



## Treasury Committee

### Oral evidence: [Independent review of the report into the failure of HBOS](#), HC 654

Monday 14 December 2015

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Members present: Andrew Tyrie (Chair); Mark Garnier, Helen Goodman, Stephen Hammond, John Mann, Chris Philp, Mr Jacob Rees-Mogg

Questions 1-97

#### **Examination of Witnesses**

#### **Examination of Witness**

*Witness:* **Andrew Green QC**, Independent Reviewer of FSA Enforcement Actions into HBOS, gave evidence.

**Q1 Chair:** First of all, thank you very much for coming to give evidence to us this afternoon. On behalf of the Committee and Parliament, I would like to say a particular thank you for taking on this role, onerous and demanding as it has been, and for producing such a lucid report, which is the basis of the hearing this afternoon. Can I begin with a pretty straightforward question, which is: why do you think the regulators were so chary about being robust on enforcement?

**Andrew Green:** In my report, at the end in section D(9), I have identified six reasons as to why I think mistakes were made. Those created, in effect, a perfect storm of problems. You have, for example, enormous internal pressures with work; you have inadequate internal procedures.

Perhaps if I have to identify one of them above the others, it is the fact that there was a real concern within enforcement about losing cases. They would start off at the point at which they were considering whether or not to investigate and they would ask the question: are we ultimately going to win this? As I have described in the report, that was a misguided approach because, until such time as you have conducted your investigation, you cannot have any real idea as to whether ultimately you are going to win. There was this very negative approach within enforcement to actions against senior bankers. If I had to identify one factor, it would probably be that, but you have to take into account the totality of the reasons that I have given.

**Q2 Chair:** The Parliamentary Commission on Banking Standards recommended, and it has now been enacted, that we had a senior managers regime that brought about much more direct lines of accountability and emphasised individual responsibility, somebody carrying the can for particular decisions. If that already been in place, in what respects do you think the decisions of the regulators would have been easier?

*Andrew Green:* That regime is yet to come into force and so it is very difficult to see how it is going to work out in practice, but it seems to me that the statement of responsibilities, which is absolutely at the heart of this proposed senior managers regime, might well be something that will be of assistance to the regulators.

If you go to paragraph 156 of my report, I am dealing, at that stage, with the decision-making process in relation to Mr Hornby in early 2010, when the regulator was considering whether or not to investigate him. Ultimately, it decided not to do so for reasons that I say were misguided and wrong. Now, in paragraph 155, you have a report within enforcement, and this is the point at which somebody within enforcement says it appears that “the low evidential hurdle test for launching an investigation is met”. Notwithstanding that, what then happens in that section is that the individual identifies various problems with nevertheless pursuing Mr Hornby. If you go the bottom, he says, “In addition, it is likely that we will be drawn into a difficult position of seeking to separate [Andy Hornby’s] behaviour from that of the head of risk and group FD.” The concern was how we separate out Andy Hornby’s conduct and responsibilities from those of others.

Now, if you have the statement of responsibilities, I am assuming that that problem would not arise, and so it would be easier for the regulator to allocate blame, or potential blame, in the circumstances. The new regime is likely to be helpful in some regards. Having said that, as I understand it, it will still be necessary to establish personal culpability and I think establishing personal culpability will always be a very big ask when you are dealing with senior bankers.

**Q3 Chair:** I have noticed that you talked about blame and then culpability, but really the first stage is responsibility. It is a statement of responsibility, not necessarily blame. “Were you responsible for this? Right now, are you culpable to the point that subsequently enforcement action should be taken?” It is a two-stage process.

*Andrew Green:* Absolutely, and the allocation of responsibilities in this way will enable the regulator to decide, at an early stage, if this is somebody we should be investigating, and then we would investigate them and decide whether, ultimately, we are going to be able to establish personal culpability in subsequent prohibition or misconduct proceedings.

**Q4 Chair:** You made pretty clear in your report that you thought the regulator could have done better, a lot better. Do you think they need a senior managers regime?

**Andrew Green:** That is a point I would like a little more time to think about.

**Chair:** You could see it coming, though, because you were smiling even before I got to the question.

**Andrew Green:** That is true. Obviously the FSA is a defunct organisation.

**Q5 Chair:** There are successor bodies.

**Andrew Green:** I am sure the successor bodies are very mindful of the criticisms that have been made of them or of their predecessor, and are certainly looking to do a very much better job than was done in this case.

**Q6 Chair:** Do you think identification of individual responsibility within regulators might have a role to play in helping them to do a better job?

**Andrew Green:** It was no part of my terms of reference to allocate blame to particular individuals. I was assessing the reasonableness of the conduct of the organisation as a whole, and that is very much what I have done. Certainly it is no part of the analysis I have done to point the finger of blame at anybody.

**Chair:** I was not asking you that, though.

**Andrew Green:** You were asking me whether, as a matter of principle, it is sensible to point the finger of blame at anybody.

**Q7 Chair:** It is to have a structure within the regulators, where the regulators themselves know who is individually responsible.

**Andrew Green:** I certainly cannot see any downside to such a regime.

**Q8 Chair:** Did you identify the absence of it when you were looking?

**Andrew Green:** That certainly was not something I was looking for.

**Chair:** It was not a major issue.

**Andrew Green:** No.

**Q9 Chair:** You have made clear your disappointment at the removal of a number of names. We are talking about individual responsibility here. Individuals have to be named if they are going to be responsible, so perhaps you could just explain to the Committee and those listening what your concerns were.

**Andrew Green:** The view I took was that, for everybody I identified in my report, their names should appear in the final version of the report, so there ought to be full

transparency. The view that the regulators took was that they did not want to identify any former FSA employees below the level of director, so that would include heads of department, managers and anybody below as well. I made it very clear that I took the view that there should be full transparency; the regulators obviously disagreed.

**Q10 Chair:** On what grounds?

*Andrew Green:* There were two grounds, as far as I recall. The first was that identifying less senior personnel would perhaps inhibit their decision-making processes or inhibit robust decision-making going forward. The second reason was that they wanted to protect their employees. The view that I took, first of all, was that neither of those reasons was sufficiently compelling to remove people's names. In any event, the first of those reasons did not strike me as a particularly compelling reason at all.

That was a matter that I raised with you, sir, in September last year, inviting the regulators to reconsider their decision. They did not, or perhaps they considered the position again, but were insistent on removing names. One of the slight oddities of it, or perhaps one of the unsatisfactory features of it—and I can give this by way of an example—is the 9 January 2009 meeting, which is where the regulator decided to pursue only Mr Cummings. I deal with that in paragraphs 76 to 79. There were four FSA employees who attended that meeting and were no doubt involved in the decision-making process, two from supervision and two from enforcement. All four of those individuals have been given fictitious names and have not been identified. Now, I regard that as somewhat unsatisfactory.

**Q11 Chair:** There is only one issue I want to pursue further in this area. You are saying, as you put it, “somewhat unsatisfactory”. Is that diplomatic speak for unacceptable and not in the public interest?

*Andrew Green:* I certainly take the view that it was in the public interest that there should be full transparency, so it is not in the public interest that there has not been full transparency.

**Chair:** And unacceptable?

*Andrew Green:* I have said unsatisfactory. If you want to use another word, I am not going to have a row with you over that.

**Q12 Chair:** The reason I raise it is that the Committee has the authority, if it wants to exercise it, to require the provision of these names and we will have to take a view ourselves, in private session, about this. We have no intention to go on any witch hunt. We want to do what is in the public interest, and have spent £7 million or whatever it is producing this report in order to learn lessons and improve the quality of regulation in this country. We will want guidance from you and the specialist advisers we appointed to help us come to a decision on that.

*Andrew Green:* It is very difficult for me to say more than I have said already. I regard it as an unsatisfactory situation. I take the view that there should be full

transparency. As far as I am concerned, the regulators' reasons were not sufficiently compelling to remove the names.

**Q13 Chair:** You are basically saying that there is a public interest override to the two concerns expressed, one of which you completely dismiss.

*Andrew Green:* Indeed.

**Q14 Chris Philp:** Mr Green, thank you for your extremely thorough report and for the time you have taken to prepare it. Looking at paragraph 8 of your report, you describe their enforcement investigations as “not reasonable” and their decision-making process as “materially flawed”, which are obviously quite strong criticisms. You have already hinted at some of the reasons behind that, but could you amplify for the Committee what you think the particular flaws were which your investigation uncovered?

