ECONOMY, ENERGY AND TOURISM COMMITTEE

Wednesday 16 September 2009

Session 3

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CONTENTS

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ECONOMY, ENERGY AND TOURISM COMMITTEE
23rd Meeting 2009, Session 3

CONVENER

*Iain Smith (North East Fife) (LD)

DEPUTY CONVENER

*Rob Gibson (Highlands and Islands) (SNP)

COMMITTEE MEMBERS

*Ms Wendy Alexander (Paisley North) (Lab)
*Gavin Brown (Lothians) (Con)
*Christopher Harvie (Mid Scotland and Fife) (SNP)
*Marilyn Livingstone (Kirkcaldy) (Lab)
*Lewis Macdonald (Aberdeen Central) (Lab)
*Stuart McMillan (West of Scotland) (SNP)

COMMITTEE SUBSTITUTES

Nigel Don (North East Scotland) (SNP)
Alex Johnstone (North East Scotland) (Con)
Jeremy Purvis (Tweeddale, Ettrick and Lauderdale) (LD)
David Whitton (Strathkelvin and Bearsden) (Lab)

*attended

THE FOLLOWING ALSO ATTENDED:

Nigel Don (North East Scotland) (SNP)

THE FOLLOWING GAVE EVIDENCE:

Paul Chisnall (British Bankers Association)
Adrian Coles (Building Societies Association)
Owen Kelly (Scottish Financial Enterprise)

CLERK TO THE COMMITTEE

Stephen Imrie

SENIOR ASSISTANT CLERK

Katy Orr

ASSISTANT CLERK

Gail Grant

LOCATION

Committee Room 2

Scottish Parliament

Economy, Energy and Tourism Committee

Wednesday 16 September 2009

[THE CONVENER *opened the meeting at 09:31*]

Financial Services Inquiry

The Convener (Iain Smith): I welcome colleagues to the 23rd meeting in 2009 of the Economy, Energy and Tourism Committee. There have been no apologies, but I welcome Nigel Don, who is here as a visiting member.

Nigel Don (North East Scotland) (SNP): I do not think that I am a substitute.

The Convener: No. We are expecting a full turnout today.

Agenda item 1—our inquiry into the way forward for Scotland's banking, building society and financial services sector—is our main business for the coming months. We embark on our inquiry two years on from the US firms Fannie Mae and Freddie Mac being taken into public ownership, and a year to the day since Lehman Brothers collapsed in the US, which resulted in 5,000 job losses in the United Kingdom—the biggest single loss of jobs since Rover in 2005. The resulting chaos wiped £50 billion off the value of shares in FTSE 100 companies and was closely followed by various rescue bids for Merrill Lynch, AIG and others. Here in the UK, competition law was waived to allow the Lloyds TSB takeover of HBOS. Bradford and Bingley failed and was partially bought by Abbey, which is owned by Santander.

On 24 September 2008, the former chief executive of the Dunfermline Building Society told the committee:

> "we have seen over the years that the building society model is robust."

He went on to say:

> "Our stress testing shows that we have the capital to withstand and ride out what might be classified as the perfect storm."—[*Official Report*, *Economy, Energy and Tourism Committee*, 24 September 2008; c 1026-7.]

Of course, he was proved to be rather wrong, as the Dunfermline was taken over by the Nationwide Building Society shortly afterwards.

In addition, the Royal Bank of Scotland has largely been taken into public ownership.

The ramifications of all of that on the real economy have been huge, and as a committee we have been continually approached by businesses and their representatives about their problems in accessing finance.

I remind everyone that we are trying not only to set the scene and understand what went wrong, but to look forward to identify the challenges on the road to recovery and the best decisions that we can make for Scotland's financial services industry as a whole. We also want to ensure that we celebrate and promote our successes, of which there are many. Not everything in our financial industry has underperformed.

I welcome our three witnesses and ask them to introduce themselves and make brief opening remarks. I thank them for their written contributions.

Adrian Coles (Building Societies Association): I am director general of the Building Societies Association. All 52 building societies, which are mutually owned by their saving and borrowing customers, are members of the BSA. We also represent the interests of the merged Britannia/Co-operative Financial Services.

Paul Chisnall (British Bankers Association): I am an executive director of the British Bankers Association. I have responsibility for financial policy and operations, and, latterly, banking reform. My chief executive, Angela Knight, asked me to say that she would have liked to have been at this meeting but, unfortunately, our board meeting today meant that that was not possible. However, she would be happy to participate at a future stage of the inquiry if that would help the committee.

Owen Kelly (Scottish Financial Enterprise): I am chief executive of Scottish Financial Enterprise, which is a member-funded body. Our membership is diverse; it is drawn from all sectors of the industry. We are proud that it includes all the major banks in Scotland.

As members know from previous discussions, the financial services industry in Scotland is diverse. It includes insurance, life assurance, pensions and fund management. All those services operate successfully in Scotland. I know that the committee is keen to address the interests of the whole industry rather than just those of the banks.

I am pleased to be here. If we can do anything to help members individually or the committee collectively as the inquiry progresses, we will be delighted to do so.

The Convener: I thank the witnesses for their opening remarks and the offers to assist the committee in its inquiry. They are greatly appreciated.

I want to draw attention to two things that were said this week—as I said, it is the first anniversary of the collapse of Lehman Brothers. Yesterday, the Institute for Public Policy Research published a report that said:

> "there are already signs that lessons have not been learnt … as evidenced by the rapid return of the City's bonus culture."

On Monday in the United States, President Barack Obama said:

> "Instead of learning the lessons of Lehman and the crisis from which we are still recovering",

the financial industry is "choosing to ignore" those lessons. Do you agree?

Owen Kelly: From my experience and conversations with companies in Scotland, I do not think that that is the case at all. I have not met a single individual who works at any of our banks or institutions who has ever used phrases such as "back to normal" or "everything has recovered". If one had to generalise and characterise the industry, one would have to say that it has been humbled by what has happened. It is clear that our banking sector in particular has faced unprecedented challenges. People are working to come to terms with and overcome those challenges.

Barack Obama's description is useful; it suits the purpose of injecting urgency back into the situation, and I think that that is what he is trying to achieve. However, I do not think that there is any complacency; I certainly have not picked that up in my discussions in the industry.

Adrian Coles: I agree with that. We are nowhere near back to normal. Institutions are almost too cautious as a result of the recession that there has been over the past two years. They are reluctant to extend lending and are almost too reluctant to take on risk. They are taking very careful lending decisions and are being very prudent. They are concerned about their capital and liquidity levels. We have a long way to go to get back to normal, even if we accept that the years from 2005 to 2007 were above normal. We are not back to an average level yet, or anywhere near it. In net terms, there will be no new mortgage lending in the United Kingdom this year, for example. That is not getting back to normal at all.

Paul Chisnall: In the United Kingdom, the Financial Services Authority and the industry have prioritised the completion of the code of practice on remuneration. The intention behind that code is to deal with some of the fault lines that have come out in the inquiries that have been held into what went wrong. It seeks to align remuneration with risk, which is entirely appropriate.

It is unfortunate that the headlines are displacing the reporting of the work that has been undertaken. The FSA has had a dialogue with the large institutions that pre-signed up to the code. The code, which is thorough, deals with some of the excesses and puts us in the position of being able to achieve what we want to achieve: rewarding people for success, and not rewarding them for failure.

Rob Gibson (Highlands and Islands) (SNP): Last year, when we interviewed the Royal Bank of Scotland's chief economist, Stephen Boyle, he admitted that only a couple of people in the bank knew how securitised instruments work. Was that organisation fit for purpose?

Adrian Coles: I do not think that it is up to me to offer an opinion on one individual institution that is not in my membership.

Rob Gibson: I will ask about the development of building societies such as the Dunfermline Building Society, which began to take decisions that could be related, so you are not off the hook.

Owen Kelly: The RBS is a member of our organisation and, as I say, we are proud of that.

The RBS has been very frank and open about what went wrong at headline level in the institution. The takeover of ABN AMRO has now been recognised as a pretty huge strategic error, and the new chief executive, Stephen Hester, has been quite open about that, as were his predecessors.

