



## Treasury Committee

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

Tuesday 15 December 2015

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Members present: Andrew Tyrie (Chair); Mr Steve Baker, Mark Garnier, Helen Goodman, Stephen Hammond, George Kerevan, John Mann, Mr Jacob Rees-Mogg

Questions 98-204

#### Examination of Witness

*Witnesses:* **Andrew Bailey**, Chief Executive Officer, Prudential Regulation Authority, and **Sir Brian Pomeroy**, Non-Executive Director, Financial Conduct Authority, gave evidence.

**Q98 Chair:** Thank you very much for coming to give evidence to us this morning. It has been a bit of a marathon, or, to change the metaphor, it was quite hard work getting the regulators to the water trough on some of this work on RBS and HBOS, and they were very reluctant to drink when they got there, but we do now have a pretty thorough report, by the look of it. The review team—and we have the two leaders up here in front of us—bear some of the responsibility and the credit for having got to where we are in the process. Thank you very much.

We have also had a separate report done on enforcement. I would just like to clarify a few things. First of all, before we go any further, did Andrew Green—whom, as you know, we saw yesterday—get it right? Is there anything material in the Green report with which either of you wants to take issue?

*Andrew Bailey:* No.

*Sir Brian Pomeroy:* No.

**Q99 Chair:** Just to be clear, he recommended, “Given the inadequacies in the FSA’s decision-making processes...the FCA and/or the PRA should now”—“now” is underlined—“consider whether any other former senior managers of HBOS...should be the subject of an enforcement investigation with a view to prohibition proceedings.” Are you getting on with that?

**Andrew Bailey:** Yes. As you know, we have both accepted that recommendation and the work is under way.

**Chair:** Well under way, we hope.

**Andrew Bailey:** Yes.

**Q100 Chair:** People have waited long enough for this to be done—more than long enough. Andrew Green said that it was in the public interest that at least a small number of senior managers be named, in addition to the very small number that were named in the report. The review team are against this. Why?

**Andrew Bailey:** The position that we have taken is consistent with the previous report; it is consistent with the RBS report. To be frank with you, our thinking has also been informed by the development of the senior managers and certification regime. We have named those people in the FSA—and this is entirely consistent with the naming of people at HBOS—who held positions of responsibility. We have not named more junior staff. Those are people who, in our view, did not hold positions of responsibility. When you map them into the thinking of the senior managers regime, they might fall into the certification element if you were doing that process, but that is a process that is done within firms.

The reason for doing that is that, in our view, those people should not be regarded as responsible for the direction, the strategy and the policies of supervision and regulation. As the chief executive of the PRA, I am very sensitive to the view that junior staff are held responsible in ways that, frankly, do not match the responsibilities that they hold in reality. That is the thinking behind it.

**Q101 Chair:** But these are not junior staff that we are talking about here, though, are they? These are very senior people, just below senior SMR level, right at the top or very near the top of the organisation.

**Andrew Bailey:** They are not very senior, no. That is not true.

**Q102 Chair:** It certainly would be incorrect to call them all junior staff.

**Andrew Bailey:** I can tell you—

**Chair:** If they arrived in your office—I am sorry to interrupt—and you said, “You are a junior member of staff and we are looking forward to seeing whether you do better next year,” they would get a bit of a shock, would they not?

**Andrew Bailey:** Let us take the structure of the FSA. In practice, what that means is that the chief executive and the level below him, who are senior directors, and the level below them, who are directors, are all named. It is below that that the naming does not take place. It is two levels below the chief executive, so two levels below me, in the current world.

**Q103 Chair:** We will need to think about this as a Committee. We may decide to require that these names be produced; we have not yet discussed it. One

concern is the fact that you have made a great deal of fuss about this; at least, some might argue that. Certainly, you have pushed back heavily on the recommendations from the independent reviewers, all three of whom, in their different ways and from different angles, have come to the same conclusion about the public interest with respect to the naming of these individuals. We will come back to it also in the light of one point that was made yesterday, which needs to be borne in mind: that now you have generated all that pushback, undue attention may be given to the names that are finally released.

**Andrew Bailey:** Can I just make two points? First of all, to reiterate, we took a decision which was entirely consistent with the treatment used in the RBS report, for instance. We did not change anything in that respect.

**Q104 Chair:** We may have got it wrong, you and I, with respect to the RBS report.

**Andrew Bailey:** We may have done. That is possible, but it is not a point that has been made in respect of the RBS report, if you do not mind me saying so. The second thing—and I did follow yesterday’s hearing—is that the term “public interest” needs to be defined here. What is the public interest in naming these people? I would say with confidence that there is nothing you would learn about either the FSA in the context of the Green report or HBOS, and indeed the FSA, in the context of the main report that is not in those reports, by knowing those names. Other than the names themselves, there is nothing that you would learn. So the public interest point is important.

**Q105 Chair:** I would like to come to the reasons that we brought Mr Green in to do this work. I just want to go through the chronology, to make sure that everybody understands it. When the parliamentary specialist advisers were appointed, there was already a working first draft, was there not?

**Sir Brian Pomeroy:** Yes.

**Chair:** I think it was called “draft nought”. In any case, it was a pretty detailed working first draft. That was self-exculpatory, was it not?

**Sir Brian Pomeroy:** It was written in line with the terms of reference we agreed at the beginning, which mirrored the RBS terms of reference. In that report, you will recall, Chairman, the nature of the enforcement section was different from the others. The others were evaluative; that is to say that they were to evaluate what had happened, why and who was responsible. The terms of reference of the RBS report, the equivalent of this, were to be an explanation by the regulators of what they had done. It was deliberately and explicitly by the regulators. That was brought forward into the early stages of the HBOS report. I believe that there were discussions between ourselves and the Treasury Select Committee about it being equivalent to the terms of reference of RBS. That was the reason why the report was written by enforcement people; it was in line with that.

There was then, absolutely as you say, the intervention by the independent reviewers, who said, “Why are they doing this?” but importantly, at that point the terms of reference

changed. The terms of reference are no longer that the regulators give an explanation of what they did. The terms of reference are now an assessment of the reasons for what they did, and that is why the authorship changed. So there was, very importantly, a change in the terms of reference.

**Q106 Chair:** Yes, but I go back to the question that I asked. The first draft, any reasonable person looking at it would conclude, was exculpatory. Is this correct or not, in your view?

**Sir Brian Pomeroy:** It was certainly intended to be an explanation of what had happened. I will say that all drafts would, at one point, have come through our steering committee and we were pretty rigorous about getting any undue self-exculpation out of it.

**Q107 Chair:** I will ask the question a third time. In your view, when you read this, did you consider that this was a self-exculpatory draft?

**Sir Brian Pomeroy:** I think that it would have been too self-exculpatory, but, had it gone through the steering group process, that would have been changed.

**Q108 Chair:** So it is true to say that the first draft was self-exculpatory.

**Sir Brian Pomeroy:** The very first draft, un-reviewed, was indeed self-exculpatory.

**Q109 Chair:** Therefore, it did take the initiative of the parliamentary specialist advisers to get this changed and improved, first, by changing the terms of reference and then, secondly, by bringing somebody else in to do the work—a wholly independent person.

**Sir Brian Pomeroy:** Yes. If I may add, the change in authorship would follow naturally from changes in the terms of reference, because clearly, you could not have the people who did the work reviewing the assessment of their work.

**Q110 Chair:** Still, it is a highly regrettable state of affairs that this first draft was not in better shape, is it not?

**Sir Brian Pomeroy:** I agree with that, but I repeat again that you will see, in the independent reviewers' report, they are good enough to be complimentary about the work of the steering committee in ironing out inconsistencies and, indeed, over-self-praise. That would have happened to that, had it got to that stage.

**Q111 Chair:** Bearing in mind the struggle that this Committee had in the middle of the last Parliament to get independent advisers in to do the similar work on RBS, which set the precedent for HBOS, does this not tell us a great deal about how important it is that work of this type should be put out to external review?

**Sir Brian Pomeroy:** I agree completely.

*Andrew Bailey:* Of course, there are new arrangements, as you understand, under the new legislation for future reviews. Our very strong view is that future reviews should not be done on the basis that these past reviews have been done; they should all be done by independent people. It is a much better way of doing it.

**Q112 Chair:** We might get into the substance of these decisions in a minute, but the enforcement section in the FCA as now is, and was the FSA before, has come in for a good deal of criticism in one way or another, in the Green report and elsewhere, with respect to other issues in recent years. There is now quite a large group of people saying that we should do something about the enforcement section. I know that there has been a review by the Treasury, but we have the Treasury Select Committee, the previous Committee, the Parliamentary Commission on Banking Standards and the former chief executive of the Financial Services Authority all now saying that this body should be at least given more autonomy, if not made an independent regulatory body run in a quasi-judicial manner. But you are still vigorously disagreeing with that, are you not, Sir Brian?

