrix together.

There is no alternative. You can weight the balance in one direction rather than the other, and Stuart Gulliver in effect said that he was weighting the balance in the direction of controls and the lines of business. The domestic regulator in every country continues to expect the country manager to be answerable for all aspects of the business of the bank in that country.

Lord Kerr of Kinlochard: Yes, of course, but why does banking come so late to this change? I should declare an interest. My only financial interest is as a director of an investment company, but I used to be a director of an international oil company and an international mining company. All the points that you have made applied, but all the international oil companies—certainly all the European ones—abandoned the country head model 20 years ago. The international mining companies have abandoned it. They do have central compliance functions; they have had for some time. Is banking different in some way? Why was HSBC so slow to come to a more centralised system?

Lord Green of Hurstpierpoint: Banks are different from oil companies and mineral companies, yes.

Lord Kerr of Kinlochard: Why are they different? Suppose you have the chance to acquire somebody's oil company in Mexico. You do not know, but you have to undertake the best due diligence that you can to discover whether his oilfield has oil in it or not, but you also have a very real need to establish the principles and values that your company is run on, very quickly replacing those that the company you are buying ran on. Who bought the bank in Mexico? Was it the country boss in Mexico? What was the system for ensuring that the values of HSBC were embedded as fast as was possible in the bank in Mexico?

Lord Green of Hurstpierpoint: Who bought the bank in Mexico? The board of HSBC bought the bank. I would not accept that it was Mr X or Ms Y. The board of HSBC decided on that, knowing that there were some risks attached to it, as they had done several years previously with Brazil. They then appointed a country manager. We then sent in internal audit. Yes, with the benefit of hindsight, we should have focused earlier on the anti-money-laundering issues that were plainly in the bank. We should have done that. We did not get this right. My successors have clearly concluded from that experience and others that the right thing to do now is to move away from the federal model towards a much more centralised model. I have described a journey from a previous era through to a more complex period when we were growing by acquisition as well as just numerically, to a situation now where that federal model was put under sufficient stress that my successors decided to change it. My only gloss on all of the above is the point that I have already mentioned: that you nevertheless need to have somebody in the country who feels responsible for all the things that go on in the country in the bank's name.

Q7 Lord Kerr of Kinlochard: May I ask Sir Win whether the federal model, as it applied in the very different circumstances of HBOS—but it was still a federal model that they were running on—was one of the factors in the failure of HBOS?

Sir Winfried Bischoff: HBOS was of course not wholly domestic but was very much more a domestic institution. Therefore, the power, the authorities and the senior people were in fact in this country. Yes, it did have operations in Australia and in the United States, but—I cannot remember what it was—perhaps 70% of the activities of HBOS were in this country.

Lord Kerr of Kinlochard: But the different functions were not reporting direct to the CEO of the bank.

Sir Winfried Bischoff: I do not know, Lord Kerr, how the system worked. The interesting thing, just in elucidation of this point, is not just that the regulator is very keen that you should have global oversight, but that the legal entity has become very much more important. I chair the legal entity of a very major American bank—JP Morgan—in this country and am held responsible for certain things. You have the global side of it. You have the federal side, which has come into some disrepute, but the regulator would in fact like to keep his hands on the domestic side of things and not have the money siphoned off elsewhere. We are now getting to a stage where the federal model in some areas is perhaps not all that good, but from a regulatory point of view it allows the regulator to have responsibility at a local level, which is important to all regulators.

Lord Teverson: Lord Green, if I am extending my house a little I am entering into an area I do not know very well and I go through a formal process of tendering. What I really do is I talk to people I know—my network—and try to check out with them the reality about the performance of this institution or this company. Coming back to Lord Forsyth's question, I find it very difficult to understand that a bank that is probably the most connected and networked in the world, which is what HSBC promotes itself as, could not have found out the difficulties and the challenges of that bank at the time through the connections that they had. It seems almost incredible to me. It almost leads me on to the question of whether that was actually understood to a degree, and maybe it was thought, "This is a little racy and a bit interesting. Therefore, maybe we will try it out". I find it incredible that you—

Lord Green of Hurstpierpoint: I am happy to answer that question and say absolutely not. We went into all our acquisitions wanting to assure of the highest standards. I assert that categorically. We were always aware with all acquisitions—we have inevitably dwelt on two of them, but there were a number of them—that there would be an initial gap. That gap might be quite sizable. If it is sizable, you are only going to do it if there is a good strategic reason for it. As I have already argued in the case of Mexico, there is a perfectly good strategic reason for a bank such as HSBC to want a presence in Mexico with a good branch network. With the benefit of hindsight, we should have drilled in more closely and more quickly on the anti-money-laundering side.

Lord Teverson: I am trying to get at whether you were not able to use your knowledge of markets and people who knew people to get a real view of this, apart from the formal due diligence process.