The question that you raised about the understanding of trading and the risk implications of securitised products is, if I may say so, one of the central questions that arise from the entire crisis. How did those products come to be traded to such a degree and at such a level that they generated such systemic risk? The situation was perceived only by one or two institutions and bodies—the Bank for International Settlements comes to mind—but, unfortunately, they were not listened to. Your question is a big question, but it covers the whole banking system. Notwithstanding the RBS's openness and the fact that it has now set out a clear plan for recovery, I differ from you in that I do not think that the problem was unique to the RBS.

Rob Gibson: I do not think that the problem was unique to the RBS; I used the RBS as an example because it is the biggest bank in Scotland. We are trying to deal with how we got to where we are so that we can avoid doing so again.

Let me press the RBS example. What about the board members who came with starry credentials? Why did they not ask harder questions? We could ask the same question of the other banks. Why were their boards out of touch with the degree of difference between deposits and loans?

Paul Chisnall: We seem to have gone straight into some specific areas. I wonder whether it would help to take a step back and put your inquiry into the context of a number of highly significant reports that were written during the past six months. I say that because you will end up having a more strategic understanding of some of the work that has been undertaken to address some of the issues that you are raising.

The Turner review and the UK Government white paper "Reforming financial markets" try to set out what their authors believe went wrong. You have talked about remuneration, overcomplex products, whether we had the right governance and risk structures around those products, and whether the boards had the right understanding of the risks involved. Those questions are the bread and butter of the reports that I mentioned.

The Turner review and the Government white paper try to analyse what they believe went wrong. Turner talks about macroeconomic imbalances meeting financial innovation; rapid credit growth in the UK; and a poor understanding of the risks involved. He describes the situation as an overreliance on "sophisticated maths" and a lack of understanding of the risks involved in some of the instruments.

The Treasury takes a more direct approach. It talks about

"excessive leverage and risk taking; over-reliance on wholesale funding; overdependence on particularly risky product streams … or poor management decisions".

I take us back to those reports because they take us some way down the process of looking at the remedies. Turner looks at all the areas that the committee has raised and sets out approximately 10 themes for the work that needs to be undertaken to address some of the shortcomings that existed. He talks about capital, liquidity, accounting and scope for regulation, as well as remuneration, understanding of macro-prudential risks, market infrastructure and the complexity of some of the products. He also certainly talks about risk management and governance, which I think lie at the heart of the issue

09:45

Turner's recommendations are bound into the 92 or so action points that are being pursued under the aegis of the G20. A lot of the issues that are relevant to what went wrong with UK institutions are relevant to what went wrong with institutions elsewhere, and a lot of the remedies are not unique to the UK.

The white paper sets out the UK Government's formal acceptance of the action points that are set out in the Turner review, but it also talks about some of the additional action that is needed in the UK. It looks forward to a further bill that the UK Government will bring to Parliament this autumn covering the infrastructure of the tripartite authorities and some of the powers that the Bank of England, the Treasury and the FSA need. It also looks at additional measures that the UK Government believes are appropriate and necessary in the UK. Right at the heart of those are improvements in corporate governance and risk management remuneration, which are also at the heart of Rob Gibson's two opening questions.

Rob Gibson: I understand what you are talking about. You are saying that those reports are trying to draw a line under what happened. I am trying to look at what led up to that stage. It is important for us to know why major institutions in this country became so incapable of understanding what they were doing. We need to find the answers to some of those questions before we can know whether all the things that you have just listed can be applied rationally in the banking world in future.

Paul Chisnall: I have related some factors briefly, but when you get into the detail, you can see that they have real practical effect. There is a combination of circumstances, some of which are direct and are related to understanding around board tables, decisions taken by boards and individual responsibility—I accept that. For example, the Walker review recommendations look at whether our arrangements for corporate governance and risk management stood up to the expectations that we had of them. In some cases, they did; in some, they did not. The review also looks at the improvements that we need to make to ensure that those arrangements are more robust than they were before.

However, those issues cannot be examined in isolation from the more general background. The convener's opening remarks put the UK crisis into the context of the global crisis. That is an important point. Previous crises often had different causes, such as, in some cases, fraud or a deliberate attempt to act outside the regulatory rules. In this case, at the heart of what went wrong was a fundamental misunderstanding of the risks that were involved in some of the products that we are talking about, not just in the banks but in the regulatory and academic communities. There was widespread misunderstanding of the risks involved in many of the products that we are talking about.

There was also a belief—with hindsight, it is clear that it was a misbelief—that instruments in the trading book, for example, should attract less capital because if there were difficulties, one could trade out of them. That is now seen to be entirely inappropriate. There was also a belief that, for a lot of the financial instruments that led to the losses that we are talking about, slicing up risk and spreading it around would reduce it. That part of the Turner review is worth reading because it gives the clearest explanation of why risk dispersal does not necessarily reduce risk.

Rob Gibson: You have given a long explanation and raised many issues that members will want to pick up in detail. There seems to have been a willing suspension of belief. There are trade cycles and there are things that regularly lead to crises, but during the past 10 years, when interest rates were low and there was a gung-ho feeling, no one in the boards was saying, "Whoa! We've got to slow down."

You have provided a list of reports on which we can muse, but at this stage we do not need to consider all the possible outcomes; we need to know a bit more about the organisations and what discussions were taking place among bankers and others in the financial community about the probity of what they were doing.

Owen Kelly: I am not equipped to get into a discussion about individual banks and board meetings. I suppose that if the committee wants to take that further it will have to do so with the individual companies.

I add a couple of brief points. First, it is important to recognise that what happened in some banks in Scotland is very much something that was a common issue internationally; the difficulty was not unique to Scotland but reflects the completely internationalised and interconnected nature of modern financial services.

Secondly, banking is a diverse industry. The Clydesdale Bank, for example, has a different story to tell about what has happened during the past couple of years. I leave that thought with the committee. Although we have seen tremendous, all-engulfing problems at some institutions, the picture is more diverse.

Ms Wendy Alexander (Paisley North) (Lab): The submission from the British Bankers Association was helpful. In response to question 1, on the cause of the difficulties in the financial sector in Scotland, the BBA said:

"there are factors specific to Scottish institutions".

Will Paul Chisnall itemise those factors?

Paul Chisnall: Different institutions were affected in different ways. In making that comment I was alluding to factors that were specific to HBOS, in particular to do with the company's corporate lending and property book, while in the case of the RBS the acquisition of ABN AMRO was an issue. When the committee meets representatives of the institutions, they will be able to comment in more detail.

Ms Alexander: In paragraph 12, you said that there is

"concern about the potential that the various legal and regulatory changes overall may combine to make the UK a less attractive place in which to conduct financial services business".

Which legal and regulatory changes give the BBA cause for concern?

Paul Chisnall: I do not think that anyone in the banking industry is not in a reform mind—I underline that point. We understand that a lot has gone wrong, and I do not think that a single stone of regulation is not being lifted up, looked at and acted on if action seems necessary. Banks are holding more capital and are under increased liquidity requirements. We are considering the international accounting rules and the corporate governance arrangements. In the UK, the Banking Act 2009 is intended to ensure that the authorities have the powers that they need to deal with the consequence of failure. In the white paper on reforming financial markets, consideration is given to strengthening the arrangements for the tripartite authorities. I do not think that there is an area of bank activity or regulation that is not being considered.

There are many areas of regulatory review and reform, and across all those areas the regulators, whether they are international or in the UK, have the support of the industry. We are working closely with regulators to ensure that proposals are capable of practical application, so that regulatory reforms can meet their objectives. However, given that reforms are being considered in an international context, there is concern that if we take certain actions in the UK ahead of international agreement we will simply take a problem from one place and put it somewhere else. That is what I meant by the comment that you quoted.

We have all the proposals from the Turner review, work is being undertaken internationally by the Financial Stability Board—there are 92 action points in that regard—and work is being taken forward by the European Union, given that even when measures are devised at an international level it is often the EU that gives legal status to them. When we consider all that work, we are concerned that if the most demanding policy option available is chosen in each area we might end up with overregulation.

It is quite difficult to present that view, because we do not want to sound as though we do not accept that change is needed. However, it is time for an aggregate impact assessment, so that we understand in the round the benefits and costs of all the measures that are being considered. There perhaps ought to be a socioeconomic impact element to such consideration. We have raised the issue with the FSA, the Treasury, the better regulation executive and the National Audit Office, and we now have an opportunity to raise it with the committee. The issue is hugely important.