*Sir Brian Pomeroy:* We are supporting, I think, the conclusion of the Treasury paper, that there is a trade-off here between co-ordination, a free exchange of information and independence. Certainly, the view of our enforcement people, and therefore our board as well, is that co-ordination would be easier and the ability of the regulators to deploy strategically the whole range of their tools across a range of regulated bodies in respect of individual infractions would be greater if they had control of the whole panoply of tools. It is those arguments—co-ordination and the deployment of the whole range—against independence. Our people have, indeed, come down on the side of the former and therefore leaving things as they are.

**Q113 Stephen Hammond:** Good morning, gentlemen, and thank you for coming this morning. I want to continue looking at the effectiveness of the FSA board and senior management, as a starting point. Could we look at your view, first of all, as to whether or not you think the FSA board should have done more at the time to consider emerging prudential risks and why that did not happen?

*Andrew Bailey:* Do you mean at the time leading up to the failure of HBOS?

**Stephen Hammond:** Correct.

*Andrew Bailey:* I think it has been well documented in previous reports. From memory, if you go back to even the report that the FSA did itself on Northern Rock, prudential issues had very little airtime at the FSA board in the pre-crisis period. There was a rather startling statistic somewhere that literally only a handful of issues that could be tagged as prudential were raised at the board during that period. I was not involved in that period, so I am obviously something of an observer, but I would observe from being in the FSA for the last two years of its life that one of the challenges with the single regulator doing conduct and prudential under the same roof was this problem of balancing prudential and conduct objectives and priorities. My observation would be—and I have said this before—that I don't think the FSA ever achieved that balance, so what you had were periods where one dominated the other.

It was not always the same way round. In the pre-crisis period, it was pretty clear that conduct objectives, such as the “treating customers fairly” initiative that the FSA undertook, dominated prudential. You can probably say that, once the crisis hit, the thing shifted the other way and the prudential came to the surface, as a natural reaction to the crisis. But this was the lesson I drew from observing it in its last two years: it had clearly proved very difficult, if not impossible, to achieve what one might call that stable balance, by which both were getting their due consideration.

**Q114 Stephen Hammond:** I take that point and I take the point about balance, but let us just look at some of the things that happened. At one stage, Sir Hector Sants was saying, “We will use all enforcement action to be taken,” and yet, at the staff level, that did not happen, if anything. That implies there is a failure of communication between senior and junior management, and that is either cultural resistance or management failure. I just wondered which one you thought that it was.

*Andrew Bailey:* To be clear, you are talking there about the 2009-10 period.

**Stephen Hammond:** I am.

*Andrew Bailey:* I was making a point about the lead-up to 2007-08. But I think you are right, and this is one of the things that Andrew Green has laid out very clearly. There was a comment, which I think Andrew Green made yesterday, that the tone from the top, the tone that Hector gave, was not being followed through. It is the responsibility of the CEO to ensure that that does happen, and it didn't. That is a very clear message from the Green report, it seems to me.

**Q115 Stephen Hammond:** But the other argument is that if it were a resistance of the staff on another level, it would therefore be helpful to have the transparency on names that Mr Tyrie was asking about earlier.

*Andrew Bailey:* Let me just come back to this point. There were two levels below Hector who would be named, and indeed are named, in the report, so it is not the case that it was straight from Hector to people who were not named. That is not true. There is the head of enforcement, and I cannot remember the exact structure at the time, but if you map it into today's structure, and map it into the supervision structure of the FSA at the time, there were two levels of people who are subject to naming.

**Q116 Stephen Hammond:** Given what we have just discussed about the failure, are we saying that the supervisory staff were let down by the senior management? Andrew Green notes in his report that he regards the staff as committed and hard-working, and yet the reports they produced were flawed. Can we conclude that it was the senior management letting down the supervisory staff?

*Andrew Bailey:* The key point we have discussed many times is that senior management in any organisation have to take responsibility, so the answer to your question is yes.



**Q117 Stephen Hammond:** How confident are you, Sir Brian, that your current board has enough market and enforcement expertise to do its job?

*Sir Brian Pomeroy:* The current board certainly has market expertise. We deliberately recruited, quite recently, somebody with a market background, precisely because we did not have that. If by enforcement expertise you mean legal enforcement expertise, on the board itself, among the non-executives, there is not, but we have a very competent enforcement division working under the chief executive, which I think will carry enforcement forward very competently.

**Q118 Stephen Hammond:** But you recognise that there is a widespread view in the wholesale financial markets that, while the FCA may have competence on the retail side, it lacks competence on the wholesale side.

*Sir Brian Pomeroy:* I am aware of that. That is one reason why I went to recruit our most recent non-executive director, who comes from a solid and deep markets background.

**Q119 Stephen Hammond:** I suppose the same question to Andrew Bailey: do you think your current board now has expertise in the areas it needs expertise and is superior to the pre-crisis FSA board in banking knowledge?

*Andrew Bailey:* On that point, quite a few of our board have appeared before this Committee. We have one extremely experienced former lawyer—well, he likes to call himself a former lawyer, but I don't think you can ever be a former lawyer, actually. As you know, Charles Randell is an extremely experienced commercial lawyer and Mark Yallop is an extremely experienced wholesale practitioner from the City, so we have a lot of expertise on our board. Clearly, for both boards, you have to keep assessing it and, as the board members turn over, you have to have a proactive process of finding new ones, but we work very hard at that.

**Q120 Stephen Hammond:** My last question goes back slightly to where we were a moment ago. The ExCo of the FSA has not only been described by Sir Hector as “dysfunctional”, but the Green report particularly notes the failure to keep proper practices. When you saw that, what were your thoughts?

*Andrew Bailey:* Again, I think Andrew Green makes very powerful points. I am afraid it pre-dates my time; I came in very much at the tail end of this period. But I can tell you that, although we do not have quite the same names in the PRA, in the equivalent structure, we put particular emphasis on keeping minutes, recording decisions and ensuring that people know what the decisions are. Indeed, the board sees at every meeting a record of the decisions that have been taken by the executive at the level below them.

**Q121 Stephen Hammond:** One of the points Mr Green made yesterday was not only the failure, but that the quality of some of the minutes was too poor for a regulatory or review purpose afterwards. How sure can we be that there is enough detail in those?

**Andrew Bailey:** Both the FCA and the PRA accept the recommendations that Andrew Green has made. Obviously, there has been a change of institutional structure since the period that he is referring to, but we will both now go and test Andrew Green's recommendations against the practices that we use today. Our boards will both require that, quite sensibly.

**Sir Brian Pomeroy:** The FCA minutes are published and you can see them, and they are in reasonable detail. They do not say what everybody said; they are not verbatim. They are a balance between a summary—they are not a high-level summary—and a reasonable flavour of the discussion. They are visible to you. You can see them.

**Q122 Chair:** They are published partly because Parliament asked you to publish them.

**Sir Brian Pomeroy:** That may well be true, Chairman.

**Chair:** In fact, it was basically this Committee. I just thought I would point that out.

**Q123 Mark Garnier:** May I turn to the delays in the publication of this report and the fact that it has taken such an awfully long time to get something worth having? In particular, I would like to look at Maxwellisation. To start off with Maxwellisation, July 2014 was when you started the Maxwellisation process, and yet it was 14 months later before the report was published. Is the Maxwellisation process being abused? Is it a good process? Do you think it is worth having? Should we intervene to try to limit how much people are taking the mickey on this? What do you think?

**Andrew Bailey:** Let me be clear. First of all, we took a lot of legal advice on this and the legal advice was very clear: Maxwellisation is not a statutory requirement in this country; it is a matter of precedent coming out of the courts. "Fairness of treatment" was, I think, the phrase used. Frankly, I have somewhat mixed feelings about it. The good side is that it very clearly provides an opportunity to those who are going to be named in the report to tell their side of the story in relation to what is proposed to be written about them.

**Q124 Mark Garnier:** This is for a second time, though, is it not?

**Andrew Bailey:** I will come to that in a moment. Let me come back to that. We did learn things. I think we had 1,425 representations, all of which we then had to go through, from 82 parties who were Maxwellised in the first round.