Lord Green of Hurstpierpoint: I was not associated personally at the time, but a considerable amount of talking around the Mexican environment was done, yes. It plainly did not help us understand that there was a sufficiently serious anti-money-laundering problem in that bank as to need very close attention very urgently, and I am sorry about that.

Lord Turnbull: Can I come back to this question of centralisation versus the federal model? Stuart Gulliver, in evidence to the Parliamentary Commission on Banking Standards, described how he changed it from a super-federal organisation to a much stronger group structure. When you look at what our regulator is doing, I just wonder whether it is pursuing an inconsistent objective. It is creating not just subsidiaries but subsidiaries with a very high degree of independence. One of the things that Stuart said was, "The presumption of the board would be, because that country head was a DNA carrier for the firm, they would be doing the right thing". What the regulator is doing is saying that the senior people in the subsidiary must not be DNA carriers for the firm. Do you think those two lines of thought are really consistent?

Lord Green of Hurstpierpoint: That is a good question. This is complex. There is another complexity in this, which is that one of the cardinal pieces of the new regulatory regime that is coming into place is, of course, the senior managers regime and the certification process, in order to be able to define a particular person's responsibility for areas of business and create a presumption of responsibility. That is a perfectly understandable objective in the current regulatory regime, but it cuts across something else that you really do want to achieve if you are going to have a successful business, which is a good sense of teamwork. Reconciling those two instincts is quite hard. There are no simple answers to this, other than that in the limit you make everything so small as to be manageable without much management structure, but I do not think anybody is suggesting that we go there. Therefore, there is always this balance particularly between, on the one hand, the regulator's incentive to be able to get hold of a legal entity and now increasingly a person who they can hold to account, and, on the other, the management's desire to have some global coordination that ensures that we are (a) maximising the business potential and (b) not putting the reputation at risk. The hard learning out of all this is that an institution with a great reputation had that reputation sullied by things that we did not get right in a couple of places in particular—to some extent in the markets but particularly in those two geographies. It is perfectly understandable that the senior management want to get tighter control over all this, and reconciling that with the regulator's instinct, both locally and globally, is complex.

Q8 Lord Monks: We have talked quite a lot about the size problems, and you mentioned the growth. We have talked about the structure and the difficulties of getting a management structure to cope with the size. I want to focus a bit on the culture. Something happened in the 1990s in the banking system, in both your banks and in many others, which led to an explosion of rewards for people at the sharp end and people at the top of the banks. We saw a different culture of appetite for risk-taking, which was not traditional to the banking structure and to the banks that you have both been associated with for a long time in the earlier years of your career. I want to know when it started to worry you, this risk-taking consumer-focused culture, with huge rewards out of all proportion to those that had been paid to predecessors. When did you start to worry about that? Did you worry about that? Did it keep you awake at night? Did you think, "What are these entrepreneurs acting in our name doing?", whether in Mexico, Switzerland or, indeed, in Edinburgh, in terms of the Bank of Scotland? I know you were not the boss then, so I forgive you for that. I should congratulate HSBC on not buying ABN AMRO and having the sense to leave that to the Royal Bank of Scotland, with all the disaster that followed from that for them. This culture issue, and coping with that, is at the heart of a lot of this. Did you worry about it? Were you at war with it, or did you let it flow?

Sir Winfried Bischoff: Perhaps I might answer. I was chief executive of Schroders until 2000. It became apparent to me, probably in the middle of the 1990s, that the compensation packages being offered by our competitors were very substantial. We were not able to match those other than with our share price; we paid our people in shares and they performed quite well. In the mid-1990s, I became concerned that the compensation packages were in fact becoming very high and that some banking institutions used compensation packages as a competitive weapon. There is no doubt about that. That is what I would say to that. More generally speaking, it became exacerbated probably 10 years later, in 2003-07, with higher leverage and, particularly in some of the larger institutions, through risk-taking and so on, which appeared for a time to be very successful but which, as we all know, was not as successful as it might be. So, probably 1995, I would say.

Lord May of Oxford: Can I just follow that by asking you if it ever occurred to you that, by hiring the sorts of people you hired for obscene salaries, you were hiring the wrong kind of people? They were not all that bright, even at the mathematics that they were supposed to be good at. They were pretty crap at that.

Sir Winfried Bischoff: I am going back quite a long way. I do not think we hired people on obscene salaries at Schroders. It was very different in those eras, and the multiples of salary as against the people in the business were quite different from what they are now.

Lord Green of Hurstpierpoint: It certainly kept me awake. For me, I would almost say that this issue of remuneration was the most difficult one that we wrestled with. How could anybody be comfortable with a situation where you have either very senior people being paid large amounts of money or, indeed, quite young people being paid very large amounts of money, an enormous multiple of, let us say, the compensation of a head of a large inner-city school? There is no possible way on moral grounds of justifying this. Did that leave me uncomfortable? You bet it did.