In our discussions with the authorities, we have been told, “Of course we do impact assessments,” but such assessments tend to happen much further down the line. The approach is almost, “Right, we’ve decided what we’re going to do; let’s do an assessment as a matter of cross-referral.” We think that impact assessment is a critical part of the process and needs to be undertaken at a much earlier stage, with more thoroughness than perhaps has been the case with some impact assessments in the past.

Owen Kelly: I give an example that illustrates the point quite well, which relates to wider financial services rather than just banking. The alternative investment fund managers directive has come from the European Commission and has bypassed the usual consultation procedures. The media call it the hedge fund directive, but it is about all kinds of investments. I draw it to the committee’s attention because a real international strength of Scotland is our investment community—our fund managers and so on—and the directive threatens that community quite significantly as it includes in its ambit products such as investment trusts, which are a bedrock product that was developed in Scotland in the 1880s and has been successful internationally. From our perspective, the ultimate losers of such an approach to regulation will be pension holders and others who have an interest—at whatever distance—in successful investment and successful investment management.

The way in which that example relates to the regulation that Paul Chisnall talked about, which might be taking place at UK level, demonstrates that the issue is multilayered. It would be helpful if the assessment that Paul Chisnall is calling for was done.

Ms Alexander: The Turner review has been in the public domain for some months. It would be helpful if the BBA itemised the proposals that it is in favour of and those that it is not in favour of. I invite the BBA to write to us about that.

In paragraph 13 of its submission, the BBA said:

“There is no reason to believe that access to finance will be more restricted in Scotland than other parts of the UK.”

Given that the market structure for retail banking in Scotland is rather different from that in the rest of the UK, can you provide evidence to support that proposition?

10:00

Paul Chisnall: I made that comment against the backdrop of an inquiry into how the crisis has impacted on Scotland. I asked BBA colleagues and members about the matter, and the response was that there are no factors specific to Scotland that mean that their lending decisions would in some way be made against criteria that are different from those that are used in the United Kingdom in general.

Over the weekend, I read the report on small and medium-sized enterprises’ access to finance, which the committee produced in the summer, I think. I was surprised by some of the points that are made in that report, because I understand—I hasten to add that I am not the BBA’s expert on SME finance—that finance has held up reasonably well, although that is clearly a broad statement that does not apply in all cases. I was surprised that the report said that, if there were difficulties, they were at the micro level for growth businesses. Our understanding of the figures that are being put together at the BBA is that finance has held up reasonably well. If there is a difficulty, it is at the mid-firm level rather than at the micro level. Therefore, we will want to consider your report. I assume that our retail team and the people who work on SME finance have already had access to it. I had not read it before the weekend, but I wrote to colleagues after reading it.

On evidence, my colleagues in our statistical unit considered finance for agriculture and fisheries. The BBA can break that down and provide a figure for Scotland. I can provide to the committee the chart that my colleagues provided to me that shows that finance has largely held up over the past six or seven years, including the past two years.

The Convener: For the record, I should make it clear that the report on SME access to finance is a Scottish Government rather than a Parliament report. It is referred to in the Scottish Parliament information centre briefing.

Ms Alexander: I want to push Mr Chisnall a little further on the implications for market structure in Scotland. On access to lending, HBOS has disappeared from the market in Scotland as a result of the merger with Lloyds TSB, while Barclays and HSBC, the other major clearers, have only a small presence here. Should I take it from what has been said that you have no concerns about the implications of the market structure in Scotland, which is rather different from that in the rest of the UK?

Paul Chisnall: It is clear that HBOS is no longer independent, but it has been subsumed into Lloyds Banking Group, which has a long history and tradition of undertaking business in Scotland. It has had a presence in Scotland for a long time. I am sure that you will see representatives of that bank and that they will be keen to ensure that they give business in Scotland the same attention and focus that they give to business in the rest of the UK.

Ms Alexander: We would be interested in your reflections, perhaps at a later date, on whether there are any issues to do with the unique concentration of banking services in the Scottish market, which is contingent on the market structure that now prevails here. However, I will leave that subject.

The closing paragraph of your submission states that the committee should consider

"whether the FSA had a sufficient local presence and whether its plans for staffing Scotland are consistent with ensuring that firms with a presence in Scotland benefit fully from its Supervisory Enhancement Programme."

Will you elaborate on that for us?

Paul Chisnall: My point was simply about how, with the industry's support, the FSA is reviewing how it goes about its business of supervision.

The FSA produced its report shortly after the Northern Rock situation when it held its hands up and said, "We don't seem to have our supervision process right." Two broad areas were identified: first whether the FSA approached the task at an appropriate strategic level; and secondly whether it had the overall resource to conduct supervision in the way in which many thought it was being conducted and certainly people would like it to be conducted in the future. My point in the written submission is that, if we accept that a strong and robust regulator strengthens financial institutions, when the FSA is increasing its resource to adopt a more intrusive approach to supervision—with the industry's support—there is the question of whether it is devoting sufficient local resource to activity in Scotland.

Owen Kelly: I have a brief comment to add. I talked to Hector Sants about the matter some time ago, and he explained a couple of points. My understanding is that the FSA operates on a UK basis, so it can serve English customers from Scotland and vice versa. Hector Sants said that the FSA was increasing its presence in Scotland. If it helped, I could find out a bit more about that and let the committee know.

Ms Alexander: I have questions for Adrian Coles and Owen Kelly, but I am happy to leave them for later, convener.

The Convener: We will come back to them.

Gavin Brown (Lothians) (Con): According to yesterday's financial press, the credit rating agency Moody's believes that £110 billion has been lost so far by UK lenders and predicts that another £130 billion is likely to be lost over the next two or three years. Leaving aside the issue of the reputations of the various credit agencies that gave triple A ratings to bonds that were clearly junk bonds, what is your response to that prediction? You have all certainly downplayed the suggestion that we are out of the woods to any extent—and I accept that—but if we are only £110 billion down and we will be an extra £130 billion down in the next few years it suggests that we have a long way to go. What is your response to Moody's statement yesterday?

Adrian Coles: Moody's and the other credit rating agencies are almost forced to take a pessimistic view. For example, the housing market is my particular area of interest and, when we spoke to Moody's in the spring, its core assumption on house prices was that there would be a peak-to-trough decline of 40 per cent, with a stressed decline of 60 per cent. However, the house prices peak-to-trough fall in the UK has been about 20 per cent, and prices have been increasing for the past four or five months.

When interpreting, we should therefore be careful not to confuse what could happen with what will happen. Certainly, our experience so far is that the credit rating agencies were perhaps too optimistic in the upturn and that, so far, they have been proved to be too pessimistic in the downturn.

Paul Chisnall: I have not had a chance to look beyond the headline in the newspaper, but I certainly echo what Mr Coles said. I do not understand whether Moody's is using a gross or net figure and whether it has any bearing on some of the losses that have been booked so far. Considering the way in which some of the credit reference agencies look at losses, there is a sense that some might have been overstated because of the way in which the accounting rules work. In what happens next, there might also be an element of rebalancing. I therefore think that it is possible that Moody's reported figures are unduly pessimistic.

Owen Kelly: I do not want to comment on how pessimistic those figures are, but I note that they deal with the assets that, over the past couple of years, everybody has struggled to place a value on. However, the figures remind us that there is no room for complacency.

Gavin Brown: On a similar theme, Lord Myners was interviewed by various journalists in the financial press yesterday. The question, "Who's next?" was put to him numerous times, and he was asked whether any other banks, financial institutions or building societies were in jeopardy. I do not expect any of you to name names, but from the discussions that you have had with your memberships, do you think that other institutions are set to fall, or are we at least over that part of the crisis?

Adrian Coles: It would be nonsensical to say that there will be no more mergers in the building society sector, for whatever reason. There have always been mergers in the building society sector. I do not know of any immediately likely developments, but it is conceivable that, if the recession worsens, if we have a double dip, if house prices fall again sharply or if Moody's is correct and is not being pessimistic, we might have more enforced mergers. I do not expect that, but I would not rule it out.

Paul Chisnall: I believe that we are through the financial crisis. I believe that the shocks to the system over the past two years have taken us to a point of some stability. Over the past year, the larger banks, together with the FSA, have stress-tested their balance sheets, and the outcome has largely been positive. I do not believe that events that take place in the future will look like those that have taken place over the past two years.