**Q125 Chair:** It is good business for lawyers.

**Andrew Bailey:** Undoubtedly.

**Chair:** Sorry to interrupt.

**Andrew Bailey:** No, that is all right.

**Chair:** Lawyers are all over this report. You can sense it.



**Andrew Bailey:** Absolutely; that is a fact of life. By the way, on that very point, our own in-house legal advice about Maxwellisation—I discussed this many times with our in-house lawyers—was that we would get exactly what you said: legal firms would be active on this front. The advice I got from our lawyers was, “We are not going to water this report down. We will just see this process through. We were not going to water it down to curtail the process. This is a matter of seeing Maxwellisation through and coming to the end with a report that is not watered down.” However, we did learn things out of Maxwellisation. Sources were revealed, so we found some new documentation that people had not previously unearthed.

**Q126 Mark Garnier:** It was useful in that respect, then.

**Andrew Bailey:** Yes, it was useful. We also, obviously, got some essays; we got essays about the iniquity of what we were doing. They were put to one side, largely, unless they had information in them. To come back to your point on what wonderfully gets called “re-Maxwellisation”, there were somewhere around 34 or 35 parties, and we got 227 representations. That was all done, basically, over the spring and summer of this year. The 35 were a subset of the original 82.

**Q127 Mark Garnier:** Just to be clear, this was the second round, so, after the first lot, they came back and had another pop at it.

**Andrew Bailey:** Yes. You could reasonably say, “Why on earth did you do it again?” Now, one piece of very strong advice we had from our lawyers was that, “If the consequence of the first round of Maxwellisation is that you actually intensify the criticism, you are going to have to go back to the people.” That did happen. You may think it is a bit odd that it happened, because you might have thought showing it to people would only go one way, but in some cases information was revealed that allowed us, in the phrasing we used, to tell a starker story.

**Q128 Mark Garnier:** So, presumably, person X could say, “You have written this about me, but actually it was not me; it was person Y. You should change your story.”

**Andrew Bailey:** Or person X says, “You have never seen document Y before. Here it is.” You go to document Y and, unfortunately, the consequence for person X of document Y being revealed is that the story becomes rather starker. This is what you might call a sort of backfiring. That happened; it did happen. If anything, the report in some places became starker. It became—

**Q129 Mark Garnier:** So it became better as well.

**Andrew Bailey:** Well, yes. That is the good story. The other side to it is your point: it all took a hell of a long time. As I said, the clear advice from our lawyers was, “Just stick it out and we will come out on the other side with a report that is robust,” but it is a lengthy process and it is intensive. Brian and I, and the rest of the steering group, sat for hours, going through these representations.

*Sir Brian Pomeroy:* There were hundreds of representations.

**Q130 Mark Garnier:** I had heard, second hand, from one individual who was slightly aggrieved at the fact that they had been Maxwellised once but not given the opportunity to be Maxwellised a second time. Are you 100% confident that the process was entirely clear?

*Andrew Bailey:* You don't get Maxwellised a second time just because you fancy it. It was a very narrowly defined legal process, by which, if there was a sufficient change in the body of the report, then it had to go back, but otherwise you did not get a second bite at the cherry.

**Q131 Mark Garnier:** Of those 82 people who were originally Maxwellised, is it the case that you felt you needed to go back to only 35 of them?

*Andrew Bailey:* Yes.

**Q132 Mark Garnier:** My maths is not quick enough, but as to the remainder—47 or whatever it is—those people had not had the report materially changed against them, so they would not need it.

*Andrew Bailey:* That is correct.

**Q133 Mark Garnier:** You have given quite a good view of this, but do you think, at the end of the day, people are really taking advantage of the process? I am not necessarily suggesting that lawyers are taking advantage of the process purely for commercial gain.

*Sir Brian Pomeroy:* I would not say “taking advantage”. They are exercising their right and, of course, if your reputation is at stake in a very high-profile case, which this is, you do that fairly diligently; you get the best lawyers; and you use the resources at your disposal. I am not necessarily saying that that is taking advantage in the pejorative sense, but they are making full use of the facility that the law—it is case law, as Andrew said—gives them to make their representations, which you can understand.

**Q134 Mark Garnier:** Do you think there is a case, though, that Parliament should have a look at this? I realise that it has come from the courts, and so it is a precedent rather than a legislative thing. But do you think we should take a look at it, in order to make sure that there is a proper framework by which this can be done and there is not a process whereby some people just get completely carried away? At the end of the day, there is a process of interpretation. We have all seen people being commented about in the press, and some people feel very, very aggrieved by that, whereas some people think it is just the rough and tumble of the press, so interpretation is a lot to do with this.

**Andrew Bailey:** Giving people their say is of course important. Going back to the point about Parliament, which is obviously for you, I am not really familiar with how long this process takes in other reports. I did a little bit of homework the other day and I read the Chairman's pamphlet, "The Poodle Bites Back". There was an annexe in there with a list of 17 public inquiries, and you can work out the duration of those and compare them to this one. The average duration of these things is longer than the HBOS report. What I do not know is how long Maxwellisation is taking in these other inquiries; I have no idea about that. It would be interesting to know the answer to that question.

**Q135 Mark Garnier:** Clearly, there are some high-profile cases, like the Iraq inquiry, which is taking years and years and years. If I ask a couple of questions on the relevance of a report that has taken such a long time, the failure of HBOS was in 2008; in March 2009, the FSA started its enforcement investigations. There has been an argument that this report could not get started until the enforcement actions had been pretty much undertaken. None the less, though, there are some quite useful lessons to have been learnt from a report like this. We are now at the end of 2015, fully seven years after the event.

Does the fact that we are such a long way behind diminish the value of a report like this? Of course, there have been other reports on this, like the extraordinarily well written and very gratefully received report from the Parliamentary Commission on Banking Standards; we did one of those as well. Do you think there is a diminution of value?

**Andrew Bailey:** It does feel like a long time has gone by. I would say that the very strong legal advice—Andrew Green made this point yesterday—is not to carry out a report of this nature while enforcement proceedings are taking place. That remains the advice today, as I think Andrew Green confirmed in his hearing.

**Q136 Mark Garnier:** None the less, particularly because you are in a very special position as a regulator, is there not a value in having a mechanism whereby a parallel process can be run that does not interfere with the legal process?

**Andrew Bailey:** That would be much more valuable, because it would be much more timely. I agree with you, but the legal advice is very strong on this point.

**Q137 Mark Garnier:** That is very helpful. I have one last, slightly cheeky question; it is not meant to be too cheeky. These are clearly really useful reports, but in your experience, are you getting any sense that the wider public, not people like us or those with legal interests, or the wider banking community are reading these reports to learn the lessons of other people's mistakes? Do they largely find themselves—notwithstanding Treasury Committees, lawyers and compliance officers—ending up on dusty shelves?

**Andrew Bailey:** I do not know. That is an interesting question. They probably read some of the press coverage. I would not want to get my hopes up too much that it is a bestseller.

**Q138 John Mann:** Is there a trade-off, for the regulator, of conduct versus prudential?

*Andrew Bailey:* In what sense?

**John Mann:** In terms of how you do your work and your priorities.

*Andrew Bailey:* This is going back to the point about the FSA that we were discussing with Mr Hammond earlier. There are clearly very strong interactions. Sadly, the biggest interaction we see at the moment is that the cost of misconduct—which, by the way, is a necessary cost; I am not making this point to, in any sense, deny it—is sizeable enough, as you can see from our stress tests, that it is a prudential issue. That is where we have to have very strong contact and co-ordination, and we work very closely together.

I do not think there is a trade-off; I really do not. These two things are both necessary and very important. As I said earlier, the FSA found it difficult to pursue both of them in equilibrium at the same time.

**Q139 John Mann:** Would it be a fair criticism to say that the FSA was overly focused on conduct?

*Sir Brian Pomeroy:* At the time, that appeared to be the priority. On the other side, apparently—I say only “apparently”—as you can recall, the economic outcome was benign and prudential risks were apparently not on the horizon. They had Equitable Life; they were embedding “treating customers fairly”, and so forth. It was really a question of focusing on where they—erroneously, as it turns out, because of their view of the economy and the prudential risks—saw the main risks to be at the time. I think, if they had seen the risks to be somewhere else, they would have gone somewhere else.

*Andrew Bailey:* It is worth give a little bit of history on this. If you go back to before the FSA’s time, to the Bank of England’s bank regulation regime, it was a purely prudential regime. There was no conduct regulation at all in that regime. There was essentially no conduct regulation of banks, outside whatever other statutes provide. The reason I raise that is that I suspect the FSA then inherited what I would call a catching-up agenda, which was coming from various sources, including Parliament. This was probably the origin of the “treating customers fairly” programme, as it was called, that they put in place, which consumed a lot of time.

**Q140 John Mann:** When we talk about conduct at the time, whose conduct are we talking about?

*Andrew Bailey:* The banks’.

**Q141 John Mann:** Not individuals’?

*Andrew Bailey:* No. This was the firms, yes.