What do you do about it? There are some practical things you do. We have come a long way as an industry from the times, a number of years back, when people were taking cash bonuses in multiples of their salary on the basis of either day-one profits or even gross revenue. These were extraordinary arrangements, but they were in place—three-year hiring guarantee arrangements, and so on. The situation now is partly regulatorily driven, but there is also an element of common sense spreading through the industry, where bonuses are paid in structures that defer the payments in relation to the risk that has been put on the balance sheet. We are in a much better place. Nevertheless, that does not take away from the fact that bankers are pretty highly paid. I personally cannot sit here and morally defend that. I can point to the realities of the international marketplace within which we operate. In the case of HSBC, there was certainly a growing awareness in the 1990s, I would say, and in the early 2000s that we risked being behind the curve of a market that was unquestionably becoming more compensation-oriented. There was growing evidence of dissatisfaction amongst our people that we were not where we ought to be on a competitive basis, and there was a growing sense that unless we did something about this, we might start losing people. There is clear evidence—I can name them, but I am not going to—of people at senior levels who left the group and the decision was certainly in part compensation-related. You live in this awkward world, particularly in an international bank, where you need to live in an international market. By the way, it is not just the Americans. It is often said that it is the Americans who are driving this up. Actually, it was Asians as well—and that mattered, of course, to HSBC—as well as the non-banks. You get it coming from all sides. It is the most uncomfortable thing. I am on record as expressing that discomfort. I am on record as saying that those individuals who are the recipients of these kinds of remuneration owe a debt to society and that it is up to them to discharge that debt in appropriate ways. I am not going to sit here and tell you that I think this was an ideal situation.

Q9 Lord Forsyth of Drumlean: Can I take you back to Mexico again? I know you acquired the Mexican bank in 2002 and you did not become chairman until 2006, but in 2007 HSBC's senior manager of group compliance warned that the anti-money-laundering committee in Mexico was "not functioning properly". The US Senate investigation that was carried out and reported in July 2012 said that between 2007 and 2008 HSBC's Mexican operations moved $7 billion into the bank's US operations. Both Mexican and US authorities warned HSBC that the amount of money could only have reached such a level if it was tied to illegal narcotics proceeds. The chairman of the Senate committee, Carl Levin, said, "HSBC's compliance culture has been pervasively polluted for a long time". You said earlier in answer to Baroness Blackstone that when you take over businesses it takes time to adjust the culture, but this seems to have taken an inordinate amount of time. Then, in 2010, US Senate investigators criticised HSBC for providing Banco Africano de Investimentos, an Angolan private bank, with ready access to the US financial system. There was a whole range of things going on that suggest that compliance was not effective. Did you know about that? When you were asked to join the Government, did you disclose that to the Government?

Lord Green of Hurstpierpoint: I certainly disclosed our Mexican issues to the Government, yes. Indeed, I drew attention to the statement in the HSBC annual report about matters under investigation by the Department of Justice. On the substance of the issue, no, I cannot say that I was specifically aware of that. Indeed, had I known, I would have done something about it. It is very clear that we did not get it right, and I apologise for that. I cannot say more than that.

Lord Forsyth of Drumlean: I am sorry to interrupt you, Lord Green, but am I missing something? It just occurs to me that if you are chairman of a big bank and both the Mexican and US authorities have warned that the amount of money could only have reached such a level if it was tied to illegal narcotics proceeds, that seems to me to be something that absolutely should be reported to the chairman and that the board should take immediate action. Was that to do with the federal structure? What was going on here?

Lord Green of Hurstpierpoint: I am not sure that I can remember specifically. I certainly remember it becoming very apparent to us that we had an issue by 2010, from memory—I am relying on my memory here. There were warning signals earlier. I do not remember what specifically was being done in response to the warning signals, but I am not going to sit here and say that we covered ourselves with glory. This is plainly not true. We got fined £1.9 billion—that was an awful shock—and the response has been very clear.

To be clear, I am proud of HSBC. It did not get everything right. One of the reasons I am proud of it is because it says that it does not get things right and then it works hard on remediation. Since then, they have—I am no longer there—very substantially reinforced the compliance function. It is clear that we needed to do that. One of the most obvious lessons from that saga was the need to strengthen the compliance function, which has been done enormously. I am proud of HSBC, by the way, for other reasons. For all the issues that we have dwelt on, this was a time of economic crisis and this was the only bank that was lending into the sterling market. It was the only bank that stood behind its obligations to companies of our own that got into difficulties. This is the bank that took $1 billion of losses in Argentina when other banks walked away from their subsidiaries and so on. There was a lot going on at the time.

Q10 Baroness Blackstone: In answer to Lord Monks' question, you touched on moral issues and you have made something of the fact that you are concerned about ethics and having the right values in running big banks. I wanted to pick up on that in relation to very high levels of pay. I will not use the word "obscene", which Lord May used, but it is the case, is it not, that the current chief executive of HSBC is paid over £8 million? This is over 200 times more than what the average employee of HSBC is paid. How can you justify on moral grounds that vast difference between the pay of the average and the pay of the person at the top?