*Andrew Green:* The particular flaws are then set out in paragraph 9. First of all, the initial decision-making process in late 2008 and early 2009 was materially flawed, in circumstances where the only person who was ever properly considered for enforcement action was Mr Cummings. The scope of the investigation was too narrow and should have extended to Mr Hornby, so that was unreasonable. The decision in March 2010 not to investigate Mr Hornby, albeit in relation to the corporate division rather than in relation to the wider problems in the bank, was also unreasonable, and there was inadequate communication within the FSA throughout this period.

**Q15 Chris Philp:** You have mentioned that you think Mr Hornby should have been investigated on at least, if I counted correctly, two occasions. What is your basis for having reached that conclusion?

*Andrew Green:* There is no doubt that the statutory threshold test for investigating Mr Hornby was met. That is the test under Section 168 of the Act. It seems to me that the FSA then had to consider all the relevant circumstances in deciding whether or not to investigate him. That is the procedure they set out under their own enforcement guide. It seems to me that, in circumstances where the CEO of a systemically important bank fails, is failing across multiple areas, not just corporate but treasury and international, and is clearly overly reliant on wholesale funding, given the CEO is responsible overall for the control systems in the bank and has oversight on the board for risk management, it is pretty obviously in the public interest that he should have been investigated in early 2009, in those circumstances.

**Q16 Chris Philp:** You have laid down an extremely compelling rationale as to why he should have been investigated. Why do you suppose he was not?

*Andrew Green:* First of all, the reason why he was not investigated in early 2009 is because the only person who was ever considered for investigation was Peter Cummings. The decision-making process was significantly flawed and no one appears to have even

considered in those early months whether or not to investigate the CEO. Two or three more junior employees raised the question why not the CEO, and that question appears never to have gained any traction among the senior employees and was never the subject of any discussion. There was never any consideration of Andy Hornby in those early months.

Perhaps the most significant reason for that is what was described by one employee as the “richness of information” relating to Peter Cummings. From the moment this went wrong and from the moment they started considering enforcement action, because of the richness of information relating to Peter Cummings, he was the only person who was ever considered.

**Q17 Chris Philp:** This is extraordinary, because simply having one person whose culpability appears to have evidence attached to it is no reason for overlooking other misdemeanours.

*Andrew Green:* That is particularly when it was absolutely clear to the FSA by late 2008/early 2009 that the problems in the bank extended well beyond the corporate division.

**Q18 Chris Philp:** Yes, it is extraordinary. If you roll the clock forward, at which point within the FSA did these flawed decision-making episodes appear to cease, or did they continue for an extended period of time? Was it just 2009-10 or did it go beyond that to the point when the FSA passed over its powers to its successor bodies?

*Andrew Green:* One has to bear in mind that, by mid-2011, the time for investigating anybody else for misconduct had gone. Really the key flaws in the decision-making processes were late 2008/early 2009; then there were significant flaws in the decision-making process relating to Andy Hornby in January, February and March 2010. During 2009, there was a failure within the FSA to consider whether or not they ought to be extending the investigation beyond Peter Cummings.

**Q19 Chris Philp:** The situation with HBOS, in common with many other banks at the time, was evolving on certainly a monthly and possibly even a weekly basis. As the situation of the bank deteriorated materially, do you feel that the FSA was sufficiently on top of that changing situation or was it looking at a snapshot of what had occurred previously?

*Andrew Green:* That is a very difficult question for me to answer, because it really involves the question about supervision in the period leading up to the failure of the bank on 1 October 2008. I do not think I am really in a position to answer that.

**Q20 Chris Philp:** What level of comfort do you have that the slightly altered approach of the successor entities to the FSA would prevent a recurrence of this sort of episode, or is that again hard to say?

**Andrew Green:** It is very hard to say. I can say that I would hope that, if the recommendations I have given in relation to internal procedures are adopted, and I have no reason to believe they will not be, going forward, we will have rather better and more robust decision-making processes. In answer to the question of whether this could ever happen again, you cannot legislate for the fact that people will sometimes be under enormous pressure, as these people were at the time within the FSA. When people are under enormous pressure, mistakes are made.

**Q21 Chris Philp:** That really comes to my final question, which is to say that you can invent the most perfect set of procedures but, if the individuals operating those procedures, for whatever reason—pressure or otherwise—exercise flawed judgment, then you will still get a flawed outcome, no matter how good the procedures may be. I wonder if you would agree that attention needs to be paid, first, to the individuals being placed in these positions but, secondly—and the Chairman hinted at this earlier—to the scrutiny and standards that they are held to and the sanctions that can be applied to them, should they be asleep at the wheel.

**Andrew Green:** I agree with that. All of the propositions you have made I do not dissent from.

**Chair:** It is very good to have a witness who can get straight to the point like that.

**Q22 Stephen Hammond:** Good afternoon, Mr Green. Like others, I would like to echo my thanks to you. Can we pick up on some of what you have just said and some of the things that are in your report? You have just described the investigation or the failure to investigate as “materially flawed”. That raises two questions. At points, you say you get the impression that the staff were committed and hard-working, yet they produced a materially flawed investigation. That suggests to me a lack of detail from the director of enforcement, in terms of how the investigation should have operated, or at even more senior levels. Is that your conclusion?

**Andrew Green:** It is not explicitly my conclusion. What I have done in section D(10) is set out my reasons as to why I think mistakes were made. That is partly to do with internal procedures being inadequate. It is partly to do with enormous pressure on individuals, and it is also partly to do with the fact that the regulatory regime at the time did not encourage people to be particularly ambitious in their approach. Those are the reasons why I think mistakes were made.

You asked me to identify whether or not there were particular individuals. It was no part of my remit to allocate blame to particular individuals, and I have not done that, save for paragraphs 353 and 354, where I do say there was inadequate communication between Sir Hector Sants and enforcement. That certainly does strike me as a significant problem.

**Q23 Stephen Hammond:** I was going to come on to that in a minute’s time, but I will come straight to that point before I go back to the other point. You have just made that point. Was that disconnect a resistance of staff? Was that a failure of the chief executive to get his message across? If it was the resistance of staff to

listen, for instance, then that would be another good reason for having those names being made transparently available.

*Andrew Green:* It is very difficult to know exactly what the cause of the problem was because, on the one hand, what you had, as we see in paragraph 353, was Hector Sants setting what he called a tone, which encouraged ambitious enforcement action in relation to the failure of HBOS, yet the approach that was adopted by enforcement was very different. The approach, as I have already said, was that they simply would not investigate unless they took the view that there was a very good chance of a successful outcome. There was a significant mismatch between what Sir Hector Sants was setting as the tone from the top and what was then going on operationally, on the ground.

Again surprisingly, Sir Hector Sants appears to have been entirely unaware of the fact that enforcement was adopting a rather different approach, and indeed he appears to have been unaware of the fact that enforcement had concluded that the statutory threshold test for investigating Andy Hornby was met. Now, who ultimately was responsible for this particular failure of communication? It is very difficult to say.

**Q24 Stephen Hammond:** In terms of the ambitious enforcement, surely, in any other corporate environment, that would be taken as a failure of the chief executive to communicate to his staff what he expects to happen.

*Andrew Green:* Ultimately, where a chief executive sets a particular tone, if that tone is not followed through, the chief executive must bear responsibility for that.

**Q25 Stephen Hammond:** Not being aware of the threshold is a key point, in terms of whether an investigation into Mr Hornby could or should have taken place. Do you regard that as the senior executives of the organisation simply not being up to speed and perhaps taking their eye off the ball?

*Andrew Green:* Somewhere between enforcement and Sir Hector Sants, somebody was taking their eye off the ball. Sir Hector Sants should have been told that enforcement took the view that the statutory threshold test for investigating Andy Hornby was met. Why he was not told that I simply cannot explain. It may well be that it was because people were under so much pressure at the time.

**Q26 Chair:** You are confident he was not told.

*Andrew Green:* He certainly said he was not told and I have no reason to doubt that.