**Q142 John Mann:** But, at the time, Lord Turner was saying that the obsession was with mis-selling, which was also about individuals.

*Andrew Bailey:* Lord Turner became chairman in the crisis, in a sense.

**Q143 John Mann:** But, commenting on what he inherited and the problem, he told this Committee that that was the fundamental problem.

*Andrew Bailey:* Sorry, I was going back to pre-crisis.

**Q144 John Mann:** I know you were. My question is: in terms of what was going on with the regulator at the time and the definition of conduct, would it be fair to say that, in the middle of it, there was one bit missing, which was conduct of senior people?

*Andrew Bailey:* Absolutely, because that is consistent with everything that has happened since. That is consistent with the senior managers regime; it is consistent with the unfortunate litany of mis-selling, so you are right. But my point, and I do not think we disagree on this, is that at the time, going back to the pre-crisis period, I do not think they saw it that way.

**Q145 John Mann:** If we compare with Iceland, which dealt fairly succinctly with conduct issues of senior people, is it not the case that the pendulum simply swung dramatically the other way: everything became prudential and the conduct issues were conveniently parked so that, in moving from conduct of individuals lower down the pecking order—mis-selling—through to prudential risk, in the middle, conduct of the senior people before and after remained largely untouched?

*Andrew Bailey:* Correct me if I am wrong, but that was the point I was trying to make in response to Mr Hammond. What happened was that, once the crisis hit, to use your phrase, the pendulum swung the other way: prudential became the dominating issue of the day, because we were saving the system, and I suspect that, therefore, the relative importance and time given to conduct diminished.

**Q146 John Mann:** But the people who swung the pendulum were Mr Sants and Lord Turner, and previously Mr Tiner and Mr McCarthy. They were the people who swung the pendulum, were they not? In fact, it was the regulator at the top that was flawed, in advance but also at the time and afterwards. They swung the pendulum, so they left the conduct issues conveniently out of the way.

*Andrew Bailey:* I am not sure we are disagreeing on this. You are right. This was a system where the number of responsibilities with which the FSA was dealing tended to engender what you describe: you shift the pendulum one way or the other, depending on the things that are hitting you in the face at the moment. The crisis obviously engendered a different reaction.

**Q147 John Mann:** Who is going to hold Mr Sants, Mr Tiner and Lord Turner to account for their failings in this?

*Andrew Bailey:* This report probably goes further than previous reports in describing how the FSA operates. You could argue this versus the RBS report.

**Q148 John Mann:** I am not sure the general public would be too impressed. The fact of the matter is that the people at the top of regulation were fundamentally at fault and they are getting away scot free.

*Andrew Bailey:* I was going to make a second point. Funnily enough, this goes back to a number of hearings by this Committee during the previous Parliament or even the one before it. You look back at the financial crisis and the previous period, and we now have a series of reports, some of which the Treasury Committee has done, some of which the parliamentary commission did, some of which the regulators have done. They all fill in parts of the picture. If I am interpreting you rightly, you are trying to get at a different thing, which was discussed in this Committee back in around 2008 or 2009: should there be a broader review of the crisis in terms of the whole story?

**Chair:** 2010?

*Andrew Bailey:* Yes. For whatever reason, that never happened. We could spend a long time debating that.

**Q149 Chair:** It did not happen because the euro crisis broke and it was all hands to the pump at the top of these organisations. We would have been taking those people out of that work in order to answer the questions we wanted to pose. That is the reason, in a nutshell.

*Andrew Bailey:* That is an interesting take on it. You are right, in a sense: we have this patchwork of reports.

**Q150 John Mann:** If I am right on that, the accountants also get away scot free, as ever, do they not? They somehow managed to miss everything. That seems to be part of the wallpaper: accountants miss everything that is going on but somehow still get huge fees, and their profit line does not seem to be affected. Why are KPMG not literally in the dock?

*Sir Brian Pomeroy:* In relation to KPMG and this report, you will see that we referred KPMG to their regulator. We are not their regulator. There is another regulator, the Financial Reporting Council, which has not only the legal jurisdiction but the technical skills to regulate them. We referred KPMG to that regulator. As you will know from our report, at the point of delivery of our report, the FRC said it had not seen grounds to investigate, but it left it open to look at our report and said that if it saw any new information, it would reconsider that. As far as I understand, that is the position today.



**Q151 John Mann:** I am sure my colleagues will come back to KPMG. I just wanted to throw that in, because people are a little frustrated. It was the Halifax. I joined it aged eight. People I went to school with worked for it and then lost their jobs. I joined it because I was told by my mother it was the safe place; it was where you put your money. Most of West Yorkshire did, and yet these people have wrecked it. The regulators have got away with it. The auditors have got away with it. The only person who seems to have been sacked in the middle was Mr Wheatley, who, from what I can see and my questioning, was the only person who took it seriously at any stage, other than your good selves.

*Andrew Bailey:* I do not think Mr Wheatley was involved in HBOS.

**Q152 John Mann:** No, he was not, but in terms of the approach to regulation, he is the only person who seems to have lost his status. Everyone else has got other jobs elsewhere. The roundabout carries on.

Let us come back to the regulator. Why should the regulators of the day get away with it? I have Lord Turner's and Mr Sants's responses. All Lord Turner would say in this context, when I questioned him on this Committee some years ago, was, "You do not appear to understand the issue." That is what he says each time I ask a question. Am I misunderstanding these issue or is it rather simple? A major building society, the Halifax, disappears in reality. Loads of people lose their jobs, some of whom I grew up with. Customers are dissatisfied. Everyone is getting away with it, including the regulators, who even after finding the problem sit on their hands. Is that not a fair comment?

*Andrew Bailey:* As you can see from the report, we are very critical of the FSA and its failings. We have not pulled any punches on the FSA in the report.

**Q153 John Mann:** What are you going to do about them—Lord Turner and Mr Sants?

*Andrew Bailey:* I was asked this question when we published the report. I said that, for those individuals who are approved persons today under the regime, who are former regulators and who are in this report, all the evidence that has gone into the report will be taken into account. We have a continuing responsibility to undertake a continuous assessment of fitness and properness, and we will do that. Lord Turner is not in that, to be clear, because he does not come on the scene until after the thing fails.

**Q154 Chair:** Hector Sants, now Sir Hector, was on the scene. There was a—how should I put it?—pretty lively exchange in front of this Committee with respect to his role at that time. Some of the tone of that is reflected in this report, but I think you can get a sense of the concern on the Committee that there should

be individual responsibility in regulators, just as there should be in firms. The question of how far down that should go, with which I began the hearing, is also one that will concern us. If this were in the private sector, names would certainly be put in the public domain. Indeed, the regulators have in the past come to this Committee and to Parliament, suggesting in evidence that people lower down private sector firms should be named.

**Andrew Bailey:** Yes. That is not a point we have made, but I am aware of that. The only point I would make is that although, as I said earlier, I am not a supporter of this style of report and I think, in the future, they should all be done by independent people, we can both say quite honestly that we have not pulled our punches on the FSA. We have worked very hard at this and taken it very seriously.

**Chair:** It was the best we could do, bearing in mind where we started, which was a refusal to produce anything, four years ago, on RBS.

**Q155 Helen Goodman:** I would like to ask you some questions about the HBOS governance. Do you think it was reasonable for them to appoint a non-specialist to the position of group risk director?

**Andrew Bailey:** No.

**Helen Goodman:** Would you like to elaborate?

**Andrew Bailey:** In today's world, if a firm put forward somebody in that position to be the chief risk officer, we would interview them, because that is the process we have under the regime at the moment and it will be the process under the future regime. If somebody had no background in risk, they would have to have some very special talent that had not been previously revealed to be acceptable for the role.

**Q156 Helen Goodman:** I am not saying I agree with this proposition, but some people have argued that, had there been more women at the top of banks in the crisis, they would have been more cautious than the men and would not have pursued such aggressive strategies, and we would not have seen the problems that we did. Can you remember how many women there were on the HBOS board?

**Andrew Bailey:** One or two—a very small proportion.

**Q157 Helen Goodman:** Out of 12. There was a lot of focus in this report on Jo Dawson. Do you think it is possible that appointments were made, or have you seen any evidence to suggest that appointments were made, to improve the gender balance of the board?

**Andrew Bailey:** At that time or since?

**Helen Goodman:** At that time. I am going to ask about since later.

*Andrew Bailey:* I was not, to be honest with you, involved at the time. I do not think there was much attention paid to it, is the answer, which goes to your point.

**Q158 Helen Goodman:** It does. I was wondering whether the issue was that the City came late to the issue of gender balance in visible positions, and was then desperately looking for people and maybe appointing people who did not have the depth of experience they needed. I say, in parenthesis, I know that happened in Whitehall.