Lord Green of Hurstpierpoint: In a sense, I addressed this a few minutes ago. I am not going to comment on an individual and certainly not an individual within HSBC. I do not think it would be appropriate for me to do. The general point is that what is true of HSBC will be true of much of the industry and, in many cases, I suspect more than that. I believe that we are in a situation where the international market drives us into this position. It is very obvious from a shareholder's point of view that you do not want pay rocketing up to ridiculous levels, so you would not do it as a shareholder and you would not do it as a board of directors on behalf of a shareholder unless there were good and sound business reasons for doing it. These headline numbers very often include quite a lot of conditionality. One of the things about the HSBC schemes—I cannot vouch for this now, but I suspect it is true, and it was certainly true when I was there—is that they had very heavy conditionality in them, such that on average rather less than a quarter of these headline numbers translated into awards when the due date came. That is not to say that they were not still sizable numbers, of course, but the headline numbers are often misleading.

At the end of the day, you either compete in an international market or you face steady attrition. That is the experience that HSBC at any rate and other banks were confronting in the late 1990s and early 2000s. Even now, it is worth noting that surveys that I have seen recently suggest that the bonus payouts of American institutions doing investment banking in London are higher than those of UK-based institutions doing investment banking in London and that the market share of the US institutions is rising. There is a policy issue here as well as the moral one. Would we be content, as a public domain, if the end result were that the investment banking market in London was dominated by American institutions?

Baroness Blackstone: I am puzzled by your answer, because it is simply not true that all other banks are paying at that level. You may not want to be ad hominem about this, but there is an issue. Lloyds is also a very, very big payer as far as the chief executive is concerned, who is earning about £7 million. If you look at the figures for two of the other big banks, they are at about £1.6 million, not £7 million and £8 million. I am talking about Barclays and RBS.

Lord Green of Hurstpierpoint: This is an international market. I am afraid that the decision that the board of a company like HSBC faces is not just about what the domestic players are doing; they will also be looking at what JP Morgan, or indeed Goldman Sachs, pays. I repeat that the Asians are an issue. We talk a lot about Americans, but the Asian market for experienced people is very hot, and the evidence is that people are willing to pay very considerable amounts.

Q11 Baroness Wheatcroft: I would like to take you further on the issue of remuneration, if I may. Investment banks today are very different from the merchant banks that used to be around. I wonder whether you have qualms about the fact that people called bankers were, and probably still are, paid very large sums of money for doing what Adair Turner termed "socially useless" work.

Lord Green of Hurstpierpoint: There was a lot of, to use Adair Turner's phrase, socially useless activity in the markets in the run-up to the crisis. I think there is rather less socially useless activity in the markets now, not least because the whole regulatory environment is now very different. Capital adequacy rules are completely different and much more onerous, as are liquidity parameters and leverage ratios. The whole economics of the business are different from what they were in 2007. It is important to recognise that, because we are at a stage at the moment, I believe, where most of the regulatory apparatus for the new normal is now in place. Some of it comes into effect over the next two to three years: the market abuse regulation, MiFID II and so forth. You see what the new regulatory environment looks like, but we do not yet know what the banks will conclude for their own business models in the light of that new regulatory environment, because it will dramatically affect the profitability of different activities.

The Chairman: I am going to adjourn the Committee now until the Division has been completed.

The Committee suspended for a Division in the House.

Q12 Lord Turnbull: Can I come to this question of sanctions for wrongdoing? A very rough estimate of the total fines paid by banks is £200 billion to £250 billion or $200 billion to $250 billion—huge sums of money—coming at a time when regulators were also trying to get banks to increase their capital. Could that money have been put to better use by being kept in business and the emphasis being placed more on sanctions on individuals? One is struck in adding up all the fines that you could barely see it; very few people were disqualified and very few people were imprisoned. Could the whole balance of sanctions, if it happened again, be better shifted so that it acted more effectively on the people who were responsible at the time, rather than acting some years later on the company when the management may well have changed?

Sir Winfried Bischoff: I certainly agree with that thought. After all, it is not the institution that got things wrong—it is an inanimate object—it is the people in the institutions who got it wrong. Therefore, logically, the penalty should fall on the people. The regulators have looked at that, the PCBS has looked at it, and the senior managers regime is trying to deal with it. It is the right thing to do. However, in order to have the right kind of conduct, you need an element of carrot and stick. You need an element of stick, but are the fines too large? Should they not have been levied on the company at all? I would say that there is a balance to that, but it certainly seems odd that the people who may have been the perpetrators have walked away scot free.