**Q27 Stephen Hammond:** Given that failure, do you think it is reasonable for the Committee to conclude that certain people in senior positions of this regulatory authority should not be approved to undertake those sorts of roles in future?



*Andrew Green:* That is way outside my remit. It is not something I have considered. I would be very reluctant to offer a view on that.

**Q28 Stephen Hammond:** To try to cover something that is within your remit in one of my last two questions, you highlight in your report that there was a failure to record decisions, minutes, correspondence and important decision-making processes in relation to the direction of enforcement actions. Could you give the Committee your view on why that happened and why that culture was allowed to build up?

*Andrew Green:* Part of the problem was that there were inadequate internal procedures. That is probably the key problem. There were no internal procedures that required the FSA, when they were considering enforcement action, to identify all of those individuals in respect of whom the statutory threshold test for investigating was met and then require them to decide, in the light of all relevant circumstances, which of those individuals they were going to investigate and which they were not and record that in writing. There is no doubt that a significant factor here is the absence of internal procedures.

Beyond that, I assume that the reason why the decision-making processes were so flawed in the respects that you have just identified is simply that people were under enormous pressure to do something, and they had many other things to do. This was one of many things they were doing. As I have said, there was a richness of information in relation to Peter Cummings, so they alighted on Peter Cummings and everything else was simply overlooked.

**Q29 Stephen Hammond:** I take your point about time pressures, but we can all argue that as a defence.

*Andrew Green:* I am not giving it as a defence. It is simply that I think that is the reason why it happened.

**Q30 Stephen Hammond:** Is the failure of the ability to record board minutes, standards and that sort of thing just a reflection across the board, in all areas, of a laxness inside this organisation at the time?

*Andrew Green:* It is very difficult for me to comment about laxness across the board in the organisation. Certainly, I have seen a number of problems, and the problem that you are alluding to there is the problem with the ExCo minutes. The problems with the ExCo minutes are very surprising; the fact that the board itself could not or did not ensure that its minutes were accurate is very surprising and unsatisfactory, as I have said in the report.

**Q31 John Mann:** Did you view or look at the transcripts of the Treasury Committee meetings with the FSA at the time, in this room or a nearby room, in 2009, 2010 and 2011?

*Andrew Green:* I may have looked at some of them, but I do not recall that. I certainly looked at the Treasury Select Committee report on the banking crisis, for example. I looked at various TSC documents, but I do not recall looking at those.

**Q32 John Mann:** Perhaps I or others should have highlighted that to you. It is not a criticism, but there is a very interesting approach within the FSA to answering questions, whereby the chairman was always much keener and more dominant in taking the lead on what the position and role of the FSA should be. He gave the impression that the new FSA, with its relatively new chief executive and its new chairman, was an entirely different beast from the previous one. That was the impression I got, sat and questioning at the time. Do you think that that impression has been proven to be accurate?

*Andrew Green:* In a sense, you are asking me to mark the scorecard of the new regulator.

**Q33 John Mann:** I mean over the two or three years from 2008 to 2011, when they were at the heart of moving on these things. Were they a different beast from what was there before, in your view?

*Andrew Green:* That is terribly difficult for me to say. All I have been able to do is effectively assess the story from late 2008 to mid to late 2012. What I have not done is identify any particularly fundamental problems in late 2011 up to late 2012, subject to the deficiencies in the ExCo minutes.

**Q34 John Mann:** In terms of the starting point that the FSA had, the mind set of the FSA at the time appeared to be business as usual but to keep an eye out and, if there are easy pickings, go for those easy pickings. Is that way off the mark, do you think?

*Andrew Green:* I certainly think that is fair in relation to Peter Cummings. On this richness of information point, they took the view that Peter Cummings was the key person to go for because they had lots of information. I think “easy pickings” is perhaps an unfair way of putting it, but he was the easiest of the pickings.

**Q35 John Mann:** The FSA is a revolving door, or has been, into the industry. That is demonstrably the case. It is almost self-regulation, in the sense that it is the same players moving backwards and forwards. Was the culture at that time a fundamental problem?

*Andrew Green:* That is terribly difficult for me to comment on. I can comment on what I saw throughout the course of the period that I was dealing with in my report and in the context of HBOS alone. I am not really in a position, I feel, to make wider criticisms of the organisation as a whole.

**Q36 John Mann:** There was no shortage of people raising issues in relation to HBOS with the FSA in public, including myself and other members of the Committee. Was Lord Turner too close to both Government and the financial sector at the time to be effective as chairman?

*Andrew Green:* Again, sir, I do not wish to be unhelpful, but it is something that simply has not hit my radar in the course of doing this review, so I would not be in a position to give you a helpful answer to that.

**Q37 John Mann:** You are seeing the internal documents. You are seeing what is happening. You are seeing how meetings are being run and how investigations are being picked out. It seems to me that you are hedging your bets rather too much. You have had the chance to look from the outside, but with a lot of expertise, demonstrably so. You are therefore in a good position to grasp what the culture was and why people were doing things or not doing things.

I am putting to you that my observation at the time, not now but at the time, was that it was all too cosy, nothing was going to change and this was all about just managing everything, because it was a major financial crisis and we all had to get over it for the sake of the country. It was steering out of the crisis, rather than looking at what the role of regulation should be. That was my impression at the time. You must have some inkling or insight into what the culture was and whether it was all too cosy.

*Andrew Green:* I did not take the view, or it did not occur to me throughout the course of my assessment, that this was a culture that was all too cosy. Primarily I was looking at the culture within enforcement and, actually, these were people who were working very hard and were committed to their jobs. They were doing their best. They fell down in this particular instance and they fell down very significantly, but I certainly did not form a view that there was a lazy or a cosy culture within enforcement.

**Q38 John Mann:** There was a culture of weighing up the public relations benefits of each enforcement action, was there not?

*Andrew Green:* They looked to the public outcome, without a doubt. I am not for a moment suggesting that they should not do so. It is an institution funded by the public. The public interest is important. Lord Myners said to them at one point that it is in the public interest to take ambitious enforcement action, so it is perfectly legitimate for them to look at the public interest. No, I did not take the view, at any stage, that they were too cosy.

**Q39 John Mann:** If you are looking at public outcome and defining public outcome, some people, at the time and perhaps now, would define public outcome as not rocking the boat, in order that the financial sector can recover and re-engineer the UK economy, UK plc.

**Andrew Green:** In the few months after HBOS failed, it is noticeable that they did not consider enforcement action until very early December, so a few months after the failure. What they were doing in those first few months was trying to make sure that they kept HBOS afloat. It would be difficult to criticise them for wanting to do that.

**John Mann:** That then continued.

**Andrew Green:** They did then continue to consider enforcement action, but they considered it in a way that, as I say, was materially flawed and deficient.

**Q40 John Mann:** My final question is: is there one specific fundamental change to the concept of regulation that you think needs to happen?

**Andrew Green:** That is an extremely broad question. I would need a little more time to think about that. I am perfectly happy to come back and give you my views on that. I have to say I think a fundamental thing that would help avoiding some of these problems in the future is the adoption of my recommendations in relation to internal procedures relating to decision-making processes. That would make a significant difference.

**Q41 Mark Garnier:** I would like to ask you a bit about Maxwellisation but, before I do, can I ask one or two about the length of time it took for this whole process to go through? This is not necessarily a criticism of you, but one of the FSA for refusing to start work on this review until 2012, citing the reason that it could jeopardise existing enforcement proceedings. Do you think that is a fair comment from them and do you think also it misses the opportunity perhaps to learn lessons early on, while they are fresh in people's minds, by delaying this?

**Andrew Green:** That is certainly a fair point. Having said that, it was on the recommendation from the Chairman that the FSA took advice from leading counsel as to whether or not they should in fact pursue the production of an HBOS report while the enforcement action was proceeding against Mr Cummings. The advice they got was that it would be sensible not to start an HBOS report while those enforcement proceedings were ongoing. In the circumstances, it would be difficult to criticise them for adopting that position.

**Q42 Mark Garnier:** Aside from possible Maxwellisation problems, were there any reasons why it took such a long time to get to the end of this process?

**Andrew Green:** The position is that I was appointed by the regulators in January 2014. I was then approved by the Treasury Select Committee, following a private session in February. The lion's share of my work with my team was done by the end of August and I delivered a first draft report to the regulators on 7 September 2014. From then on, it was primarily issues about legal privilege, the naming of people, confidentiality and then Maxwellisation.