*Andrew Bailey:* You are talking about the appointment of Jo Dawson as the CRO. I do not think we ever detected that it was particularly a gender-based thing. I do not think it was, “We have to get the quota up.”

**Q159 Helen Goodman:** Do you think that, today, the situation is different? When boards are looking to change their gender balance, either at the board level or among senior management, is there a pool of women with sufficient experience to fill these posts?

*Andrew Bailey:* I would certainly say, from my own experience, that I think people take it very seriously, as they should do. I do not have any sense that they compromise on talent and experience.

*Sir Brian Pomeroy:* There is much more focus on wanting a better gender balance—particularly gender, but ethnicity, disability and other things as well. I know, from experiences outside the context of which we are talking today, that there are recruitment agencies working very hard to build lists of competent women, not women who are just placeholders. I know that is happening and I know that some firms—and I am not talking just about financial services—go out specially to these firms, because they know they have good strong lists of women, as well as men.

**Q160 Helen Goodman:** One of the roles of this person was to discuss the risk issues with the regulator. Do you think that there was an inadequacy in that communication with the regulator on the substance of risk?

*Andrew Bailey:* Yes, and that reflects on both sides. In the report, we make it very clear that we think HBOS failed in its own risk management, its own ability to assess risks, but equally we are very clear that the FSA was not challenging in the way that takes place these days.

**Q161 Helen Goodman:** Do you think that HBOS failed in terms of the quality of the management information that it was getting on this?

*Andrew Bailey:* Yes.

**Q162 Helen Goodman:** To come back to the question that you were trying to answer at the beginning of my little inquiry, what has changed?

**Andrew Bailey:** Across the board?

**Helen Goodman:** Yes, across the board.

**Andrew Bailey:** First of all, the regulatory framework has changed. From the financial point of view, obviously the capital framework has changed. There is a piece in the report where we essentially map HBOS's capital position onto today's standards. It had a Basel III core tier 1 capital ratio at the beginning of 2008 of about 4%. You may have seen that the Bank of England and the FPC put out a publication on the capital framework when we released the stress tests and the Financial Stability Report, where we think that the steady state system-wide capital level in the current regime is probably sustainable at about 11%. On top of that, you have a countercyclical buffer and firm-specific elements that would come in, and then you have the loss-absorbing capacity in resolution.

If you do not mind, I will give you a quick bit of numbering on that. In the report, we said that the incurred losses of HBOS between the point of failure and the end of 2011 were about £26 billion. Impairments are higher, but if you take off income and offsetting elements you get back to £26 billion. If you map that into the numbers I just gave you on capital, it is quite interesting. If you can take that £26 billion, the change on the capital position from 11% would take you down to about 6%. If you think about a stress test, that is where it would go in that circumstance. That is a change of around 5%, so you work out that, if it has a capital ratio of 4% in 2008, it is bust, because it has no loss absorbency in the way that we are developing today. An interesting point, which is hard to assess, is, in the current regime, if you go down to 6% do you come out naturally, or do you have to resolve it, but if you have to resolve it, you have bail-in to take it back to 11%, so that is a change.

The second thing I would say—there are many more things; there is the liquidity policy regime as well—is that the style of supervision is more intrusive and more judgmental. If you do not mind me saying, this is an interesting point, because one of the things that you get pushback on, as we saw from some of the evidence we got in interviews with people, is that there was at the time, before 2008, an attitude that it was not the role of the regulators to be that intrusive. Some people raised the so-called shadow director issue, which I personally do not believe is an issue, but it was raised. One of the things the report says is that, in the very early—

**Helen Goodman:** There is the moral hazard problem.

**Andrew Bailey:** We do raise the moral hazard point. One of the interesting things the report says is that, in the early days of the FSA, it was actually on to the issues that brought HBOS down, but they were put to one side. The style is more intrusive and judgmental, and that is a big change in the style of supervision as opposed to regulation.

**Q163 George Kerevan:** I am interested in the business culture at HBOS and particularly how regulators evaluate culture as part of the overall picture of institutions in the future. The review says that there was something seriously flawed about the business model at HBOS. In summary, was that simply a flaw that came out and was overwhelmed by a particular set of circumstances, or was there something so uniquely flawed about the business culture in the institution that it was bound to emerge at some point in some kind of catastrophe?

**Andrew Bailey:** In my experience, and Brian has a lot of experience as well, the hardest firms to supervise are the ones that are apparently successful to the outside world, but where the supervisor has a closer line of sight and can see the flaws. They can be quite tough to supervise, because the outside world is lauding them as apparently successful, which boosts the egos of those involved, and you are pushing against that, saying, “We can see the flaws.” That was very hard in the pre-crisis period, because these people were high-profile figures who were regarded as great successes. As I said when we released the report, they were the goose that was laying the golden egg, as it were.

Let me turn to the report for a moment. There are a couple of really telling comments from the chairman on page 222. In March 2008: “HBOS in an admittedly uncertain and worrying world is in as secure a position as it could be...without wishing to be the slightest bit complacent, we feel that HBOS in this particular storm and given its business characteristics is in as safe a harbour as is possible”.

**Chair:** That is why we are asking you to review the enforcement decisions.

**Andrew Bailey:** Let me just read the sentence above. On 8 January 2008: “HBOS has called the recent credit cycles certainly better than any of the UK banks and probably better than any of the world’s top 20 banks”. That is a pretty stunning statement.

**Chair:** These were quoted in the parliamentary commission report.

**Andrew Bailey:** Yes. You are familiar with those quotes.

**Q164 George Kerevan:** In retrospect, you are saying it was a flawed business model, but are you saying that you cannot tell whether it is flawed ahead of time?

**Andrew Bailey:** No, the point I was making is that you can. You have to lean very hard against that sort of stuff, because these people are out there and they are promoting this view of the world. To this day, that is the biggest challenge we have. Today we have better tools; we have more rigour to it; we have better objectives; and we have better accountability, which is important.

**Q165 George Kerevan:** I will try it again, from a different perspective. Here was a newly merged company. I concur with John Mann, from the Bank of Scotland point of view. I knew all the senior figures very well in the decade prior to the merger. Here was a deeply conservative bank, a small bank that was

beginning to feel under pressure from growth elsewhere, a bank that was desperately trying to find a partner and ended up, after a series of failed romances, with Halifax.

Suddenly, this new organisation, from two very different parts of the world, with two very different kinds of businesses, but two conservative businesses, suddenly invents this: “We are aggressive. We are going for growth against everything else.” It is a flip-over of the most amazing kind. For a business journalist sitting writing his column, everyone was saying, “This is crazy. This organisation is schizophrenic. It has completely changed.” If we could see it, it seems to me there is a question: why could the regulators not see it? Why were there no red flags, with the regulator saying, “This has now become a very odd organisation. It has completely changed from what it did before. It is a merged organisation, and we all know that it is difficult for merged businesses to integrate”? Surely this required a serious look at its business culture.

**Andrew Bailey:** There is one telling thing that the report brings out for me, and it goes to something Mr Mann was saying earlier. This is not an attack on Bank of Scotland pre-merger, but at the point of merger Bank of Scotland had hit the limits, in my view, of its capacity to fund itself in the wholesale markets. It had tried to merge with NatWest, and RBS had got in there first, so what it saw was the converted building society Mr Mann described, Halifax, with a very stable retail funding base and a much more limited funding gap. The fit looked quite sensible. Bank of Scotland, having hit the limits of its capacity to run a wholesale funding gap, would then acquire a stable funding base and it would put the thing into a more sustainable position.

The striking thing is that, by the time HBOS fails, it has a funding gap that looks exactly like the one that Bank of Scotland had at the point when it did the merger, except that it is a lot bigger, because the institution is a lot bigger.

**Q166 George Kerevan:** My question comes back to why no one could see what was obviously going wrong.

**Andrew Bailey:** I agree with you, but this is the point. We do talk about the culture of the times. There was a culture at that time of not questioning these things. It was very much a culture that these things were successful.

**Q167 George Kerevan:** I will give you some of the articles I was writing in *The Scotsman* at the time, saying, “This bank’s commercial lending policy is crazy and it will fail.”

**Andrew Bailey:** I would love to see them. We have a section in the report that looks at what market analysts were saying. Frankly, they were very slow to pick it up. You were ahead of them.



**Q168 George Kerevan:** Do regulators depend very much on what the market analysts say, rather than their own independent judgment?

**Andrew Bailey:** They did look at them, clearly. The point we were making was that there was a culture at that time—this is the whole light-touch thing that gets referred to—that these things were not questioned particularly. You were questioning them, yes, but the regulatory approach was not to question them in the same way.