Lord Green of Hurstpierpoint: Numerically, of course, you would not balance it out. I do not think that is what you were implying, though. Looking forward, essentially I agree with the senior managers regime and the certification process, but also with a clarification of the law, which is now under way and which the crisis has exposed as necessary. It is now clear that civil and criminal market abuse can apply in a whole series of markets. With the implementation of the market abuse regime, which, if memory serves, is either 2018 or 2017, but in any case reasonably soon, you will have a much clearer legal framework for bringing cases against individuals than proved to be the case in the midst of the crisis. God forbid that there is another one like that and God forbid that there is a return to the status quo ante in terms of behaviour. But if it were to occur there is a much better framework for addressing individuals and their culpability than was the case before. I am not a lawyer, to be clear, but as the recent regulatory reform—it is reflected in the Fair and Effective Markets Review, which calls furthermore for the extension of that to the spot foreign exchange markets, which are currently a lacuna—gets embedded, we will have a much better legal regime.

Lord Turnbull: Earlier on, you referred to the fact that HSBC, in order to avoid paying people very large salaries, paid a lot of its compensation in shares. It has this one-three-six model, which means that the total opportunity could be nine times basic pay. Most of it is paid in shares. A number of people, including Charles Goodhart here, have pointed out the disadvantage of paying people in shares, where the incentive is to use gearing to push up the share price. Should some of this be paid in other instruments, such bail-in-able debt of some kind? Should we move away from this total reliance on shares as an alternative to cash?

Lord Green of Hurstpierpoint: The Fair and Effective Markets Review calls for an investigation into ways of aligning even better the remuneration against risks. They address the issue that if everything is in shares you might have too strong an incentive to take actions that have a short-term effect on the share price. That is to some extent offset by the fact that there are usually three or even five years' worth of delay until the vesting, so you have to believe that your actions are not merely increasing the share price now but will have done so in five years' time as well. Nevertheless, I think it likely that there will be further discussion about ways of enhancing the remuneration structure. I said earlier, and it is worth repeating, that we have come a long way. The time was when a lot of bonuses were paid in the form of straight cash on the basis of either revenue or day-one profits. We have come a long way from that. The FEMR suggests ways in which we can go even further, and one of them is specifically whether or not some form of bail-in-able debt, or debt structure anyway, should replace at least some of the shares.

Sir Winfried Bischoff: I would agree with that. The longer-term vesting is certainly very good. It is not all that easy for people to estimate that the share price will rise in five years' time rather than three. Therefore, it is the longer term that is the important thing. The accounting regime is making some differences in relation to that, with the recognition of unrecognised profits, et cetera. There are a number of aspects in relation to that that will militate against people being able to benefit from short-term actions, and that is important.

Lord Green of Hurstpierpoint: Lord Chairman, may I just make a general point that I alluded to before the break? We are in a process of transition for the industry. You have seen a regulatory environment that has changed the economics of this business quite substantially, particularly in the wholesale end—the institutional end—of the business, retail perhaps rather less so, although even there the economics have been modified by ring-fencing for one thing, capital adequacy ratios for another and liquidity parameters for a third. I do not think that many institutions have yet reached a steady-state decision about what their new business model is going to be in the light of these regulatory changes. What I am convinced of is that there is no question of going back to the status quo ante. That means that over time remuneration will probably trend downwards. In fact, we have seen some evidence of that.

Q13 Lord Layard: I wanted to ask about the size of banks. Are a lot of the problems that we have been discussing, where the board has not known what has been going on, or the problems that happened at the time of the crash, not connected to the size of the banks? I know that it is difficult to make generalisations about this, but Andy Haldane, for example, has tried to look at economies of scale in banking and thinks that £100 billion is about where they start running out. What is your opinion on that? You said something very interesting: that a bank must grow. That cannot always be true.

Lord Green of Hurstpierpoint: If I said that a bank must always grow, I did not mean that. There is clearly a growth objective, and most companies have a growth objective. If we wanted to go into an ex-growth scenario more broadly in the economy, that is a large public policy question, but in the meantime banks are going to think in terms of growth, as any publicly owned company is. That goes with the nature of the system.

To the question of whether size per se is the issue, I suggest that it is not. For one thing, there were plenty of problems in very small banks through the crisis. It was not just big banks that had embarrassments—and, indeed, more than embarrassments, major failures. There was also a whole host of rather smaller banks, including some very small ones, in different parts of Europe and in America. I do not think that size per se is the issue. Secondly, there are a number of other public companies in other sectors that have headcounts that are the same size or bigger than any of the banks—GE to name but one, Shell to name another. Again, for me the issue is more about growth, and by growth I mean of the size of the company, and acquisitions, which we have talked about a great deal. Those are issues that call into question how effective the oversight is or that challenge the oversight. Of course, we should never forget that on the other side of the scales there are some advantages of size when it comes to extreme pressure in the markets. It is not by chance that the bank that I was involved with was the one that did not need to take taxpayer money and kept on paying its dividends and its taxes. It is because it was large, diversified and extremely conservatively structured. This did not happen by chance. The question of size per se is not the one that I would major on in short. There is an issue about rapid growth, rapid change of the business model and the ability to see through all the consequences of that.