**Q43 Mark Garnier:** Before you got to the Maxwellisation part of it, how long would that have taken?

*Andrew Green:* I delivered my first draft pre-Maxwellisation report on 7 September. There were then about two months of issues with the removal of names and with a few legal privilege issues. I delivered my Maxwellisation draft on about 11 November, and then we were into Maxwellisation. The last submission I got was very early February and the position is that my report was going at the same pace as the main report, and then I re-Maxwellised one person, who took some time to respond. The final version I sent to the regulators on 7 May, and then there were further issues about consents.

**Q44 Mark Garnier:** We are coming now to the slightly technical details of the process of Maxwellisation. When you say you re-Maxwellised, was this as a result of an individual coming back and saying that they wanted to change it?

*Andrew Green:* No, it was as a result of various issues that had been raised by other people. I then went back to the documents and wanted further information.

**Mark Garnier:** From this individual.

*Andrew Green:* Yes.

**Q45 Mark Garnier:** The reason I am slightly focusing on this is because I have heard indirectly, it has to be admitted, that one of the witnesses was uncomfortable about the fact that, having gone through one process of Maxwellisation, somebody else had been given two bites of the cherry. They were worried that, given the fact that the report could then come back changed, as a result of that second bite of the cherry, other witnesses were not given the opportunity to have a second go at Maxwellisation. Does that ring true to you and do you think that is fair?

*Andrew Green:* I do not want to get into the details of precisely what it was I was re-Maxwellising on, but it did not prejudice anybody else, so I do not think that that is a fair concern. I will say that quite a number of people said, "We would like to see your next version, so we can make sure that you have taken on board our Maxwellisation comments." A lot of people did want a second bite of the cherry and I was not prepared to go down that route.

**Q46 Mark Garnier:** You did not give that to them. The important point is that, as far as you are concerned, everybody was treated absolutely fairly.

*Andrew Green:* Yes, everybody was treated fairly and there was a very specific reason why I wanted to re-Maxwellise one particular person in relation to certain paragraphs.

**Q47 Mark Garnier:** As far as you are concerned, nobody was particularly difficult about anything. Nobody was delaying it any longer than perhaps it would have taken anyway. There was no trouble with it.

**Andrew Green:** No. Actually, I found the Maxwellisation process really quite helpful and relatively painless. You have to bear in mind that my report was a very self-contained report, in terms of the time period it was covering, in terms of the events it was covering and in terms of the number of people I was dealing with. It was very self-contained and very manageable. When you are dealing with a report that is much broader in its ambit, then I can see that things can easily get out of hand.

**Q48 Mark Garnier:** I was not going to ask you that until you ventured your own opinion of that, but do you think that Parliament should do something about Maxwellisation getting out of hand? Should Parliament legislate some time restriction on it or do you think that would be unhelpful or unfair?

**Andrew Green:** The difficulty with any time restriction is it very much depends on the ambit of the report. In a report like mine, it is perfectly possible to say that people should have no more than two months.

**Q49 Chair:** Asking it differently, is there some means by which we can reform Maxwellisation in order to ensure that it does not become a source of vexatious delay?

**Andrew Green:** That is obviously a very topical, a very interesting and a very difficult question.

**Chair:** So it is one you would have thought about a lot.

**Andrew Green:** I would need a little more time to think about that.

**Chair:** We would be interested to have your advice on that question.

**Andrew Green:** I am very happy to come back on that.

**Q50 Chair:** Have you given any thought as to whether the regulatory decisions committee is in the best shape that it should be and whether that needs further reform? You have seen the proposals that have been knocking around on that issue for some time, so that is topical.

**Andrew Green:** That is topical but, again, rather outside the scope of my terms of reference. I was not considering the RDC process at all, as part of my report, and there was really no reason to do so.

**Q51 Chris Philp:** I have a very quick question on Maxwellisation. There was a report in *The Guardian* newspaper, which I do not normally read, on 21 July of this year, which said that investigators, so you, needed to get the permission of the individuals criticised. That is not right, is it? You do not need to have their

permission, merely give them a chance to comment, which you may then either take on board or ignore. There is no right of veto, is there?

*Andrew Green:* No.

**Chris Philp:** I wanted to check that. Thank you, Chairman.

**Q52 Chair:** I should end by asking you how much your report cost. I do not know whether that is in the public domain, but I have not seen the figure.

*Andrew Green:* The total amount charged by my team, so that is by me and by the two junior barristers at Blackstone Chambers working on it with me, was £499,000.

**Chair:** We are very grateful to you, not only for knowing that answer, which is always useful, bearing in mind this is ultimately public money one way or another, but also for having put in the hard work that you and your team have on all this. You have produced a very thorough report, which we will be considering carefully in the weeks ahead. Thank you very much for coming to give evidence to us this afternoon.

### Examination of Witnesses

*Witnesses:* **Iain Cornish**, Independent Reviewer/Committee Specialist Adviser, and **Stuart Bernau**, Independent Reviewer/Committee Specialist Adviser, gave evidence.

**Q53 Chair:** I would like to start where I left off, really, which is with thanks to both of you. If Andrew Green had a difficult job, you had an even more difficult one. You started off on this process thinking you were going to be at it for a few months, and you have been at it for, what, three years or something like that.

*Iain Cornish:* It has been the best part of three years, yes.

**Q54 Chair:** You look pretty much the same as you did when you came in to see us at the time you were appointed, so it obviously has not done you any harm, outwardly at least. We are very grateful to you for doing this work. It is a very tough job, and thank you on behalf of Parliament. The first question has to be the fact that it seems regulators have been falling back, time and again in the main report, on the line, possibly you could argue an excuse, that their failure or their shortcomings are down to the climate of the times. It is a phrase that crops up from time to time. Would you say that that is a reasonable summary?

*Iain Cornish:* Do you mean the regulator's own failings or HBOS's failings?

**Chair:** I was starting there with the regulator's.

*Iain Cornish:* They put a lot of emphasis on that having been the reason for the shortcomings that have been identified in the review, and that is one of the things that we pressed them on, because it did feel, in the initial drafts, that they reached for that excuse

before even thinking through the material and sifting through the evidence. With that said, clearly there was an agenda of light-touch regulation. The FSA board at the time was very comfortable to buy into that. They highlighted some of the pressures in the economy and some of the pressures in the domestic and global banking environment at the time, but they just did not see those as being anything like as significant as they turned out to be.

**Stuart Bernau:** I would just add that they seemed to be operating in a very intellectual environment, as opposed to perhaps more of a practical environment. That was the view that came across when we interviewed the senior people in the regulator. As you know, nearly all of their work was concentrated on conduct issues, as opposed to the issues around prudential capital and liquidity. There is no doubt about it: they had not really focused on the capital implications of a downturn in the economy or the liquidity position.

**Q55 Chair:** A group of intellectuals at the top somehow disconnected from practical considerations below—is that the impression that you are seeking to convey?

**Stuart Bernau:** Having spoken to them, I would say that our interviews with the people from the regulator were much more forthcoming than interviews that we had with HBOS, because they tended to be on their own, did not have legal representation and tended to give very frank answers to us, but it did not come across as a team working together. They were concerned in their own areas and you did not really get an impression of a team working closely together on some of these issues.

**Q56 Chair:** That does not sound very good either. We have divorced intellectuals and people operating in silos so far, and we have only been going five minutes. Am I summarising that unfairly?

**Iain Cornish:** I would broadly agree with what Stuart has said. The other point is that they simply did not have the information, so assessments were done and reported to the FSA board saying that the banking sector was very resilient and, even in extreme scenarios, there would not be a systemic crisis. It is not obvious how firmly that conclusion can have been based because, as we saw in the case of HBOS, they did not have an understanding of the basic underlying assets that would come under strain if there was an economic downturn.

**Q57 Chair:** Before we get on to one or two other more detailed issues, I would like your general view on what we have really learned about the regulator, the way the regulator is operating, what lessons we should be drawing from that, whether the draft reports that were put before you at the start were more or less up to snuff or whether you felt that a great deal of change was required. After all, that is what you were brought in to do: to verify whether they were doing a proper job and not just marking their own prep, which is what a lot of people were concerned about. Sorry about that rather periphrastic question, but perhaps you could give a feel for what you encountered and what we can learn about the regulator from your experiences there.