**Q169 George Kerevan:** My worry is: will we do all this again? Clearly, this was a bank trying to buy market share. Yes, Bank of Scotland was happy to merge with Halifax, because it would have access to all their deposits, which would give it credibility to go back into the wholesale market and borrow even more. You could see that coming a mile away. Then it invests in property, and then not only is it investing in commercial property, but it starts to take an equity share in commercial property. Once it does that, we know we are in serious trouble: if ever there is a downturn in the commercial market, as there always is every few years, then the bank is so stuck in with equity that not only does it have non-performing loans; it has a serious loss on its corporate side, which is driving its dividend. How would the regulators this time round react to a bank that is trying to buy market share?

**Andrew Bailey:** Badly.

**George Kerevan:** Even though everyone is telling you this is a great bank run by great people.

**Andrew Bailey:** This is the really big challenge in this. I hope that we have an institutional structure and regulation that are more robust, more transparent. We have published stress-tests, for instance; we have just published another set. It is more transparent, and we are able to identify these things, call them out and correct them. But this is the big challenge, because a lesson of this report is that it talks about a period when these things were accepted; there was a culture. You were writing about them, but these things were accepted.

**Q170 George Kerevan:** *Is this ever going to change? Will the regulator always conform to the prevailing culture?*

**Andrew Bailey:** Sorry, that was not the point I was making. We have a more robust regime now, but it is still the thing we have to watch out for: that there is not, as I tend to call it, a broad cultural shift in attitudes. We went through a period after the crisis broke when the boot was on the other foot. There was an enormous call to get in there and regulate them. As you know, a lot of column inches are being written at the moment about the attitudes towards the banks. My greatest concern, as the prudential regulator, is that we do not bend either way. We should maintain consistent standards of regulation.

**Chair:** We are devoting, on this Committee, quite a bit of work to trying to establish how best to protect these institutions against groupthink, and we have

already had a number of hearings related to this subject. But I think Parliament should also accept some of the blame. We have a mote in our own eye. We did not do enough in the run-up to the crisis to challenge regulators. The Government of the day, too, got off lightly. This was the era of “we have put an end to boom and bust” and the abolition of the Board of Banking Supervision, without an adequate replacement on the prudential side, so it is not just that you were asleep at the wheel, as John is suggesting. I should not be making a speech, but it is important that we have on the record that we, Parliament, are not wholly blameless as an institution.

**Q171 Mr Baker:** Turning to the role of the auditors, HBOS Corporate classified loans into 10 risk categories, with the least risky top seven being in the good book, but your report says that the corporate division had not been properly recategorising its loans into the bad book when they became distressed. Do you think it was reasonable that, at least initially, the audit process for the corporate bank did not involve checking whether the loans in the good book had gone bad?

**Sir Brian Pomeroy:** There is clear evidence in our report that HBOS was slow to reclassify loans, but we make the point clearly that we are not making a judgment in this report, for reasons I gave earlier, on the capability and competence of the auditor. That is for somebody else. If the question is, “Should the auditor have said something or done something?” the answer is perhaps, but that is not for us to determine. That is why we sent the case to the FRC.

**Q172 Mr Baker:** If I might interpret that slightly, you are saying it might be the case that the auditor should not have taken for granted that the loans were correctly classified into the top seven least risky loans, but that it is not for you to judge and needs to be done by the FRC.

**Sir Brian Pomeroy:** Yes. To be clear, when I said it might be, I was not being directional in any sense. I was simply saying that it is one possibility, but it is a possibility we do not opine on in either direction.

**Q173 Mr Baker:** Why can you not be more categorical on this point?

**Sir Brian Pomeroy:** This is a matter for the organisation that regulates auditors. They have the legal jurisdiction, which we do not. They also have the professional auditing skills.

**Q174 Mr Baker:** We need to see the FRC on this point, then. Is it for you to say whether the sudden deterioration in impairments over the last six months of 2008 was principally due to macroeconomic conditions or something else?

**Sir Brian Pomeroy:** That is a major question to be answered and you can do that only by a more atomistic look at the notes individually, which we have not done. That is something

auditors might have done. No doubt that is something the FRC, if it looks again—it has said it might look again—will take into account. We have not done an audit of the loan book and looked specifically, loan by loan, at what might have been identified as bad when, which is what would be necessary to answer your question.

**Andrew Bailey:** What we do point to is the process between HBOS and KPMG on the question of impairment provisioning. As you know, after about paragraph 720 in the report, there is a whole section on KPMG arguing for an increase in impairment provisions. I think the phrase used is that it eventually gets into the lower end of what they would regard as the acceptable range, but they had to push quite hard to get it there, even.

**Q175 Mr Baker:** I am sure you recall that I am a longstanding critic of IFRS, in particular for using the incurred-loss model of impairments, and also for mark-to-market and mark-to-model. Andy Haldane said that IFRS is pro-cyclical. Do you think the IFRS standards in place at the time might have been a factor leading both HBOS and its auditors to underestimate the eventual impairments that were seen?

**Andrew Bailey:** Yes, in the sense that there was no expected loss provisioning requirement. That is IFRS 9, as we have debated, and I know we have discussed this in the past at these hearings. Without an expected loss provisioning requirement, that is the case, to that conclusion.

**Q176 Mr Baker:** Getting to the bottom of this point about IFRS and its appropriateness for banks, is this something for you to look at or is it something that you must refer back to the FRC? It seems to me fundamental. If the loan loss provisioning was wrong and KPMG was raising these issues, who should be determining whether IFRS is appropriate to banks? It seems material to your role.

**Andrew Bailey:** Let us take the policy question you raise, to start with. What has happened subsequently is that we have introduced a number of regulatory tools, of which the stress test is one. That allows us to, in a sense, take the provisions as given and then say what regulatory capital we want banks to hold on top of that. You can either put these reserves into the bucket of provisions or you can put them into the bucket of regulatory capital. More has had to be put into the bucket of regulatory capital as a consequence of not having expected loss provisioning than if it were there.

IFRS 9 will introduce expected loss provisioning, so the question we then have to go back to is: “How do the buckets adjust for that?” That is a policy issue, which is firmly with us and with the accounting standard-setters, but ultimately it is going to come back to us, because we will have to decide on how it will affect the buckets of reserving that are there.

**Q177 Mr Baker:** A recognised feature—let us say, rather than shortcoming—of the accounting standard implies a higher level of regulatory capital.

*Andrew Bailey:* Higher than a system with expected loss provisioning?

**Mr Baker:** Yes.

*Andrew Bailey:* Yes, that is true.

**Q178 Mr Baker:** That is an interesting observation, but in a sense you are stuck with the standard as it is, and therefore you must accommodate it, rather than making any particular judgment on the accounting standard.

*Andrew Bailey:* Yes.

**Q179 Mr Baker:** Do you think that the management placed too much weight on having the audit of the bank? Do you think they were too willing to accept the valuations of assets as they passed through the audit?

*Sir Brian Pomeroy:* The evidence is that the senior management of the bank and the management of corporate were arguing for lower provisions.

*Andrew Bailey:* It is, of course, the duty of the management to do the valuation. They have a responsibility in that respect.

**Q180 Mr Baker:** Reflecting on this conversation as it has evolved, it seems to me that prudence in accounting standards has been related with higher regulatory capital to deal with the consequences of imprudent accounting standards.

*Andrew Bailey:* That is true in the case of the absence of expected loss provisioning.

**Q181 Mr Baker:** That is a very helpful thing to say. To move it on, 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 undermines its credibility as an industry regulator?

*Sir Brian Pomeroy:* I do not know whether it is normal practice when it does not investigate. It is very clear that this case has engendered a great deal of public interest, not least through the Chairman's recent letter, and, while I cannot speak for the FRC or say what their norms should be, I have no doubt that is something they will focus on.

**Q182 Mr Baker:** You are saying you have no doubt, but is it your view that the FRC should undertake a full investigation, in particular where a bank has been bailed out at public expense?

**Sir Brian Pomeroy:** It is for them to look at the evidence and see whether it meets their standard for starting an investigation. You will know from the report that we passed a lot of information to them. Hitherto, they have concluded that the standards—“the grounds” is how they express it—for starting an investigation were not met. It is for them to decide whether what is in the report and anything else that may come to light changes that.

**Q183 Mr Baker:** Andrew Bailey, were you surprised that the FRC did not want to undertake such an investigation to give certainty that the right processes were followed?