Owen Kelly: I agree with that, in that action has been taken in the UK to bring stability. I also agree with Adrian Coles: there may be further reconfigurations in the industry in the normal course of business, but that is different from companies, banks or other institutions going under.

That is a UK observation. There are still significant uncertainties in eastern Europe about lending there, but I am not aware that that has a direct impact on UK institutions.

Gavin Brown: This issue has been touched on already, but the subject that will be filling most legislators' mailbags at the moment, certainly in Scotland, is credit—its availability, and the terms on which it is granted. We have heard some general submissions on the matter. Mr Chisnall suggested that it

"has held up reasonably well",

or words to that effect—I do not want to misquote him. One of the critical parts of our inquiry will be to get to the nub of that issue. On one side, we hear from businesses that they are being totally squeezed and on the other side, we hear that lending has stayed stable, and some people have suggested that it has increased slightly. Both cannot be right, so it is critical that we get down to the detail.

I understand the positions of some of the banks, which are being asked to do several different things at the same time. The Treasury is asking them to go to 2007 levels, while the Bank of England says that only 2004 levels could ever be achieved. Banks are being asked to increase their capital ratios at the same time as they are being asked to increase lending. I totally understand their different objectives.

As far as the position on credit is concerned, are any of you able to give us specific figures—not for individual institutions, obviously, but for your respective memberships as a whole? To say that finance has generally "held up" okay does not tell us very much. Are your members increasing the availability of credit to residential and business customers? What about the terms on which credit is being offered? Is it being offered at punitive rates? Could those rates be lowered? Are you able to put figures to the general statements that have been made?

Adrian Coles: I will start with the housing market. Building societies generally do not lend to small and medium-sized enterprises; they are housing market institutions. As I said earlier, and as is stated in our written evidence, there will be no net lending to the UK housing market this year. There is no doubt about that, and I think that everybody accepts that mortgage credit has fallen very sharply indeed. In 2006, net mortgage lending was £110 billion; this year it could be plus or minus £5 billion—it will be about zero. There is no doubt that lending into the housing market has fallen very sharply, partly as a result of an absence of funding.

There will be no net addition to retail deposits across the whole UK banking, building society and national savings and investments system this year. All institutions are trying to attract funds from the retail savings market, but there are no funds to attract because that market is not operating appropriately. The wholesale markets are certainly easier than they were this time last year, when they seized up, and than they were two years ago, but they are nowhere near back to normality. It is difficult, especially for building societies, to attract funds from the wholesale markets. Local authority lending to building societies has more than halved over the past year, so it is very difficult to attract funding.

10:15

On the lending side, there is pressure to increase liquidity—to hold more money in easily withdrawable cash that is available to reassure depositors and which can be, in the event of a Northern Rock-type episode, available to pay out to them. That money cannot simultaneously be lent on 25-year mortgages if it is being held on short-term liquidity that earns only 0.5 per cent. That puts pressure on margins and forces mortgage rates up further than they otherwise would be.

As far as pricing is concerned, there is competition in the mortgage market for loan-to-value ratios of 60 per cent or perhaps 75 per cent. However, there is little competition if someone wants to borrow 85 per cent, 90 per cent or 95 per cent. That is typically the first-time-buyer market because, naturally, first-time buyers do not have significant deposits. If any lender sought to increase its lending significantly in the 85 per cent, 90 per cent or 95 per cent market, it would face attention from credit rating agencies. The agencies would point out that house prices might fall 40 per cent, that the lending is risky and that the lender might lose lots of money, and they would downgrade the lender. That increases the costs of funding in the wholesale markets and makes it less likely that institutions will fund somebody, so it is not open to an institution to make a sudden unilateral decision to support first-time buyers. That would be a brave step that would ultimately not be implementable.

Paul Chisnall: We can and will provide figures. I think that they will show that lending from the major UK banks has held up. However, they will not show that funding from other sources—hedge funds or overseas banks—has reduced and we have to think about the consequences of that.

When it comes to terms, as Adrian Coles said, the requirements on banks and building societies are greater. Banks are holding twice the amount of capital they were holding at the start of the crisis. They also have to hold more instruments in liquid form, which brings them a lower rate of return and increases the costs that the banks incur.

My other point is important to bear in mind when looking to the future as well as at the present. At the start of this evidence-taking session, we talked about banks not understanding the risks that are involved in some of their business. That includes corporate loans, SME loans and housing loans. Although my last mortgage might have been struck at 0.2 per cent above base, it is highly unlikely that it would be struck at that level in the future because there is a broad understanding that one of the problems that have brought us to the point at which we are is the mispricing of risk. If we accept that risk has been mispriced, we have to accept that the consequence is that it will be priced higher in the future.

Owen Kelly: Gavin Brown asked how it can simultaneously be true that the banks are, as they consistently say they are, lending at the same rates while borrowers cannot access credit. We have wrestled with that seeming contradiction over the past period. Stephen Hester said the other day that the RBS is approving 85 per cent of loan applications from business, which is the same level as a couple of years ago. However, because of the scale of the institution, the 15 per cent of businesses for which the answer was no still represents 50,000 people. I do not know whether that is part of the answer, but it is a conundrum and I can well understand why the committee will examine it.

The Convener: When I speak to the bankers, they tell me that they are open for business, but when I speak to businesses, they tell me that they have difficulty getting credit or the terms are more expensive. Adrian Coles's submission highlights the fact that quantitative easing by the Bank of England has been used not to increase lending but to restore banks' balance sheets. Do you plead guilty to that charge?

Paul Chisnall: I certainly think that the banks needed to restore their balance sheets, but that is different from the suggestion that the money from quantitative easing has not consequently fed through to the marketplace. I understand that the constraints on banks' balance sheets have meant that there is less money than would otherwise have been available—M3 has fallen. Quantitative easing has put that money back into the economy. The last presentation that I saw on that indicated that quantitative easing has had a real effect in making good the shortfall that would otherwise have existed as a result of the difficulties with banks' balance sheets. I believe that it has fed through to the marketplace.

Marilyn Livingstone (Kirkcaldy) (Lab): I have a question about the cost and availability of credit. I chair the cross-party group on construction, of which Nigel Don is the vice-convener. We hear from the construction industry that there are huge restraints on credit and that there has been renegotiation of the terms of credit. We have encountered many anecdotal examples of that in the sector, which is important to the Scottish economy. At every meeting, we hear that the availability and cost of credit is the big issue for the construction sector in Scotland. People in the sector say that the money from quantitative easing has not fed through to their industry; I am sure that Nigel Don will support what I have said.

We have also received letters from trade associations backing up the claim. They have given examples from among their members of long-term secure businesses that have gone out of business for the sake of very small amounts of money. In the case of one such business the other week, 50 people were made unemployed. As the convener said, the anecdotal evidence that we have received indicates that the money is not feeding through.

I would like to have more information—you may need to go away and look at the issue, so that you can provide us with exact figures. The committee faces a huge dilemma. We hear from the banking sector that money is still available, but we hear from the construction and manufacturing sectors in particular that it is not.

Owen Kelly: We have wrestled with this question. Any credit arrangement is a two-way thing, especially in the property sector. I do not want to speculate about individual cases, but given what has happened to property values, the collateral value of property holdings must in most cases have diminished. That must mean, in turn, that from the lender's perspective the risk profile and the value of the collateral to back up lending have changed.

It is quite difficult to aggregate many individual decisions to reach a general view. Paul Chisnall will agree that the headline figures from the banks, such as the one that I just cited for the RBS, point in one direction, but behind those lie a range of different decisions in individual cases. Changing collateral and expectations of a business because of the downturn may affect a credit decision. I am afraid that I do not have a straightforward answer. I can only go back to the figures and to the clear message that the banks are giving that they are open for business. How that translates into individual lending decisions is obviously a different question.

Paul Chisnall: I agree.

Nigel Don: There might be a very simple answer to this question. To what extent is a bank able or willing to take into account the huge social cost of pulling the plug on well-established construction companies or other businesses? To what extent do your businesses recognise that, despite the fact that a company's asset values have dropped and its order book is not full, it would be in the interests of the society in which the bank is physically located to take a little bit of a risk on it rather than simply put 50 people out of work?

Owen Kelly: Those questions are for the boards of individual institutions. I guess that they could bring what might be called non-commercial considerations into their lending decisions, but such an approach would raise questions of accountability to shareholders and others on the business's profitability. It is an institution-by-institution choice but, in general, banks are and have always been run as commercial businesses. I am not saying that what you have suggested is impossible; it raises a number of questions and, as I say, it would depend on an individual institution.