**Stuart Bernau:** You have to remember that the regulator, when they started this process, had already conducted their report into RBS. They therefore felt that they had covered a lot of this ground and understood a lot of the issues. At the outset, they did not feel that this would take a long period of time, which was where this initial view came that it would take six to nine months. Initially, they were hoping to produce the report before the legal cutover between the FSA and the two subsequent bodies, and they also thought that they could do it at a much lower cost. They found out that it was a much longer process than they had thought.

One thing that is quite important is that we came on board right at the very beginning and were given packs of material, but pretty early in the process we were also given a first draft of the report. It became very apparent to us at that stage that there was a lot of work to be done in the drafting. Our first three months probably turned up in the region of 1,500 to 2,000 questions around various parts, around all kinds of things.

**Q58 Chair:** When you say a lot of work to do with the drafting, are you talking about the process or approach they were taking being in some way defective and not going to get to what you thought was required, or are you just saying that they were at an early stage and there was a lot more ink that needed putting on paper?

**Stuart Bernau:** They thought that the processes and the challenges they had, based on what they had been through with RBS, would be reasonably simple. The first draft was on that basis. They had brought on outside consultants at an early stage to write one of the chapters. As you know, they had originally produced the part that you have just been interviewing Andrew Green about. We had very serious misgivings around them writing chapter 5, as it was then, themselves.

**Chair:** Chapter 5 being the enforcement section.

**Stuart Bernau:** In the report, yes. We had concerns about that.

**Q59 Chair:** At that point, you came to me to discuss this problem. I had kept completely at arm's length from the process up to that point. We discussed what should be done and you came with a proposal. It might be helpful for the public record that you set that out.

**Iain Cornish:** In answer to your question, there were weaknesses in the process but, fundamentally, there were a lot of areas that we thought were very material to the failure of HBOS, where they did not seem to us to have dug into sufficient detail to reach meaningful conclusions.

In respect of the risk of marking their own homework, we did see that in terms of their analysis of supervision—and we have highlighted in our evidence where we thought they needed to sharpen up—but we felt that was true most acutely in relation to the investigation of enforcement. The first draft was very superficial. Even a cursory look at the underlying raw material highlighted the issues that Andrew Green has highlighted. It was not obvious at all why decisions had been reached. That was the only section of the first draft that we saw that had been written not by the review team but by members of the enforcement team, so we felt very queasy about that.

**Q60 Chair:** It is a pretty shocking state of affairs that you have just described: a superficial report with no clarity about who took what decisions, which was written by the enforcement team. It does not sound very good to me.

**Iain Cornish:** Yes, in relation to that part of the review. It did not feel very good.

**Chair:** It was marking their own prep. It was a completely circular piece of work.

**Iain Cornish:** That aspect of it was absolutely marking their own.

**Chair:** They marked it out of 10, gave themselves 10 and passed it back. That is what you just said.

**Iain Cornish:** It just did not address the fundamental questions, and that was the point at which, as you rightly say, we approached you. We were not qualified to undertake that review ourselves, but we felt very uneasy about that being conducted within the FSA.

**Q61 Chair:** Now you have seen the product from the QC that Parliament put in, do you think that satisfies what was required and has done the job?

**Iain Cornish:** Absolutely, and I do not think anything like that report would have been produced had it been left to the review team to do that.

**Q62 Chair:** Do you agree with those conclusions?

**Iain Cornish:** Yes.

**Q63 Chair:** Bearing in mind where we were—this is in relation to impairment on the balance sheet of a sizable bank, the worst bank failure in British history, which is saying quite a lot, because we have had quite a few—one of your recommendations is that we need a full independent inquiry for these things. I am not suggesting we have one, but, if we did have one, do you think we would get a lot more than we have this time, or do you think at least this process, although it has taken some time, has put into the public domain what is required, in broad terms, to enable people to work out how to avoid these mistakes again?

**Iain Cornish:** Yes, I do. I personally do not think there would be much additional value to be served from any further inquiries, but that is not to say that it has not been a very frustrating process and could not have been better, for the reasons we outlined. As it did not start for so long, some of the evidence had decayed; because records had been lost and minutes were so unsubstantial, it was very hard to say what was going on. Some of the witnesses have been quite defensive. That has made it hard to see what is going on. In broad terms, especially in largely factual areas like the composition of the balance sheet and how that led to losses, we have probably learned as much as we are going to learn.

**Q64 Chair:** Perhaps we could just get on to the removal of names in the regulator briefly. What view do you take on that?

**Stuart Bernau:** We also raised that with the steering group or with the review team.

**Chair:** Perhaps for the benefit of the wider public you could just explain what the steering group is.

**Stuart Bernau:** The review team reported to a steering group, which was chaired by Sir Brian Pomeroy. The senior executive was Andrew Bailey, and they had another non-executive from the PRA and one from the FCA sat on that as well.

**Chair:** We are having them in tomorrow, as you know.

**Stuart Bernau:** We raised the issue with the steering group and, in fact, they responded to us. We wrote to them and we got a response that was approved by the steering group, running through the reasons they were giving for why they did not feel it was appropriate to name the individual below director level. There were a number of reasons for that. They felt that, when they had interviewed those people themselves, they had effectively told them that they would not be named. They had looked at previous reports and people below director level had not been named within them. They felt that it would produce a focus on individuals, which they did not think was appropriate. From our point of view, there was one individual who perhaps had been consistent throughout the whole crisis, who we felt, on balance from us looking at it, should have been named. They gave the reasons to us and they did that in writing.

**Q65 Chair:** Tell me if you think there is any incongruity between the emphasis on identification of individuals in enforcement cases by the regulator, on the one hand, and here the retention of anonymity in the regulator for mistakes.

**Iain Cornish:** That is only true at senior management level and, if this individual had not been in a senior management position and had not, as Stuart has said, been in a key position throughout the review period, we probably would not have felt as strongly as we did. It is also worth saying that, in a sense, it is a shame that it was not just included as a matter of record, in which case people would have just read it and passed on. To now bring that name into the public domain would attract a level of scrutiny and attention that is not warranted by that person's role in the affairs.

**Chair:** We are doubly worse off, really.

**Stuart Bernau:** We also felt that some of the issues that pointed in the report to the senior management at the FSA, which were under-resourcing and turnover, were beyond the control of that particular level. It was at the director level that decisions were being made, and there is an acknowledgement in the report that the supervisory teams were severely under-resourced and subject to a lot of turnover within the numbers as well.

**Chair:** We will come back to a number of other topics in a moment, but we might move on to audit.

**Q66 Mark Garnier:** Can I turn to third-party involvement and particularly that of the auditors? There have been a lot of criticisms of the auditors, but one of the criticisms is that the audit process of HBOS's corporate bank did not involve checking whether loans in the good book had gone bad. Do you think it is

reasonable that that was the case? Do you think there should be more responsibility on auditors to review those loans?

**Iain Cornish:** Yes. Any key processes that the auditor is relying on to reach its conclusions, it feels to me, there is a case for saying they should have tested. In the case of HBOS, the process of allocating loans to the different buckets of performing, impaired and with or without loss was identified to be clearly deficient. You would expect the auditors to have looked at whether that process was working effectively before reaching conclusions about impairments.

**Q67 Mark Garnier:** One of the interesting things was that the impairment deteriorated quite alarmingly over the second half of 2008. The big question really is whether they had got their lending wrong or if this was genuinely attributable to the big problems that were going on in the banking sector and economically at the time. What do you think it was?

**Iain Cornish:** It is impossible to allocate the reasons for losses precisely to a deterioration in the environment, as opposed to the quality of the lending. With that said, if you look at the nature of the lending and its risk profile, versus the risk profile of lending done by other banks, it is clear that the underlying quality of the lending played a very significant part in determining the overall losses. Now, I am sure you can argue about the odd billion at the margins, but the losses were tens of billions.

**Q68 Mark Garnier:** They were. It is an interesting point, because of course they were very keen on expanding their lending book and their assets. Clearly, it turned out that they were being a bit racy, in terms of those people they chose to lend money to. The other thing is the IFRS standard at the time. Do you think, if the auditors had been better at examining and auditing that lending book, and the IFRS standards had been better, then such a big catastrophe could have been avoided?