**Andrew Bailey:** We engaged the FRC very early on in the process, because we have memorandums of understanding with them, so it was required of us to do that and we were happy to do that. My view all along was that I thought it was sensible for them to reach the conclusion on the case once we had given them the full final report and the full set of evidence. It is an open question, to which I do not know the answer, as to on what basis they took the interim decision. We have now discussed this quite a few times, and the strong view on our side is: “We are going to give you this report and the information, and then it is a matter for you to reach the conclusion.” That seems to me the sensible thing. I think it is quite right that the Chairman has written to them and you will no doubt wish to hear from them.

**Q184 Mr Baker:** I think we can safely say that. I will just ask, in order to close my remarks, how you, Andrew, currently interact with auditors themselves.

**Andrew Bailey:** Sorry to give you another bit of history, but it is important history. In the old pre-1997 Bank of England regime, there was a requirement for the supervisor to have regular engagement with the auditors, both bilaterally and with the firm, but importantly bilaterally. That was something that Nigel Lawson put into the 1987 legislation. One thing that I have to say surprised and shocked me, after I took a 17-year sabbatical from supervision and came back in 2011, was that the relationship between the FSA and the auditors had just gone. It was not there. It was worse than that, actually: there was real mutual distrust, I would say.

This struck me as very bad. Supervisors, while they have their own responsibilities, naturally have a relationship with auditors. Clearly, we have strong common interests. Rebuilding the relationship has therefore been very important. One of the helpful things is that the new legislation has essentially put back the requirement to have that contact on a statutory basis, which was also something Nigel Lawson was very keen on, and I think he was right. We have rebuilt it. We have rebuilt both the bilateral and the trilateral things. It is a requirement for supervisors that they meet the auditors bilaterally at least once a year, so that they can discuss, without the firm being present, what they think of the firm and issues of relevance. That is crucial; it is absolutely crucial.

It is also crucial, as part of that, that they understand what we are looking for and what we expect. We do not seek to influence audits, because that would not be appropriate, but we are quite happy to challenge auditors on what they are doing and to be challenged by

auditors as well. That is fine, from my perspective. The relationship has been rebuilt; I am pretty confident about that, but I have to say that what had happened in the interim was pretty shocking.

**Q185 Mr Baker:** I have one small rejoinder. As I listened to you, I was recalling that IFRS was introduced some years before the crisis, and the capital requirements changed only subsequently, so it feels to me as if there was a considerable period when the capital implications of adopting the incurred-loss model of IFRS were not dealt with by the regulator. Is that the case?

**Andrew Bailey:** That is probably true. In the Basel I days, which run up to the break of the crisis, that is probably true because it reduced the use of general provisions, which were in the Basel I framework. In the Basel II framework, it depends whether you are on models or not. If you are on internal models, then there is something called expected loss minus provisions, “EL minus P”, as we call it, which has an element of expected loss in the capital requirements. In the standardised approach, it is baked into the risk weights, but that only comes in after the crisis starts.

**Q186 Mr Baker:** I forget for the moment when IFRS came in.

**Andrew Bailey:** So do I, sorry.

**Mr Baker:** We will have to check, but I get the sense that, in the several years leading up to the crisis, banks were probably additionally exposed to risks for exactly this reason.

**Andrew Bailey:** That is probably right, yes. The impact of the coincidence of IFRS and Basel I may have led to some of that.

**Mr Baker:** Thank you very much. Mr Chairman, I think we definitely need the FRC.

**Andrew Bailey:** That is for you.

**Q187 Chair:** We should see what they say in response to the letter, to start with. I would like to ask a couple more questions about this. You are regulators. The FRC is a regulator, though of a rather different type. Why are they dragging their feet? Have you any explanation at all, Sir Brian?

**Sir Brian Pomeroy:** I have no explanation.

**Andrew Bailey:** I do not know.

**Q188 Chair:** We have no idea why they are dragging their feet. You say that you—that is, regulators—have a strong interest in the product of their regulatory regime, which is the audit work, among other things, but they are not the only numbers that you



are looking at. Indeed, a large proportion, would it not be true to say, of the numbers on the basis of which you work are drawn up by the same firms of accountants? I do not understand why you have not looked at their standard for investigation of whether the work is being done properly or not, because you must have a big interest, both of you, in making sure those numbers are in good nick. Why have you not looked at this?

**Andrew Bailey:** On the basis of today, we do. I have to tell you, I am not going to name it, although I am about 80% certain that it is in the public domain, but we have referred one other case to them, which has ended up in a finding on an auditor.

**Chair:** Sorry, I did not catch that.

**Andrew Bailey:** In today's world—I am talking about today now—we have close contact with them on audit standards. We have referred one other case to them, which was not out of a report but out of real supervision—I am pretty sure it is publicly known—which did end up in their taking action. I am afraid you will have to ask them on this case. I cannot cast more light on it.

**Q189 Chair:** That is fine. I want to go back to the report itself. It is in section 2.11, I think. I do not think you need to look it up, unless you want to call up something in particular, but I took a brief look at it again this morning. It seems to be written in a very matter-of-fact way. There is virtually no judgment involved—and you are agreeing, Sir Brian—on your part at all.

**Sir Brian Pomeroy:** Yes.

**Chair:** Why were you so placid with respect to the role of KPMG? Did this have something to do with those lawyers we were talking about earlier? Have they been very active in this area?

**Sir Brian Pomeroy:** No.

**Chair:** Is this a terms-of-reference issue again?

**Sir Brian Pomeroy:** Yes. We have simply told the story straight. Since impairments were a large component of the loss, which eventually ended the life of the bank, the story of the impairments, their evolution and the interactions that went on around them, not only between the auditors in the firm but in the different parts of the firm, are an important part of the story. We have told it factually.

**Q190 Chair:** That is fine. Now that you have set out the facts, you are uniquely well placed to make an assessment in order to provide recommendations and form a judgment. Why have you not done that?

**Sir Brian Pomeroy:** Are you referring to the performance of the auditor?

**Chair:** Yes.

**Sir Brian Pomeroy:** Simply because that is for their regulator to do. When you say we are uniquely qualified, we have the data—

**Chair:** Uniquely well placed.

**Sir Brian Pomeroy:** Perhaps qualified is exactly what we are not, in the sense that we are not audit practitioners. The FRC has audit expertise. If it is going to do more, it needs to apply its audit expertise to the data that we have given it and anything else it chooses to collect. That is the situation.

**Andrew Bailey:** They can also question KPMG, as I would imagine they will do.

**Q191 Chair:** The other thing I was struck by in your evidence to Steve Baker was why you have not looked at the basis on which they took their interim decision either. Why was that? The FRC took an interim decision not to take this further. I am just quoting back to you pretty much what you said to the Committee.

**Andrew Bailey:** It goes back to what I said: it was always our view that we were going to complete the report and the important decision would be taken on the basis of the final report and the final evidence.

**Q192 Chair:** We are identifying a weak link in the regulatory structure here, just looking at your body language and some of the things you have been saying to us in the last few minutes. Is the FRC a weak link in the regulatory structure? Is this a loose rivet below the waterline in an otherwise seaworthy ship?

**Andrew Bailey:** The FRC has done a lot in recent years to apply greater rigour to the standards of auditing.

**Q193 Chair:** Yes, but starting from a very low base, as we were discussing earlier.

**Andrew Bailey:** No, indeed. I do not know your view on this, but it is an area that does not get a lot of attention, on the whole. One thing I would take comfort in is that I think the degree of rigour has increased. That is in today's world; that is how they approach today's auditing standards. Going back to my response to Mr Baker, our involvement and interest in that has increased as we have put back this relationship with auditors. What I think we cannot explain to you, as we have said, is the judgment they reached on this case.

**Q194 Chair:** You will forgive members of this Committee, not least John Mann only a moment ago, coming to the provisional conclusion that this auditing business looks like money for old rope.

**Andrew Bailey:** I cannot influence what conclusions you come to, because they are your conclusions.

**Chair:** We are just listening to you.

**Q195 Mr Rees-Mogg:** I have some specific questions, but I wonder if I can come back to some very interesting points, Mr Bailey, that you have been making on what happened in the past and how things will be different in the future. A couple of your comments really struck me. You said that, had you been regulating at the time, with these companies being written up as being enormously successful, you would have been pushing strongly against the trend of the time. The other was that things are much more robust now. But I wonder whether things are more robust now because everybody wants to be robust. Let me declare, incidentally, my interest: I am regulated by the FCA and was by the FSA previously. There is no feeling in the City that they want to be as aggressive as they were prior to 2008. A banker who was cautious in 2005 was fired.

**Andrew Bailey:** Yes.

**Q196 Mr Rees-Mogg:** How do you do it, not today, but in 10 or 20 years' time? How do your successors ensure that the lessons are ingrained?