Lord Layard: There have been a number of papers on who gains from an acquisition, have there not? The conventional wisdom now is that, on the whole, the buying company on average does not.

Lord Green of Hurstpierpoint: It is the seller.

Lord Layard: Where does this idea that you must grow come from? One obvious motivation for growth, if I can put it this way, is that it justifies an increase in salary for the board. Many people have used that as a way of explaining the apparently paradoxical fact that companies buy other companies and in consequence, on average, lose. I would still like to come back a bit to this question of why you say you must grow. Why not serve your existing customers better and become more profitable that way, if you are not so sure that growth will increase the value of the company?

Lord Green of Hurstpierpoint: If you mean by "growth" growth by acquisition—buying other businesses—yes, that is a real question. Growth by serving your customers better, by acquiring new customers or by having a strong product offering seems to me to be intrinsic to the market system within which we operate. As I suggest, the notion that we should go ex-growth in that quite fundamental sense is a very large public policy one indeed. One of the most obvious learnings of the last decade or so is that growth by acquisition is often a very troubled route to growth, to say the least. I am familiar with the studies that you refer to, Lord Layard, which show that the record of acquisition is not particularly good for contributing to overall total shareholder value of a company. Indeed, it is likely that there will be pretty few acquisitions in the banking industry for some considerable time. My former employer, as far as I know, has done little or nothing in recent years by way of acquisition, and I suspect that is the new norm. Therefore, growth will come from looking at your client base and working out how to sell more profitably and more effectively to them.

There is one other aspect of this—Sir Win is better placed to comment on this than I am—and that is the role of the institutions and the expectations that they set. I do not think that growth and acquisition are driven primarily by boards' or CEOs' desire to have bigger remuneration. A lot of this comes from the expectations that are set by institutions. There was an issue—and I experienced this—of completely unrealistic expectations of what the company should be able to achieve. I remember going to investor meetings where HSBC was seen, frankly, as a middling performer because it had neither the growth nor the profitability of some other well-known competitors of ours who have subsequently got themselves into considerable difficulty. I remember one particular occasion when I was asked in quite an aggressive way why we were not prepared to dispose of our Chinese investments. The bank still has a substantial share in the Bank of Communications in China. From memory, it was on the books at $5 billion—do not hold me to that number—and the then market multiple was probably four times. They demanded that we should sell this and hand the money back to the shareholders. I said, "This is absurd. We have invested in China. We have been there for the last 140-odd years. We intend to be there for the next 140-odd years. We take a view that China is an extraordinary phenomenon emerging on the world scene. We are going to invest there and we are not selling out of investments there".

That is a long way of saying that you would want boards to have the courage to say to their investors, "We are taking a long-term view of how we develop our business". In some cases that may mean acquisition, and, of course, acquisitions are a problematic thing not only in the banking industry; I suspect that, at least for the next few years, acquisitions are not going to be a very prominent feature of the banking scene.

The Chairman: Sir Win, can I ask a question to follow up on that? Do you feel that shareholders have learnt some lessons from what happened, that they are now recognising that risk-adjusted return is probably the way to look at banks and that egging banks on to make large acquisitions that look very attractive on the face of it but in the end lead to tears is possibly not a very sensible way forward?

Sir Winfried Bischoff: Certainly investors are very much more aware of the risks of making acquisitions in the banking business. Acquisitions have actually increased outside the banking business. The M and A calendar of institutions is very much greater. In the banking business there are particular challenges in relation to acquisitions. You cannot pay in cash for a large acquisition; you have to pay in shares. At what level are the shares valued? If they are valued at less than book—quite a number of banks are still valued at less than book—it makes it particularly difficult. I agree with Lord Green that it is very unlikely that there are going to be many large acquisitions, from the point of view of management—and from the point of view of shareholders, similarly. Shareholders are much more interested in management's dealing with the institutions that they manage and getting the business model right, rather than expanding through acquisition. I agree with you.

Q14 Lord Monks: Can I prod a little further on bank cultures? Sir Win, you have said on the record in the past that perhaps your biggest regret is the mis-selling of PPI, which nearly all the banks in Britain were part of. We have read in the briefing material that various surveys have identified the growth of a consumer sales mentality and culture in many of the banks—sell, sell, sell. There is a newspaper report that the Bank of Scotland, for example, used to award vegetables to poor performers and prizes to good performers on a weekly basis, and so on. That was the kind of culture that not too many of the customers of the Bank of Scotland knew about, but that was operating there. Lord Turner said that retail banking was "polluted" by the sales culture. I am interested in two things. One is whether you agree with that. Secondly, has it stopped, or is that culture roaring ahead—the sell, sell, sell?