Adrian Coles: That said, in the housing market, banks and building societies are very aware of the social consequences of repossession. I realise that it is a slightly different issue, but it is related to the question. Only yesterday, we published a report on the impact of arrears and the extent to which institutions are willing to help people who get into such a situation, and we asked people who were in arrears whether they were satisfied with the support that they received from their mortgage lending institutions. I am happy to send the committee a copy of the report. I have to say that we were generally very pleased with the research results, which suggest that the perception of people in difficulty is that they received significant support from their banks and building societies. Building societies—and, I am sure, banks—are very aware of the social consequences of removing people from their homes and taking possession of their properties.

Paul Chisnall: There is a very clear understanding that we find ourselves in exceptional circumstances; this recession looks different to more normal recessions, if I can use that term. With the combination of Government action and the way in which banks are looking at things, there has been an attempt to take a more forward-looking view than might otherwise have been taken.

Nigel Don: Perhaps I could return to Mr Kelly's point. What about a bank that, for some arbitrary amount—say, £100,000—pulls the plug on a business that employs a couple of dozen folk? Would that decision even reach board level or would it simply be taken in the normal course of business? I am trying to tease out whether the discussions that we would want to happen will ever take place or whether such cases will always be subject to straightforward commercial decisions that will never be debated.

Owen Kelly: I do not want to give the impression that the processes behind such decisions are unsophisticated. As Paul Chisnall has rightly said, we are in different economic circumstances and individual institutions might well take a longer-term view of such matters. However, these questions are for the credit committees and so on. I suppose that my general point is that if an institution decides to have such a policy it will connect with the credit committees. If you are asking about an individual's discretion to take into account such factors in individual cases, that is a matter for individual institutions.

I should point out that commercial considerations can be a broad church. That can include long-term assessment of prospects for a dip and then a recovery and so on. Those are sophisticated processes but, ultimately, banks are businesses.

10:30

Paul Chisnall: It is about trying to take a longer-term view and supporting good lending prospects. The reason why I wanted to refer back to the Turner review and the Government reports from earlier this year is that, given that part of the problem has been excessive credit growth and an overexuberance in the marketplace, although banks would want to be as supportive as they can, we have to accept that the flip-side of having excessive growth is that you have some adjustment in the marketplace.

Marilyn Livingstone: I want to follow up Nigel Don's question, and my original question. The committee is concerned, because the construction industry is really important to our economy. Having small businesses across the board go out of business is not helpful when we are trying to rebuild our economy. We would like to hear how banks are addressing that issue and about their social conscience. I take on board the fact that banks are businesses, but given that the hurt to the future of our economy is so great, they have to address these issues.

One of the questions that were asked in the call for evidence was how we can ensure that the Scottish financial sector continues to retain a global perspective and does not retreat into purely localised lending regimes. I am concerned about our skilled workforce, for which Scotland has an international reputation, because people are losing jobs. How will the sector ensure that we have the workforce for the future, which we will need when we come through this period? There has been a loss of confidence, so how do we ensure that we are retaining as much of the workforce as we can and that we are looking to the future?

Owen Kelly: You are absolutely right that the skill of our workforce is one of our premier international selling points. The growth in the past decade or so of our asset-servicing industry—the business of supporting international transactions—means that companies such as State Street, Citi, JP Morgan and HSBC all now have sizeable operations in Scotland. The time zone is a factor, but the attraction is the high skill level of the workforce, because staff in that industry have to carry out extremely complex and sophisticated roles.

Marilyn Livingstone has raised a really important point. I picked up anecdotal evidence that young people's interest in financial services as a career choice has been pretty hard hit by what has happened. That does not affect Scotland alone—I am sure that it is true throughout the world—but it is a real issue. There is a proposal that I hope will soon come to fruition, around the body called the skills gateway, which is basically an attempt to bring together the industry and the public agencies and other providers of skills, such as the universities, in various ways. That will provide a focus for the kind of planning and discussion that Marilyn Livingstone rightly identified as being very important.

Having said all that, as we look to recovery and how the economy will look once we get beyond the financial crisis, I think that Scotland is very well placed—you might expect me to say that—because the skills that we have in financial services are world-beating, which explains why so many companies come here to benefit from them. The great challenge is to ensure that we take full advantage of that as things unfold.

The Convener: I have a general question about future job prospects. It is clear that there will continue to be job losses in the banking sector as it restructures. The Lloyds TSB and HBOS merger will eventually lead to branch closures. Other changes, such as the Nationwide Building Society's takeover of the Dunfermline Building Society, present the risk of branch closures. Has any estimate been made of the likely long-term implications for job numbers in Scotland of such changes? Looking further ahead, what are the long-term prospects for the creation of quality jobs in the banking sector? I am not talking just about call centre jobs, which are obviously welcome, but higher-quality jobs.

Owen Kelly: The convener is right—the RBS and Lloyds TSB are clear that they are going through a process of change, which has yet to be completed.

What is perhaps less obvious is that the situation is much more of a two-way street: we are not talking about a single direction of travel. For example, as the committee will know, Tesco has set up its headquarters in Edinburgh and has announced more jobs in Glasgow. That is a business that is very likely to grow. Other jobs have come in, for example, at Odyssey and, in recent months, esure. I do not want to sound complacent, because that would be dangerous, but it is not a one-way street.

One reason why is that all financial services companies are under pressure to make savings and to improve their business processes. That is a constant pressure, but it is probably more acute now. Scotland holds up very well as a place for such companies to come to because they can, from the point of view of running their operations, get high-quality people more cheaply than they might do in other parts of the UK.

We are still living through change. I know that the committee will examine the issues, but the other difficulty is that it is not easy to keep track because of the difference in roles and people and so on. If I had to give an impression—that is probably all that I could offer at the moment—I would say that the position is neutral.

Paul Chisnall: As I think I mentioned earlier, as an industry, we have been saying that it is important to have a socioeconomic analysis of the cost of increased regulation. It is easy to think of regulation as being just a cost on an institution, but it feeds through. If the cost of regulation is increased significantly, there are only two places where it can go: either the cost of lending has to increase or there is additional pressure to find cost savings in the institution's operation. That is why it is important that we look at the whole package and understand the consequences of some of the decisions that we are taking in the regulatory field.

Adrian Coles: I would add that Lord Turner, who is chairman of the FSA, began a debate about the social usefulness of some financial services activity. Is the financial sector too large? Does it employ too many people? Would it be better for people who work in financial services to be encouraged to go into other areas such as manufacturing and engineering? At the very top of the regulatory tree, questions are being asked about the size of the financial sector.

Paul Chisnall: Adrian Coles is entirely right. Lord Turner raised some of those issues—it was on the front page of the *Financial Times*. We have also seen the publication of "The Global Competitiveness Report 2009-10", which was prepared by a group that was co-chaired by the Chancellor of the Exchequer and Sir Win Bischoff. It would be worth the committee's while to dwell on some of the conclusions of that report. First, it made clear and added profile to the fact that when we talk about the City or about financial services in the UK, we are talking about an industry that employs 1 million people throughout the UK, 90,000 of whom are in Scotland. We need to bear in mind that the financial services industry is not focused on the City of London.

Secondly, the report considered whether the sector is bloated. It is clear that there are particular lines of activity that have led to losses and whose value one might question. In any case, the market will reduce those activities in the future. On whether the contribution that financial services make to gross domestic product here is out of kilter with the position in other countries, or with the position in relation to manufacturing, the report says that the industry contributes about 8 per cent of the UK economy, which is in keeping with the situation in other major economies. It compares with a contribution from manufacturing of 14 per cent.

The report also reminds us of the conditions that are necessary to make the UK—including Scotland and the regions beyond London—an attractive place for companies to list and for overseas banks to conduct business.

Lewis Macdonald (Aberdeen Central) (Lab): We have discussed the technical explanations at length, and it is clear that they are a very important part of the reason why we are where we are. However, there is for many people an issue around how far the culture of the financial services sector has brought us to this point.

The Building Societies Association has commented on the causes of the boom and the features of the bust. It refers in its submission to the importance of

"Perverse incentives … in … remuneration and bonus payment",

and to "greed" and "arrogance" on the part of some institutions. It also refers to "strong evidence of fraud" in the development of the crisis. Can you expand on that, and explain whether you believe that those features are the consequences or the causes of the misjudgment of risk, and of poor corporate governance and management decisions?