**Iain Cornish:** The provisioning methodology was pro-cyclical, in that sense. The one element of your question that I might push back on is that it “turned out” that their lending was racy. Actually that was their strategy: sub-investment grade lending.

**Mark Garnier:** Perhaps it turned out that it was racier than even they had anticipated.

**Iain Cornish:** That is probably a fairer summary. I guess that is one of the reasons why we are moving to a different basis of through-the-cycle provisioning to try to help iron out these big cyclical swings in provisioning methodology.

**Mark Garnier:** Of course, auditing is a backward-looking exercise.

**Stuart Bernau:** There are a couple of points I would quite like to make. They did not just do traditional lending, because they lent equity to the same people. They did not just do straight lending. They lent through various channels and they believed they had a way of lending that was different from other lenders. They had a different way of approaching these things and taking different risks. They also liked to support entrepreneurs. They liked to identify entrepreneurs who had been successful, so they liked

to support those, and they also ended up with quite big concentrations of lending within sectors, all of which things data would show you.

Alongside that, they took some big exposures on to their book and their way of dealing with these, instead of pre-syndicating them in advance, was that they lent the full amount upfront and then syndicated subsequently. When the markets became very difficult, they had a big overhang of loans for which they had taken the full amount, which they then could not syndicate into the market. All of those things were apparent.

**Mark Garnier:** That is a very interesting point about the syndication of loans. The fact that you cannot syndicate them means that everybody else thinks you are doing the wrong thing. Surely the auditors should have picked that up.

**Stuart Bernau:** As in all of these things, people talk about the three lines of defence in looking at anything to do with credit. You have your relationship people, who are obviously acting within your terms of reference and policies. You always have a credit control unit, which is acting as your second line of defence to make sure that you are lending to the right people, at the right rate. Then you have a third line of defence, your own internal audit function, which is making sure that they are providing assurance to the board. Obviously they had the audit committee that did that. The external auditors are looking historically but, generally, they are looking at the whole structure you have and how robust the various things are that you have in your organisation to deal with this.

**Iain Cornish:** That is relevant to the auditors once the situation has crystallised. I am not sure that you do look to your auditors to tell you that your basic business model is flawed. They will keep the scores. They will tell you, after it has failed, the extent of its failure.

**Q69 Mark Garnier:** It is interesting that they use the three lines of defence. It is incredibly important, given the fact that the market is a way of marking the homework of all of these lines of defence. If you take on risk and then cannot syndicate it out, somebody must recognise that the market is screaming at you that you are taking on risk at the wrong price: either the guys at the front desk who cannot place it out, the people who are making sure that the trade settles, the internal audit or indeed the outside auditors. The outside auditors must have picked up the fact that, even in retrospect, perhaps they were building too big a book, which was untransferrable.

**Iain Cornish:** That is right. The trouble is that that alarm bell sounds once you are already through the level crossing gates and sitting on the train tracks, because that is a very unusual model. Most people arrange the syndication before originating the loan and it all happens simultaneously. HBOS took it on to their books, so they discovered that they could not syndicate after it was sitting on their books.

**Q70 Mark Garnier:** You are saying that it is not the job of the auditors to turn around and say that that is a bad way of doing it. Presumably it is the job of the regulator.

**Iain Cornish:** It is the job of the management, first and foremost. The regulator was perfectly well aware that that was the model and indeed had highlighted it, at various points, to HBOS.

**Q71 Mark Garnier:** The Chairman has written to the FRC for an explanation of why the audit process was not investigated further. Do you think the failure of the FRC to explain in full its decision not to investigate the audit process really undermines its credibility as an industry regulator?

**Iain Cornish:** I have to say we were really quite surprised. We did not look at this in huge detail. I would make a couple of points. Firstly, the remit of the FRC is to look at KPMG, but it is also to look at both individuals within KPMG and individuals for whom the FRC is the professional body, as it were, within HBOS. Our understanding is that the PRA/FCA review team gave the FRC a lot of documentation, but the FRC then called for some additional documentation from KPMG and I am not sure whether other individuals as well. We understand that they did not go back to the PRA/FCA and ask for any more documents. They did not ask for a discussion of any of the material.

That just struck us as quite shocking, really—just a lack of curiosity, apart from anything else, given a situation of such obvious public interest. We fully appreciate that they are reviewing their final decision now, but it would be very disappointing if they reached the same conclusion without at least doing a lot more investigatory work. I struggle to see why and on what basis at least an investigation cannot be merited.

**Mark Garnier:** Even on a public interest override.

**Iain Cornish:** Even on a public interest test, yes.

**Stuart Bernau:** Having asked the review team what the process was, because obviously the FRC knew that there was going to be a referral and so had a draft referral letter, my understanding from the review team that was doing this is that the FRC made their decision not to make a referral before they received the final letter and before they received the bundle of information from the review team from the actual report.

**Chair:** They took the decision before they had the papers.

**Stuart Bernau:** That is the understanding I have. They took the decision in November 2013.

**Q72 Chair:** That is a novel way of going about deciding whether something is worth taking a look at, is it not? Decide first. That is a reverse form of shoot first and ask questions later.

**Iain Cornish:** We need to be slightly cautious, in that we have not looked at this process in detail. There seemed to be enough in what we did see to suggest that it had not been the most diligent of processes.

**Chair:** I am flabbergasted by what you have just said, Mr Bernau.

**Q73 Mark Garnier:** I was going to carry on with exactly this question. Basically, there is a bundle of paperwork, which was being sent to the FRC, upon which it would have been reasonable for them to make an assumption that they

could then look at this more closely. Based on presumably what they had read in the *Daily Mail*, *The Telegraph* and the *Financial Times*, they made a decision not to do that. Is that essentially what you are saying?

**Stuart Bernau:** Concerning the firm. I think they made a decision about individuals subsequently in 2014. They made a decision for instance around Mike Ellis later on the following year. Based on what we have been told by the review team, so you might get more information tomorrow, they made their decision before they had received the final letter, before they had received the draft details that would have been in the report.

**Iain Cornish:** In answer to your basic question, it feels to us that there should be as much transparency around that decision-making as there has been around other aspects of decision-making in this case.

**Mark Garnier:** It sounds like, if you were on this side of the table, you would be pressing this a bit more.

**Iain Cornish:** We have recommended that in our evidence.

**Q74 Chair:** Before we leave the FRC just for a moment, is there something more seriously wrong with the FRC or is this just an aberration?

**Iain Cornish:** I personally would not feel in a position to answer that question. As I say, we have not looked at this in any sort of forensic detail, but we did not form a particularly positive impression, I think it would be fair to say.

**Chair:** Why do you not translate that? That is in diplomatese, is it not?

**Iain Cornish:** I would be very reluctant to generalise from our experience in this instance to how they discharge their functions more broadly. I would not feel qualified to do that.

**Q75 Mark Garnier:** I just have a couple of loose-end questions. The quality of the information provided to senior management is something that was raised by the regulator's report. Do you think that the auditors have a role to play in making sure that the senior management gets the best quality dashboard about how the business is running?

**Iain Cornish:** Auditors should be looking at financial information. More broadly, the information flow to a board should be something that the board itself, and particularly the chairman, takes an interest in. That is where one would look for responsibility.

**Q76 Mark Garnier:** Of course, the auditors get to see the financial information within the firm. What if the auditors see that that is not up to standard or they see that the management is getting a different picture?

**Iain Cornish:** They would see it in relation to financial information, but there is a lot more information that goes to the board of a bank that is relevant to its health, which is not necessarily directly related to the financial reports.

**Stuart Bernau:** I chair an audit committee of a bank. The first thing now is that the external auditors meet with the regulator, the PRA, once a year anyway in private to discuss any particular issues. As you are preparing your audited accounts, the auditors are going to come to the audit committee. They are going to highlight what they believe are material issues that need to be dealt with. If there are issues that they feel need to be looked at, you have to put a management action plan into place to cover those off for the following year. I am just saying that, probably, since this time here, you have a closer link between external auditors and the regulator, and they are coming through the audit committee. The audit committee obviously has to then report to the board and cover all of those issues as well. Things have moved on somewhat since this time period.