Sir Winfried Bischoff: I am not in the retail banking business any longer since I stepped down from Lloyds in April last year, but I know that at that time—and I believe it has accelerated—the culture of paying people for sales, i.e. through incentive compensation, in fact no longer largely applied at Lloyds. I am not certain of that, but I have read reports about what Lloyds is doing. Was it endemic? I think that it probably was endemic in that period. A large element of selling took place in banks, certainly in Lloyds. It was partly stopped in 2010, and more recently it has been eliminated in some of the banks.

Lord Green of Hurstpierpoint: I do not work for HSBC any longer, but my understanding is that points for sales have been withdrawn, so, to answer your second question, I do not think that that culture pervades the system. It would not be a correct description of my former employer now. Indeed, we were an early warner of some of the dangers of this. Going further back into the 1990s, we have talked a lot about investment banking compensation, or very high levels of remuneration that relate to wholesale business, to a large extent, but it is also true that at the same time banks were getting more and more focused on marketing and on sales. I can remember people saying, "We have to stop thinking of 'sales' as a dirty word". The culture was shifting. It was shifting in the industry as a whole and in wider society as a whole, one might add. The banks got into the mode of setting aggressive sales targets and paying—I have not heard the story about vegetables and money—strong incentives to achieve those sales targets. I suspect that they have all rowed back on that; I know that my previous employer has.

One of the issues is not just about sales targets; it is also about product complexity. The PPI saga is a good example of this point. It is very hard for a customer to value, at the point of acquisition, what a product like that is really worth to them. There is a complexity—an un-transparency, if you will—about the product that is being put to the retail customer. That was the source of a lot of the problems.

Sir Winfried Bischoff: Transparency is a very important part of all this. The customer may not be as financially sophisticated as he might be or perhaps as the institution thinks he should be, so transparency is becoming very much more important, which is a very good thing.

Q15 Lord Griffiths of Fforestfach: I would like to come back to the Fair and Effective Markets Review of the Bank of England, which was a very thorough review following LIBOR, the foreign exchange problems and so on, and the idea of the three lines of defence in managing risk. The first is the business unit where the revenue is created managing its element of risk, then compliance and then internal audit. I may be wrong, but my sense is that the revenue-creating business units have had to face up to what managing risk is at that level and they are doing so. Compliance has had a lot of exposure. Compliance has probably been reviewed in every major systemic bank in a major way. To me, internal audit is a fundamental defence against risk, because internal audit can go in without announcing it to anyone and find out what is happening and so on. I wonder whether it has not become, in a way, the Cinderella of a line of defence, and whether more can be done in order to give it more authority within the structure of risk management.

Sir Winfried Bischoff: Internal audit has become very much more important. The very fact that internal audit in most cases no longer reports to the CEO but reports to the audit committee or to the chairman of the board is a good thing. It is more independent. I think banking managements realise how important it actually is. It is a last line of defence. I still believe that the first line of defence is the very best, because that is where the morals arise, i.e. should one rely on a policeman picking you up or should one be doing the right thing? Culture in financial institutions and in all kinds of institutions—I feel very strongly about this—has to start with the people who do the business and they have to get it right or nearly right. The others are amelioration effects—compliance, and ultimately audit, is very important. I agree with you. The very demand that institutions place on compliance and internal audit people has meant a rise in their compensation packages, as I think most people who are associated with financial institutions know, because there are simply not enough around and financial institutions need them more. So it is still the first line of defence, but I agree with you entirely on the audit side.

Lord Green of Hurstpierpoint: Yes, the first line of defence is the one that matters first. In fact, the phrase is slightly unfortunate. I wish they had not called the first line a first line of defence; the first line is a line of leadership. This is the manager leading the team, not a defence, as if the team was a bunch of bears and the manager's job was to hold them back. It is important to learn the lessons. The FEMR does focus on this. Probably all the big institutions, and certainly my former employer, are investing a great deal in training at the level of account managers and line managers, with people spending anything up to a half a day or even one day per month on training on culture, the ways that business should be done, regulatory issues they should be aware of and so forth. They are quite significant investments, both in cost and in personal time. Some of it is instructor-based, which is particularly expensive, and some of it is e-learning based. Given the cultural ethos, or the absence of a cultural ethos, that had built up in much of the markets in the mid-years of the last decade, that is an investment that they have to make. The first line is critical.

If the second line is compliance, again, you have seen all the institutions, certainly including my former employer, massively increase their investment in compliance. I think the statistic is an extra 2,000 people in the case of HSBC. Do not hold me to that, but they would be comparably big numbers in all institutions. The role of HR, by the way, is quite important in the second line of defence. It is the responsibility of the HR function to ensure that the appraisal system is picking up cultural issues and identifying people who do not have the right kinds of values. It is difficult to do that in a methodical way, of course, but nonetheless there is an expectation that the leadership within HR—I do not just mean the head of it, but through the HR system—have their finger on the pulse of the culture. That seems to me important, as well as the compliance.