Adrian Coles: Those points that we mention in our submission were features of the entire market. If we go back to the late 1990s, there was a culture of "Let's have something for nothing" when people voted for the demutualisation of building societies because they thought that they could get £2,000 of free shares with no consequences whatsoever. Now, 10 years later, we have seen all the demutualised building societies fail, and we see money moving around the retail financial services market for an extra 0.1 or 0.25 per cent.

The entire culture of the way in which the UK economy has developed during the past dozen or so years has involved people looking for the very best terms and shifting money; accepting rather than questioning the idea that it is possible to get something for nothing; and feeling that they are entitled to the benefits of the booming economy. More specifically, there has been a culture in which institutions have felt that they ought not to fall behind, and that has infected some building societies. If you stuck to the knitting, you were viewed as boring and backward, and not competing properly, and you suffered. That view unfortunately infected the management of some of the banks and building societies—Dunfermline is not the only building society that has faced difficulties during the past dozen years or so.

With regard to some of the decisions that institutions have taken, Alan Greenspan spoke in 1996—a long time ago—about "irrational exuberance". People got carried away by a herd instinct—a feeling that if everyone else was doing it, they had to. They read the newspaper articles that said that if you did not grow your business as rapidly as everyone else, you were a bad manager and had to do something about it; and that if you were not doing the same as the rest of the market, you risked the board losing patience with you as a manager and recruiting someone else.

The issue is the way in which the entire system interacted, so I do not want to blame any particular individual. It is about the culture that has developed during the past 12 years. We need conversations such as this one to pick apart that approach and to understand how we can change it.

Lewis Macdonald: I am certainly not asking you to name names, but I am interested in whether those features are recognised by the financial services sector as a whole. We have heard about the very useful recommendations from Turner and so on about ways to mitigate some of the structural and regulatory issues. Are methods in train to address the cultural issues that you mention? In other words, has that irrational exuberance melted away in the heat of the recession, or is it still there and likely to rise again if it is given half a chance?

Adrian Coles: As I suggested earlier, the problem right now is the opposite of irrational exuberance. There is almost an irrational pessimism at the moment, certainly in the housing market and on the part of the credit rating agencies.

The economics professor Charles Kindleberger wrote a very good book analysing the impact of booms and busts right back to tulip mania and the south sea bubble. Starting with the tulip mania of the 1620s, he identified at least a dozen economic cycles in which the characteristics that we have seen over the past 10 years were present. That is a very useful book to read. We do not seem to be able to learn from all those different episodes.

In my view, there will never be a steady state of solid economic growth—no one will ever abolish the economic cycle. The good times will return, and at the end of the next set of good times, people will be irrationally exuberant again and we will face difficulties, although they might not be quite as dreadful as those that we have faced over the past two years. It is natural that, when things are going well, people feel optimistic and take risks that they would not take in a more depressed time.

10:45

Owen Kelly: People often say that language is a reflection of culture. In our response to the Turner review, we encouraged him and the industry as a whole to think about how distant we have become from the customer and to think about how that is affected by the language that we use. For example, why do we always talk about equities when we mean shares or shareholdings? The growth of such baroque language is an observable phenomenon whenever people have a position that they want to protect by making it look more difficult. Some big questions need to be asked about transparency and how well our industry is understood.

One thing that the crisis has taught us—this is not in any way a controversial point—is that our industry and the banks in particular are central to and directly affect everybody's lives, therefore it is incumbent on us as an industry to explain ourselves more clearly and to promote greater understanding of what we do. I could talk about that at great length—although I do not intend to do so—as it will be a central issue for the coming years. We need to promote such understanding not only in marketing materials or in the great wodges of paperwork that come with the purchase of any financial services product but in our dialogue with the public and in our dialogue with customers.

Adrian Coles: I agree. There is a lot of conversation about the need to improve financial literacy and financial education. There is almost an arrogance on the part of financial institutions that demands that customers speak our language. In fact, customers can teach financial institutions quite a lot about how to speak plainly.

Lewis Macdonald: We cannot legislate to make people rational, but we can make institutions transparent. That is essentially the point that is being made.

Adrian Coles: Yes.

Paul Chisnall: Improvements can be made in transparency and in the weighting that is given to ensuring that people understand risk. If people do not understand risk, they should be asking more questions.

Another element is that boards must look much more closely at risk within some of their business lines. There must also be greater focus on trying to understand the risks across the system. That was perhaps a major gap in how we looked at some of the strategic lending decisions that were made.

Lewis Macdonald: A year ago—this picks up the point about language—Alex Salmond said that the merger was forced upon HBOS by

"a bunch of short-selling spivs and speculators in the financial markets."

A different view was taken by George Mathewson, who said that short selling played a constructive role in the market. Is it too early to make a judgment on who was right?

Owen Kelly: I think that, at that juncture, only a relatively small proportion of the shares—I cannot remember the figure—were on loan and therefore available for short selling. Although short selling was perhaps a factor, it was probably not the decisive factor by any means. However, that is not to say that it was not an issue.

I think that the merger, or acquisition, was very much the right response at the time. If one casts one's mind back, one recalls that the situation felt very extreme. In the discussions that took place around our board table—not on that particular company, but generally—I know that there was a real sense of “Gosh, what’s going to happen next?” In the circumstances of the time, it was the right move. However, as I said earlier, the implications of that are now being played out in the new Lloyds Banking Group.

Lewis Macdonald: I am interested in how those developments at that critical point, particularly in the Scottish context, reflected the culture of irrational exuberance that has been described.

Adrian Coles: I do not think that the merger announcement reflected the culture of irrational exuberance. Perhaps some of the lending that building societies and banks did in 2004 to 2006 reflected that culture, but the solution to that situation did not reflect that culture.

Lewis Macdonald: I was talking more about the run on the banks. How much did the culture that you have described as prevailing at that time contribute directly to the pressure that the banks came under a year ago?

Adrian Coles: The culture of irrational exuberance was a contributor to the situation in which financial institutions found themselves, but it did not contribute to the solution that arose.

Paul Chisnall: If anything, that shows the consequence of a loss of market confidence.

Stuart McMillan (West of Scotland) (SNP): I have a few questions, the first of which is for Mr Coles. The BSA submission talks about increased competition from the part-nationalised banks. Will you elaborate on that?

Adrian Coles: There is a strong feeling among building societies that, although generally—with one notable exception—they did not require taxpayer bail-outs or assistance from the financial services compensation scheme, they now face unfair competition from institutions that made mistakes and required that assistance. Those institutions are returning to the market stronger than they otherwise would have been and are damaging the interests of those that, on average—although I admit that there were exceptions—were less affected by irrational exuberance and were more prudent in their lending in the run-up to the crisis. Some of the completely and partly nationalised institutions are making very competitive offers, which we believe damages the interests of building societies in the market. For instance, Northern Rock, which is fully nationalised, last year identified a funding target in the retail savings market—where building societies compete—that it said would take three years to meet, but it has met the target in one year.

Some of the semi-nationalised banks are making very attractive offers that building societies find extremely difficult to match. From market research, we know that there is a perception in the marketplace that the semi and fully nationalised banks do not suffer from the £50,000 financial services compensation scheme limit to which all other institutions must adhere, so some savers are more willing to invest £100,000, £150,000 or £200,000 in the semi-nationalised institutions than in the building societies. It is galling for building societies that almost failed or totally failed institutions are coming back into the market stronger and are competing strongly with institutions that did not require taxpayer support.

Stuart McMillan: So it is not inconceivable that, in five to 10 years, there could be a reduction in the number of building societies, in part because of that increased competition.

Adrian Coles: As I said earlier, to say that there will be no more building society mergers, certainly over five to 10 years, is not sustainable. There will be more mergers and they might be affected by the situation that I have just described.

Stuart McMillan: Mr Kelly, in paragraphs 19 and 20 of your submission, you refer to costs being lower in Scotland and to avoiding increases in costs. That suggests to me that, in the past, Scotland sold itself short in paying staff, compared with the industry elsewhere in the UK. Is that a fair assessment?

Owen Kelly: Are you asking whether there was a perception that people got paid less if they worked in Scotland?