**Mark Garnier:** They would deal with the issues that have been highlighted by these reports.

**Stuart Bernau:** If they have particular issues that they feel that they want to raise, yes, you would have to deal with them.

**Q77 Mark Garnier:** I have a couple of final questions. The report also highlights the exchanges between the HBOS senior management and the auditors. There are always going to be conversations going on between the people who run these institutions and auditors, but do you think that the types of discussions and the types of conversations were healthy, or do you think there could have been a bit of enthusiasm by the management of HBOS to try to get the auditors to see things from a slightly different perspective?

**Iain Cornish:** This is one of the areas that, in a way, are most interesting, because it would be very revealing about the culture in HBOS, but it is one of the areas where it is hardest to tell exactly what happened, because of the paucity of minutes and documents at the time. The sense that we get, as some of the material from KPMG suggests, is that the management put the auditors under a huge amount of pressure. There were individuals within HBOS who felt that the behaviour of the senior management was inappropriate. There is an example of a senior individual in risk claiming that he was excluded from subsequent meetings, having identified the fact that he thought they were not provisioning adequately. None of that is in writing, so it is different perceptions, but you cannot help but feel, looking at all the material from the time, that the level of pressure went beyond that which would be reasonable, given the nature of the circumstances that prevailed at the time.

**Q78 Mark Garnier:** I have one very general question, if I may, about the structure within auditing firms, so it is nothing specific about one auditing firm or another. Presumably, within these very big organisations, the teams that are responsible for auditing Bank X, for example, would be pretty self-contained, I am guessing. There would not be much of a direct relationship between very senior people within these auditing firms and those teams looking after particular accounts. What would the relationship be?

**Iain Cornish:** I would have to look at it in more detail to understand what it was at the time within HBOS, but I think generally there was a quality assurance and a sign-off



process. It would not have been as simple as a partner in the team looking at HBOS having no oversight from anyone else. But I do not know what the precise details of that were, I am afraid.

**Stuart Bernau:** You would normally expect, with a large firm, different bits of the audit company auditing different parts—maybe different international parts—and then there would be a senior partner in charge of the whole audit, which they would feed up into. I would imagine with HBOS, which obviously was a very large organisation, this would have been a very large exercise. There would have been a series of audit teams looking at different bits of the business, and they would feed up through the senior partner—not the top senior partner but whoever had been allocated to deal with it. That person, therefore, would be with that team, and they would be taking things forward at the audit committee.

**Q79 Mark Garnier:** But there would not have been any undue influence coming from other people outside that team—from the senior partner in charge of that group—and nor would necessarily what that team were looking at have been discussed outside, presumably.

**Iain Cornish:** It would be extraordinary if some sort of pressure had been exerted elsewhere within the firm that then impacted on the audit partner and the audit team. We have certainly not seen any evidence of that.

**Mark Garnier:** That is quite clear. Thank you.

**Q80 Helen Goodman:** I want to begin by thanking you for all the work you have done on this. Mr Tyrie and Mr Garnier have been very self-effacing, because they have obviously done a lot of work on this over the last five years, but I am completely fresh to it. One of the things that struck me was the difference in tone between the new report from the FCA and PRA, and the original Parliamentary Commission on Banking Standards. Reading this, it looks far more as if the latest report is, in some sense, saying that HBOS was reflecting the economic climate and the values at the time, rather than being one of the institutions that was creating it. Have you noticed that difference in these two reports?

**Iain Cornish:** I am not sure I would characterise it that way.

**Q81 Helen Goodman:** How would you characterise it?

**Iain Cornish:** The language in the report is more measured, and we have said in our own evidence that some of the conclusions have had to be more circumspect because of the deficiencies in the evidence and the defensiveness of some of the witnesses. With that said, it is very clear that the report highlights where HBOS was an outlier and, in some cases, an extreme outlier in its funding model, in its concentration on highly cyclical commercial real estate lending.

**Q82 Chair:** It was pro-cyclical lending—dramatically pro-cyclical.

**Iain Cornish:** Pro-cyclical, yes, and predictably so. Every 25 years, commercial real estate lending goes off a cliff, so that is not a hindsight judgment. It is ultimately impossible to work out what would have happened if there had not been a global downturn, but it is undoubtedly the case that, even in a common or garden property recession, HBOS would have suffered very significantly. The report makes that clear.

**Q83 Helen Goodman:** Obviously there are questions about the effectiveness of the HBOS board, the risk management within the bank and the strategy of the bank. Do you think that the composition of the board and the appointments made to senior executive positions and in risk management were designed to help deliver the strategy, rather than the other way round?

**Stuart Bernau:** They certainly believed in their strategy, and they probably still believe in their strategy. You have interviewed them, and I think their view has tended to be: “We had a perfectly good strategy, and, if there had not been a global financial crisis, we would have worked through the cycle”, and so they believed in that as they did that. They put together a board. There were intelligent, successful businesspeople on the board.

**Q84 Chair:** But not bankers.

**Stuart Bernau:** Not bankers, and there is this debate that you might have: do you construct a board based on prestige—that it looks very good—or do you base it on experience? They did not have an enormous amount of banking experience, and they did not have that experience within the chief executives that had been there as well—Andy Hornby and James Crosby—because they had come up through a different route. I think, with hindsight, they would have liked to have more experience. John Mack was the first person who really had banking experience, and he came in probably quite late in the process.

There were also some issues raised at this period especially around the group risk director. Right at the very beginning of the period, they decided to appoint a group risk director, and they appointed someone internally and they appointed someone who came from the sales environment. They did not have the experience you would expect in risks and regulation, and not only that but, as you know already, they had quite a turnover of group risk directors. Over the period we are looking at, there were three group risk directors, and none of them came from what you would call a professional group risk environment. With hindsight, I would say that probably was not the best thing that they could have done. It seemed to be that, in pursuit of their strategy, they did not put the same amount of investment into risk as they did into other areas.

**Iain Cornish:** The simple answer to your question is that they appointed a very successful retailer to be their chief executive, and successful retailing has some of the dimensions of banking but not a lot of the key risk ones. You can see the concentration if you read the board papers or risk committee papers: just counting the pages, there is far more about the retail aspects of the business than there is about corporate and international, even though, by the end of the period, corporate in particular was at least as big in balance sheet and profitability terms as retail.

**Q85 Helen Goodman:** The board had individuals on it who were all extremely capable, but it was unbalanced.

*Iain Cornish:* Yes, but, if you are told that your business is world class at something, or if you are told that your funding model is far more exposed than that of other banks, I do not think you have to be a banker to ask about that. Maybe they did; maybe they did not. If they did, there is not a lot of evidence in the papers or in the minutes to suggest that they asked about it or to suggest that anything happened as a result of them asking about it.

**Q86 Helen Goodman:** You are saying that, whatever view one takes about the qualities and experience of the individual members, the responsibility for what happens must rest with the board.

*Iain Cornish:* That is true of any institution. There clearly are some topics where it would have been unreasonable to expect someone who was not a banker to have picked up on the nuances, but there were plenty of other instances where a good businessperson would have been expected to pick up on issues.

**Q87 Helen Goodman:** Was the board weakened by the chairman's tendency, as described in these reports, to deal with conflictual issues offline rather than in main meetings?

*Stuart Bernau:* This comes back to the fact that, when you read the board minutes, you cannot really get any view of discussions that were taking place. When we interviewed non-executives, they all said there were lots of discussions and there were lots of discussions that were taken offline. There is a view in there that the chairman often gave his view at the start of a paper, if you like, and that tended to guide the discussions. But it is very difficult to tell, because there is no factual evidence. The non-executives and the people on the board all say they had lots of discussion, but you cannot actually check to see whether there was.

*Iain Cornish:* I do not think that approach is helpful, personally. If a non-executive has an issue or concern with a paper, it is not unusual, certainly in my experience, for them to come and talk to you about it and say, "These are the questions I am going to ask in the meeting." That is perfectly reasonable, because it gives you a chance to make sure you have the material to answer those questions. If it works like that, that is healthy. In other words, those issues are articulated at the meeting, hopefully, when the executive has been able to respond to it or reconsider whatever it might be.