**Andrew Bailey:** This is the central question. I am pleased you got to it, because the great challenge we have—and this period of course illustrates it—is how we embed the approach to regulation in such a way that it is robust. It is inevitable that there will be changes of sentiment, changes in the economic cycle and, if I can put this politely, changes in the political economy. This happens, because it has happened over history, and the biggest challenge we have today, both FCA and PRA, and, if you do not mind my saying so, the Government and this Committee, is how we embed an approach that is robust to that.

We had the same challenge with monetary policy, if you go back 20 or 30 years, in this country. In my view, it has been proven that it can be done in that area, but I have been quite honest in saying it is the biggest challenge we face in embedding the new regulatory structure. I think we are on the fourth system of financial regulation in this country in my career, so it is clearly not embedded yet. It is the big challenge; you are absolutely right.

**Q197 Mr Rees-Mogg:** To what extent are some of the rules just very simple? If loan-to-deposit ratios get out of control, that is a very bad sign. If capital is falling below 8% at a stressed time, that is a bad sign. If definitions of capital are being adjusted to allow greater flexibility, so things one would not naturally think of as being capital or things that are not liquid are being included as capital, that is a bad sign. Can you take three items—those would be three that come to mind—and say, “These are absolute golden rules”? There is a tendency for regulation to

become overcomplicated. If it is overcomplicated, that is when you get the opportunity in the future for people to hack away at it.

**Andrew Bailey:** First of all, to your earlier point, the interesting thing is that all those straightforward judgments, as you might see them, that you just made are, of course, viewed through the lens of today's view of the world. Had you said those things in 2006, you would have got resistance.

**Q198 Mr Rees-Mogg:** My background has been looking at emerging markets. Whenever banks in emerging markets have got over a loan-to-deposit ratio of 135%, there has been a financial crisis. This has nothing to do with 2008; it just seems to be that, when they get to that level, there is one. Some of our banks got to a loan-to-deposit ratio of that height. So I don't think those things are necessarily hindsight, although people manage to explain them away. What I am trying to get at is whether there are any very simple rules that you think might work, long after you are retired and your successor but three is in post.

**Andrew Bailey:** I think those fairly simple ratios do work and they have power to them. There is a dreadful tendency of the regulatory system to become ever more complicated; I accept that and agree with you. People often say this about the leverage ratio. I am a supporter of having a leverage ratio, but I could arbitrage a leverage ratio; I am sure you could very easily. It is quite simple. You just take more risk per unit of balance sheet. It is really simple. So the simple measure on its own doesn't do it. My view is that you need a number of lines of sight of a thing, and if you have a number of lines of sight, on the whole you will get to the conclusion, because it is quite hard to arbitrage everything at the same time. You need a range of views. I don't agree that if you take one simple measure, you will always be all right.

**Q199 Mr Rees-Mogg:** Thank you. I do think this is the nub of the thing. My guess is that, when we have another financial crisis in 60 years' time, they will finally look through our reports and think, "If only they had paid attention." To come back to the specific report, Andrew Green's third recommendation relates to the information Mr Cummings was given during the investigation into his conduct. He was the only person investigated; other senior people were not. There is the comment to him by Sir Hector Sants: "You should fear me". Is it rather unfair, as much as it is unreasonable that others were not investigated, that one individual was picked out particularly?

**Sir Brian Pomeroy:** A process has begun, as we talked about at the very beginning of this hearing, to consider whether to start investigations of other senior people. This is Andrew Green's recommendation. In answer to the question you asked at the beginning of the hearing, that process has started. We will need to see what comes out of that process.

**Andrew Bailey:** One of the very good things about the senior managers regime is, of course, that it requires so-called statements of responsibility, so that it is very clear who is responsible for what. I have never met Peter Cummings, but I would imagine he would

say, “Why only me?” Well, I know that, because he has said it a number of times. The greater clarity of the statements of responsibility means that, in a sense, it is clear who is responsible for what. Therefore, what should follow in terms of enforcement would be clearly rooted in responsibilities.

**Q200 Mr Rees-Mogg:** As to the “why only me?” question, if you come to the conclusion that other people should have been investigated and steps taken against them, that only one was singled out is unjust to him, as much as it is a failure of the regulator in terms of the others. Regulators ought to seek to do justice as well as to correct wrong.

**Andrew Bailey:** In a sense, that partly lies behind Andrew Green’s conclusion, which we have accepted. One of the problems of the regime we have but will not have after next spring is this emphasis on finding personal culpability, which can lead down the track of, “Let’s find the individual who seems most associated with the most egregious act,” irrespective of who is really responsible for what at the senior level. This is not, of course, the only case in which this point has been raised.

**Q201 Mr Rees-Mogg:** A point that comes from it and from the report is that the FSA was broadly pretty incompetent in its approach, but that where it was competent, it was extremely aggressive, and that having aggressive incompetence is the worst approach for a regulator. If regulators are going to be incompetent, they should be gently incompetent—

**Andrew Bailey:** That is a wonderful statement. They should put that up on a wall.

**Mr Rees-Mogg:** But if they are going to be tough, they should be uniformly tough. Would you broadly accept that? I am not encouraging you to be incompetent, naturally.

**Andrew Bailey:** I will not take that as encouragement. I think you are right. I think you see a shift there. One of the interesting things I thought about when I read the Andrew Green report is that you do see something of a shift in the FSA’s behaviour in the later years. There is a sort of turning point, and the narrative of his report is quite clear on this, where the approach of the FSA shifts. It is still tough, but it is more across-the-board tough.

**Q202 Mr Rees-Mogg:** On some of the detailed issues with the FSA on record-keeping that come out in the Andrew Green report, I can see that, in a crisis, record-keeping is one of those things that, like filing, are always the thing that people do tomorrow. How do you ensure, in future, when under great pressure, that record-keeping is more efficient?

**Andrew Bailey:** You have to do it all the time is the answer. We have supervisory review processes, certainly in the PRA, and I think the FSA is pretty similar.

**Sir Brian Pomeroy:** We do.

**Andrew Bailey:** We have what we call a supervisory oversight function, which is reviewing case supervision and saying, “Have you done what you were supposed to?” which includes, “Have you kept your records?” Our internal auditors do this. We both have processes these days in terms of recording decision making. Board minutes have changed as well. I cannot emphasise enough that you have to do this in peacetime because, as you say, it is in wartime that it comes under most strain, although of course the problem with that is that it is often in wartime that you most need it.

**Mr Rees-Mogg:** You have to get the right practices in place now.

**Andrew Bailey:** Yes, you have to do it all the time. You cannot suddenly put it into place.

**Q203 Mr Rees-Mogg:** In terms of being in a stronger place now, do you both feel that the lever is being pulled and your respective organisations work lower down? The context of this is that Sir Hector Sants and Lord Myners both said they were keen on ambitious enforcement and then there wasn’t any ambitious enforcement. It is a pretty difficult position for the leaders of an organisation if they say X, the lever is pulled and there is no wire connecting it to the rest of the organisation. Are you confident now that that is better?

**Sir Brian Pomeroy:** I am confident. I think the levers are much firmer and better connected. On top of that, people in the middle and lower levels of the organisation are themselves encouraged to be more proactive and take more initiatives themselves. I think the levers are there.

**Andrew Bailey:** I agree.

**Q204 Chair:** It has been an extremely interesting hearing. You have caught some sense once again, I am sure, of the deep public anger about all this from a number of the questions and the types of questions that have come to you. They have not been assuaged by the passage of time and are only partly addressed by the publication of this report, on which one would have to conclude, “Thorough, and better late than never, but would have been best done much more quickly.”

I want to ask you one remaining question. Would you agree with the view that it is essential to get to individual responsibility, not in order to conduct a witch hunt, but to ensure that people understand, when taking decisions in future, that individual responsibility is meaningful and that, therefore, they need to pay great attention to the job that they have been given and its scope and limits?

**Andrew Bailey:** Absolutely. That is one of the central messages from this report.

**Chair:** Is there anything you want to add, Sir Brian?

**Sir Brian Pomeroy:** No. I agree entirely.

**Chair:** Thank you very much to the review team for seeing through something that, certainly in your case, Mr Bailey, you inherited in full. You were not there at the creation of all this mess. Thank you for giving evidence. No doubt we will be having further exchanges, not least on this groupthink problem, which has come in in various forms from questions round the table, in the months ahead.

**Andrew Bailey:** In a sense, it is my job. Brian has seen both the RBS and the HBOS reviews through as a non-executive. I have said that we owe him a great debt. He has put a huge amount of time into these reviews, I can tell you.

**Chair:** He looks none the worse for it. It just remains for us to wish you a merry Christmas and a happy new year.