Stuart McMillan: Yes.

Owen Kelly: Of course, businesses’ costs are not made up only of salaries, although salaries are an important part. I think that there is evidence that the median pay in Scotland is only slightly lower than the median pay for financial services across the UK—the evidence is in the Financial Services Advisory Board’s annual report, but I am afraid that I do not have a copy with me. If we consider the different structure of the industry in the City of London, we can see how that would arise.

In general, I do not think that Scotland is perceived in the industry as a low-pay destination. It is certainly the case—although it is perhaps too little acknowledged—that we have critical mass in Scotland. I heard that view earlier this week from our members in the big multinational American and other organisations that have asset-servicing operations here. An experienced fund accountant in London—that is an obvious example; it could also be Dublin—can come to work in Scotland knowing that they will have a real career here, because there is enough of a critical mass and there are enough opportunities. The same is true for fund management, insurance, banking and a range of sectors.

One argument that we certainly make to potential investors is that they will get higher quality for the same money if they come to Scotland. You asked whether we sell ourselves short. We could always get better at selling ourselves. As I said, this period of difficulty is perversely an opportunity for us, which is why we have continued to work closely with the Scottish Government and the UK Government to promote Scotland as a location for international financial services. Costs are an important part of that. We are not a low-cost location—there are cheaper places—but the balance of quality and cost is pretty good.

Stuart McMillan: I am keen to know what the witnesses think are the implications of the quantitative easing policy. What will the situation be in five or 10 years' time?

Adrian Coles: The full implications are not yet clear. Short-term interest rates in the gilts market are probably lower than they would be in the absence of quantitative easing.

When the policy was introduced, we hoped that some of the funds would flow through the wholesale markets and the retail markets. However, as I have said two or three times, there is very little flow of funds in the retail savings market or in the housing market, and it can clearly be observed that bankers' deposits at the Bank of England—which include the deposits of some large building societies, so this is not an anti-bank point made by building society people—have risen not just rapidly but hugely, by well over £100 billion, at the same time as there is a quantitative easing programme that will eventually total £175 billion. That is significant, and I do not think that it is a coincidence. It might be to do with the speed of implementation of the programme during the past six months, and the banks might gradually disperse the additional deposits that are being held in the Bank of England during the next five years—the timescale that you are talking about. We have been surprised by the extent to which bank and building society deposits with the Bank of England have risen rapidly at the same time as quantitative easing has taken place, but that might just be a short-term institutional reaction. We need to wait longer to learn whether more constructive use is made of that data.

Banks and building societies are under great pressure from the FSA to have lots of high-quality liquidity. There are regulatory pressures, so there is a range of conflicting demands on the banking system, as another witness said. Some people want the banks to lend much more money to their customers; the regulator and the Bank of England want banks and building societies to hold high-quality liquid assets—and lots of them—so that their balance sheets are stronger than they otherwise would be. We cannot simultaneously increase the quality of balance sheets by holding lots of high-quality liquid assets and lend the same money to customers in the way that you said the construction industry wants institutions to do. There are two conflicting pressures in that regard, and both things cannot happen.

11:00

Owen Kelly: I agree with Adrian Coles that it is too early to say. It is also important to keep in mind that what the Bank of England did was part of a co-ordinated international effort with other central banks that amounted to a collective effort to mitigate the effects of the global downturn. It is still hard to predict whether the work was calibrated at just the right level. I think that the work is completed now—

Adrian Coles: There is still a bit to go—maybe another £25 billion.

Owen Kelly: Is there? Okay, so the process is continuing, although there is no intention to take it beyond £175 billion.

I am sorry that I cannot be more helpful, but I repeat that the Bank of England is contributing to a wider international effort.

Paul Chisnall: And that is the point. We are facing the biggest financial crisis that we have seen for—people are saying—80 years, and quantitative easing is intended to counterbalance some of the deflationary pressures. I think that that is why the co-ordinated G20 action is able to take place—we might not have seen it otherwise. In that regard, the London-Washington summits have been successful and we have seen a real attempt by world leaders to maintain open markets and not retreat into protectionism, and to try to provide the kind of support for the economy that many of us believe is necessary.

Like everything, there are positives and negatives. By definition, the consequence of quantitative easing is inflationary. Of course it is; that is the intention. It is meant to counterbalance deflationary pressures. You ask what the consequences will be in five to 10 years' time. They could be inflationary, which is why we need to ensure that, to the degree that they can, the central banks look ahead and plan how to take the situation forward.

Stuart McMillan: Recent reports have suggested that we might be moving into an age of austerity in terms of Government spending that might last as long as 10 years or so. How will that affect the financial institutions and the financial industry?

Paul Chisnall: I have not really thought about the situation in those terms. Clearly, there is a discussion to be had about how the budget deficit can be brought down, and all political parties are considering that. The decisions that will be made in that regard will have an effect on all parts of the economy, including banks, but before we know what those decisions are, it is difficult to see what the effects will be.

Owen Kelly: At the Scottish level, it is well known that a large proportion of our gross domestic product comes through the public sector, so that will be a continuing issue for this Parliament, whether the decline in public spending is at a devolved level or at the level of the 40 per cent or so that comes from the UK Government.

The other point is that we might see increasing interest in raising taxes—parties are already talking about that at a UK level. As we said in our submission, we hope that the impact on the international competitiveness of the UK and Scotland will figure largely in those considerations.

Adrian Coles: It is difficult to respond without knowing the details. Every lobby group has good reasons why the level of expenditure on its pet project should not be cut back. For example, if there were cuts in the level of Government support for owner-occupiers who are in difficulties, one would expect arrears and, possibly, repossessions to increase. Also, the stamp duty holiday, whereby a greater proportion of housing transactions are exempt from stamp duty, is due to finish at the end of the year, and that will impact on the housing market. However, those are specific comments rather than comments on the more general point that was raised.

Christopher Harvie (Mid Scotland and Fife) (SNP): The ethos of your submissions is that it is time to move on, and I want to consider how we will adapt to the future. About 20 years ago, I interviewed Charles Winter, who was then the chief executive officer of the Royal Bank of Scotland. He was a banker's banker and a man who came from a cashier's position in Dundee to run the bank extremely efficiently and recover from the problems of the early 1980s. Fred Goodwin had a board behind him that consisted of people such as Sir Sandy Crombie, Peter Sutherland, the former EU finance commissioner, and Steve Robson, a former deputy from the Treasury, although I am not sure that I would have allowed anyone who was responsible for rail privatisation anywhere near a public concern.

The result was what we have been discussing today—an inability to assess risk, and executives who were out of control. There is an interesting and revealing article by Michael Skapinker in today's *Financial Times* about the ethics of bonuses. It shows that, even in the heart of metropolitan capitalism, there is enormous distrust of people who boost transactions in order to claim a bonus and then clear off when they have enough money to exist on. That seems to be the ethos, and it is a thoroughly dangerous one.

Have the good days of wild capitalism outpaced even the most authoritative types of control, for instance in the total failure to do any due diligence on ABN AMRO?

On the other bank, HBOS, why was Peter Cummings able to build up a debt of what is generally assumed to be about £250 billion on the investments of that bank?

Is the system repairable or do we have to look for something radically different—something that is much closer to the industrial banking of Europe, let us say? I suppose that that question is for Paul Chisnall.

Paul Chisnall: Different institutions have been affected in different ways. Clearly, some have managed to control their risks within more acceptable parameters. It is clear that a rebalancing will take place within the industry as individual institutions look at their strategies. In his review, Sir David Walker sought to consider the practices—the real, practical applications—that have meant that some financial institutions find themselves in a better position than others. The 39 recommendations in his report all have that practical feel. They are not of a high-level, highly theoretical nature. They are about what we can do to ensure that boards are more effective in their oversight of risk, what we can do to ensure that all boards have a greater emphasis on risk review, and what we can do to ensure that remuneration does not involve perverse incentives.

As is always the case when we are faced with a report of more than 100 pages, there are specific issues that we want to have the opportunity to raise, discuss and debate. As for whether the precise recommendations are the right ones, I think that most people who read the Walker review on corporate governance and the management of risk think that he has got some of the conclusions in the right place. They include having a higher profile for chief risk officers, ensuring that the function has independence and having a risk committee at board level that has an equal status to the audit committee. It is also about greater engagement by institutional shareholders so that they get to know the company better and can express views about what they think the right strategy for the board is. That will get away from what has in the past simply been a drive towards increasing yield. Such things can be considered.