If conflict is not coming to the board until there has been a resolution, so you do not get other people's perspectives on it and you just get that bilateral dialogue, that is not helpful.

**Q88 Helen Goodman:** I understand entirely what you are saying. I have been in meetings that have been run in that way. Have you seen any improvement in the quality of the recordkeeping in the institution latterly?

**Iain Cornish:** We do not know what has happened with Lloyds, but the institutions I am involved in think much more carefully now about what they record. We are all expected by the regulators to be challenging boards, but quite rightly so. Far more of that is recorded in minutes, in my experience, and minutes are a much better record of the nature of the discussion as well as the decision reached. That is an institution-specific observation rather than the generality of minutes.

**Stuart Bernau:** We both sat as executive directors on boards through this very time period. I always think a good example is the instances of papers that, as an executive, you have taken to the board that have really been pushed back and not approved, because questions have been raised and you have been told to go away, think about them and come back again. That is a question I asked. There was no record, from my point of view, of papers that had gone to the board on whatever issue where questions had been raised and they had been told, "Look, go away and rethink these issues, and bring it back again." That is always a good example of whether a board is working.

**Q89 Helen Goodman:** Either the board and the non-executives were not putting in the appropriate challenge, or there was no evidence that had happened, and that in itself is a problem.

**Stuart Bernau:** I am saying there is no evidence.

**Q90 Helen Goodman:** I understand. I have a couple more questions about the quality of the risk management, about which we have all read a great deal. PwC undertook a skilled persons review in 2004, which found that there should be some improvement, but then they signed off what happened. Do you think that they relied too much on this piece of work by PwC?

**Stuart Bernau:** While the piece of work by PwC gave what I call a general approval to what they were doing, it raised a number of issues around making sure there was clarity at the various levels. HBOS had a federal structure. The corporate division had its own committee. The international treasury division had its own committee. The thing that I find looking at this is that, when you look at 2006 and 2007, an enormous volume of large corporate advances were being put forward for approval, and they were going through the corporate division's credit committee, which was chaired by the chief executive of the corporate division. It was only if the figure was above, I think, £250 million that another executive director had to sign it off. Within HBOS, the other executive director that signed it off was the chief executive of the international treasury division, and vice versa.

**Helen Goodman:** I noticed that.

**Stuart Bernau:** They had a very large number of advances going through, and they were going through a divisional credit committee, and the board would then receive at each of its meetings a list of the advances that had been approved in the previous month. But, once again, if you looked at the board minutes, it would just be a line saying they were noted. We do not know whether there was discussion.

**Q91 Helen Goodman:** You have described this as a federal structure, but one might almost say it sounds as if it was a franchising structure: that people were allowed to do what they wanted, and everybody had the HBOS stamp on it, but it did not mean that there was a thoroughgoing management system that went up and down all the divisions.

*Iain Cornish:* Yes, that is right. There was not sufficient power and authority within the central functions to counterbalance some of the authority that existed within the divisions.

**Q92 Helen Goodman:** Clearly, they had a very aggressive sales-oriented growth strategy. Do you think there was a problem because that strategy came from the Bank of Scotland side, but they reassured themselves with a sort of Halifax conservatism, and that they never really thought through the integration of these two very different cultures and very different approaches to business?

*Stuart Bernau:* The expertise certainly sat within the Bank of Scotland, because the corporate division was very clearly the expertise of the Bank of Scotland. Of course, the merger gave them a much bigger balance sheet and the opportunity to pursue much larger deals and more of those deals. Yes, the expertise in corporate lending very much sat within the original Bank of Scotland.

*Iain Cornish:* They certainly had a very strong belief in their abilities in the corporate lending sphere, the Bank of Scotland having come through the previous property market recession in reasonably good shape, but they then seemed to use that as a reason for not questioning anything that the corporate division subsequently went on to do. It had changed its lending profile quite significantly from what the Bank of Scotland had previously done, but there just seemed to be an assumption that those skills were transferable and they had some innate ability to write credits that other banks did not do.

**Q93 Helen Goodman:** Without a mechanism for transferring the skills.

*Iain Cornish:* Seemingly, there was no mechanism for transferring skills, and no mechanism for understanding the aggregate risks that existed within the balance sheet as a whole.

**Q94 Helen Goodman:** There was a significant problem with management information as well.

*Iain Cornish:* Yes and no, because they were aware of deficiencies. There is a very powerful illustration of a board meeting in, I think, 2005 or 2006. A strategy review from corporate said, “We are one of the best banks in the world at risk management within the corporate space”, and on the same agenda, same board meeting, there was a report from the risk committee saying, “There are fundamental issues with our ability to assess credit within corporate.” They seemed to be able to live as a board with those conflicting messages.

**Helen Goodman:** There was a high level of dissonance.

**Iain Cornish:** The information was there; they did not seem to be joining the dots or testing it.

**Q95 Chair:** But this was the best board some of these people had ever served on, we were told.

**Iain Cornish:** I think that is the view of one of the members of that board.

**Q96 Chair:** I know; I am quoting. There is so much that we could go through of what you have worked on for some years, but, rather than go through it piece by piece, I want to end by asking you whether, having had this experience, you have particular lessons that you think are worth articulating orally now from what you have learnt about the way these big institutions get themselves into such a terrible mess and generate so much systemic risk.

While you are thinking about that, there is a second question that will travel with it, and fortunately there are two of you, so one of you can think about one question and the other can think about the second. We have done a heap of things to try to improve the conditions in which the banks take these decisions in order to bring much greater clarity, scrutiny and individual responsibility, and a much higher level of regulatory accountability too, so they should be held to account for the way that they are trying to keep an eye on these banks. You are both steeped in a great deal of experience in the industry over very many years, and very well placed to offer that much more general sort of view. I am playing for time a bit, to give you a moment, because I have not given you any advance notice of such a longstanding question.

**Stuart Bernau:** If I try to answer the first bit, one of the things that came to my attention in doing this was an excellent study by the Cass Business School, which you may or may not have seen, called *Roads to Ruin*. It is an analysis of a whole series of completely different organisations that ended up facing major catastrophes, and trying to look at it and say, “Are there any common themes that come out of this?” I now use this in talking to my own NED colleagues.

They came up with seven reasons. The first one is board skill and NED control of risks, which I am saying is certainly a factor that you would apply here. The second was board risk-blindness—not realising that the strategy was the same. The other one that I look at is to do with group risk glass ceilings, where risk was not coming up high enough through the organisation. If I look at this organisation, there are a number of common things that you can apply, which have been common whether it is an oil disaster or something completely different, and they still apply potentially now if you do not keep on top of these sorts of areas. I feel that those are the sorts of things for which, if you are sitting on a board as a non-executive director—which you are asked to do; you are not getting the executive pay—ensuring you get the right training and education is very important.

I suppose my view would be that there is probably more the regulator could do when people are being put forward to join boards as NEDs to help them understand their responsibilities and have examples of the sorts of things that can go wrong. As you know,

boards can become collegiate. They can become aligned with the management. It is quite an easy thing to do. You must realise clearly what your responsibilities are. The senior managers regime is going to provide these statements of responsibility, which is going to make it very clear for certain board members. We will both be subject to that. To a certain extent, I wish there was a senior managers regime for regulators that mirrored it, because it is probably just as important.

**Q97 Chair:** That is an issue that we have raised in this Committee and I have raised personally as well. The latter point, it seems to me, is every bit as important as the former. How can we expect firms to reach standards that regulators themselves appear to be falling short of?

**Iain Cornish:** There is a huge amount of material in here. For me it has been a fascinating learning experience, and I hope I am better for it. In answer to your question, one of the most fundamental things it has taught me is to question success as much as obvious problems. If something is going well, you should ask yourself why: is it because you are doing something better than other people, or is it because other people are not doing it because they have spotted something you have not? It is extremely important as well to use imagination in thinking about what could go wrong and look at one's business with a degree of humility. Do not accept platitudes about how good you are without getting under the skin of that and looking for evidence. That is a cultural point as much as anything else.

**Chair:** Thank you very much indeed for doing this work. Parliament appreciates it and this Committee appreciates it, and we will be, and indeed already have begun, as you have noticed, taking forward some of the key recommendations made in your own report and, of course, the wider report, to which you have contributed a good deal of value. Thank you very much indeed.