Finally, internal audit, the third line of defence, is critical, as you say. Yes, there should be not merely a strong internal audit function but a strong governance function of the internal audit, so reporting to the board audit committee is essential. It is not the case that none of this was there before, but it is the case that some of it was weak before. In particular, the compliance function was weak and front-line management was often not imbued enough with the values of the company—let me put it that way—in many cases, so there was clearly work to be done.

I do believe and will take this opportunity to say that the Fair and Effective Markets Review is an extremely good report. It will lead to an open forum being run by the Bank of England this autumn, which will give it more resonance. They are committed to starting an international dialogue, which is important given the international nature of the markets. A lot of their recommendations will have holes in them unless you can turn them into global standards. If we got to a position in, say, five years' time where the substance of what they are talking about in that report is in place through the markets, we would be in a whole lot better position than we have been.

Q16 Baroness Wheatcroft: We have already had LIBOR and foreign exchange scandals, et cetera. Do you think there are still more to come before we can feel confident about the banking industry making a clean start?

Lord Green of Hurstpierpoint: I do not know. I honestly do not know. I would suspect that the really big things have already come out into the open, but it is inevitable that, in an era of much higher standards of expectation, which is where we are now at, when you look back you will find things that did not live up to those. Therefore, I do not think you can say that all the so-called one-offs that have been coming through the banks' P and L statements have come to an end. No, I do not think you can, not to mention, of course, the issue of mitigation that follows on from some of it. I am not going to chance my arm.

Sir Winfried Bischoff: It would be unusual if nothing else happened. I happen to think that the severity of the misbehaviour in LIBOR and in foreign exchange is probably not there. I hope I am not going to be proved wrong, but there may still be some other benchmark indices. Liquidity could be a problem. You could have other things, perhaps not in the banks but in asset managers, with the thought that you can redeem today, but is the liquidity going to be there? There are inherent possible accidents, but the severity is probably not going to be there to quite the same extent.

Baroness Wheatcroft: That being the case, do you have confidence that the Banking Standards Board will be effective?

Sir Winfried Bischoff: We have mentioned FEMR, the Fair and Effective Markets Review. We have the Banking Standards Board and the Markets Standards Board for FEMR. I would hope that there will not be a plethora of bodies and that we can have a small number that can concentrate on these standards. I am very much in favour of the Banking Standards Board, but I would hope that perhaps over a period of time there would be a coalescing of some of these bodies into one or two bodies, rather than just a plethora.

Baroness Wheatcroft: Would it be surprising if people were slightly dubious about a board that is funded by the industry?

Sir Winfried Bischoff: If you are not going to get it funded by the industry, who is going to fund it? Does government wish to fund it? Many of the regulatory aspects are funded by the industry. That is the way that it works here and in the United States. That is the reality of life, whether it is the FCA, the PRA, the FRC—my organisation—or whatever it is.

Lord Green of Hurstpierpoint: It would be a tad cynical to assume that people are just going through the motions in the Banking Standards Board. I also think that the single most important recommendation, or one of the topmost recommendations, of the FEMR was precisely the setting up of the Markets Standards Board. Clearly you have to presume that people are taking this seriously, but all the evidence from the Banking Standards Board is that they absolutely take it seriously and they have every incentive to take it seriously. They have seen enough reputations damaged. They do not want a continuation of the fairly awful experience that they have had in recent years.

Sir Winfried Bischoff: Just in relation to that, it is not just the UK institutions that are responding to it; it is also the international institutions that are operating in the London market. That is a very good thing. There is an industry-wide acceptance that this is necessary.

Baroness Wheatcroft: The complaint generally is that although the reputational damage has been received by the institutions, most individuals who were involved seem to have gone onwards and their earnings upwards.

Sir Winfried Bischoff: That is what Lord Turnbull mentioned, and I am quite clear that the senior managers regime, as well as the FEMR, will in fact correct some of that.

Q17 The Chairman: Lord Green, you have made it clear in this session that you were not directly involved in a number of the key acquisitions. You were nevertheless the chairman or a senior executive. Looking back, are you not surprised at the lack of curiosity, the lack of scepticism or the lack of questioning not only by the executives but by the board of directors? What lessons do you learn from that?

Lord Green of Hurstpierpoint: I want to make it clear that I may not have been involved in the acquisitions but I was on the board and did support these acquisitions—I do not want any wrong implication to be drawn—and therefore share the responsibility for them. Like I said earlier, in respect of the two that we have talked about quite a lot, there were things that we should have done differently, with the benefit of hindsight. I do not believe that the problems lay in inadequate consideration of the merits of the acquisition upfront. In general, the problems have lain in an insufficiently robust implementation of recommendations from internal audit reports and a weaker compliance function than was wise. Yes, we should have addressed those.

The Chairman: That brings this session to an end. Can I thank you both very much for your helpful and informative answers? Thank you.