There is a cultural element. People who are considering their roles and responsibilities around the board table of any institution will put financial stability much higher up in the factors that they weigh in considering strategic decisions than perhaps they would have before, and that is entirely appropriate.

Christopher Harvie: On the management of risk, in my bank, HBOS, Sir James Crosby dismissed the risk assessor Paul Moore and was appointed as vice-chairman of the Financial Services Authority at around the same time. That was at that great moment of jubilation about the triumph of light-touch regulation in Britain. It is nice to see that modifications are being made but, from a Scottish standpoint in particular—it should be remembered that we have lost banks—it has been like fitting padlocks on to stable doors when the horse is several miles down the road.

I have a question for Owen Kelly. At the end of Scottish Financial Enterprise's submission, the need for infrastructural investment to boost the Scottish financial sector or at least to lead to its recovery is mentioned. Will the type of banking system that we currently have, and the relative reluctance of foreign banks to lend in Britain, aid the communications that can better our financial standing in the future, or must we start from a different model, reinvent the mutual at a local level, and bring back the Trustee Savings Bank out of Lloyds TSB? We might be forced to do that by the EU. Should we have a model that is closer to that of industrial banking in Rhenish social capitalism on the continent?

Owen Kelly: I will not discuss individual companies or what might happen to parts of Lloyds Banking Group, if that is okay. I should say that I think that Sir Sandy Crombie, whom you named as a member of the RBS board during the period of irrational exuberance, joined the RBS board relatively recently.

There is a strong case for recovering or reasserting the values and professionalism that have defined banking in Scotland for a long time. The Chartered Institute of Bankers in Scotland is one of the custodians of those values. I expect that a representative of it is on the witness list for the committee's inquiry; if not, it might be worth thinking about including one on that list. The institute is primarily an educational body; people become fellows of it. A criticism that has been made—famously in front of a House of Commons committee—is that not enough professional bankers are involved at the highest levels of some of our banks. The institute has a strong view on such issues.

There is a case for returning to those principles. That fits well with what Adrian Coles said about our having been through a period of irrational exuberance. Some of those values certainly look right to us now, but we have been through a period in which people felt justified in not paying the attention to them that they should have.

11:15

Adrian Coles: I very much agree with the thrust of Christopher Harvie's remarks—I think that he was talking about support for a diversified market. We should not put all our eggs in the one basket of the public limited company, shareholder-driven, globalised, profit-maximising model, nor should we have all mutuals. We should have a mixed system, where the incentives diverge between different types of institutions, where there are different approaches to business and where we have a greater chance of avoiding the herd instinct. You might expect me to say this, but I think that we went too far towards the plc, profit-maximising, shareholder-driven approach, which was too dominant. There is an opportunity now to redress the balance slightly. I would not argue that every institution should be mutual, but we will be publishing a paper shortly making the case for the remutualisation of Northern Rock, which could see the company go back to its pre-1997 building society status, rather than return to the plc sector, where there would be a greater chance, perhaps in 10 or 15 years' time—certainly not next year or the year after—of some sort of repeat of the issues that we have seen over the past two years. It would be advantageous to have a diversity of systems and a greater spread of incentives, approaches and institutions that are responsible to shareholders and to customers, which mutuals are.

The Convener: You raised the issue of the future shape of the sector in Scotland in particular. Over the course of the 1970s, 1980s and 1990s, we saw a big change from the old model, with the TSB and building societies, to the plc model, with many more mergers. In Scotland, the mutual sector is fairly small, because the TSB is now part of the plc sector. The European Commission is looking at the part-nationalisation of the banks. The merger of Lloyds and HBOS has resulted in competition issues, which might result in some demergers of existing banks. What are the likely moves and timescales? What is the future shape of the banking sector in Scotland likely to be? Will we see a move back to mutualisation, some new players coming into the scheme and demergers of very large banks?

Adrian Coles: I think that building societies looking forward would be somewhat afraid of the dominant market position of Lloyds Banking Group, which will have around 30 per cent of the mortgage market. It is in a powerful position, which will make things difficult for building societies. If Lloyds Banking Group chooses to flex its muscles, cut costs, close branches and concentrate its processing in one or two centres, some of the smaller institutions might find it difficult to compete. However, I always take the view that a well-managed small institution with proper corporate governance and a strategy that it knows it can implement can compete against anybody. There are clearly dangers in having overdominant institutions. We would certainly favour some reduction in the dominance of Lloyds Banking Group in the mortgage market in particular.

It is difficult to see how new mutuals can be formed from the ground. Northern Rock is an obvious example of a company that could be remutualised. It is conceivable that some of the credit unions could eventually convert into building societies, but that is not a legal option at the moment. Most credit unions in the UK are tiny, although they are important in the areas in which they operate.

There is an advantage in taking a more atomistic approach to the market, rather than having one or two huge conglomerates. We would like to see steps taken in that direction.

Paul Chisnall: We have seen a repatriation of overseas finance not only in Scotland or the UK but around the world. It is important that we think in a forward-looking way about how we can fill some of those gaps, because I think that that will continue to be the case for some time. I get concerned when the discussion seems to say that big is bad and small is better, so let us have a migration from one to the other. A more even-handed way of looking at this is to think about the new sources of finance. It is a simple fact of life that the UK market is highly concentrated. Elsewhere in Europe, there is a similar market in some ways—it is different from the market in the US, for example. There will be diversification in cases where, for example, the European Commission is investigating whether there are competition issues. However, rather than seeking to change the existing model, we should continue to work with what we have, recognising that it has strengths, and seek additional means of bringing finance into the marketplace.

Owen Kelly: I will try to look at Scotland and the industry as a whole. Banking is going through a significant change. It is not controversial to say that that change will make the sector less expensive and less profitable. However, banking will remain central to Scotland's financial services industry. If I had to give a pen picture or to look into a crystal ball, I would say that the success of areas such as wealth management, asset servicing, fund management and life and pensions, all of which are strong here in Scotland, will continue to grow. I am picking up strong signals about that. The common factor over the next few years will be internationalism and competing in an international market. Notwithstanding the regulatory changes that may be coming—some of which, as currently drafted, may introduce elements of protectionism—that will be the defining feature of future growth.

Adrian Coles: I would like to comment on one point that Paul Chisnall made. I do not want to oversimplify matters by saying that big is bad and small is good. There are some successful large institutions—our biggest member, the Nationwide Building Society, is one—but there is a huge danger if the institution that has 30 per cent of the mortgage market continues to be 43 per cent owned by the Government, with the advantages to which I have referred. That issue must be addressed.

The Convener: The Communication Workers Union proposes the creation of a form of mutual banking, through the Post Office. Post Office banking would be taken back into public ownership initially, as part of a move towards a mutual model, similar to the old TSB network rather than a building society. Would you see that as a good move that would help to develop competition in the market, or would it create another state monopoly that would be counterproductive and reduce competition?

Adrian Coles: It depends on whether you are talking about a state-owned institution or a mutual institution. A mutual institution is one that is owned by its customers, not by the state. If we create a new state-owned body, that has all the implications that I described earlier and will be damaging to purely private sector institutions. The alternative would be to create an institution that is owned by customers and is statutorily required to put customers and no other interest first. I have not thought about that proposal in great detail. On the face of it, it is attractive, but I would need to reserve my position and to work out what the impact of a Post Office financial services business owned by its customers would be.

Christopher Harvie: I offer a final observation. I imagine that many of you have experienced the delight of dipping into J K Galbraith's "The Great Crash, 1929". No one could write better about such a bizarre situation. However, despite the slump at that time, 1929 and the years following it were the beginning of the automobile age, mass flight, cheap housing, telecoms and everything of that sort. Which one of those will not in some way be interdicted over the next period because of the climate change problems that we face us today? In other words, we are in a period of difficult long-term finance when it comes to assessing the collateral damage that such finance inflicts in an environmental sense. We ought to take cognisance of that issue when planning for the future.

You have mentioned initiatives such as high-speed rail links instead of aircraft services, but such projects extend over a 20-year period. How does one devise forms of finance that can sustain investment in projects that will be of essential value over that period but which cannot be justified on a year-by-year basis?

We should also consider what happened to the volume of credit that was in circulation at the height of the boom. It bore no relation to world GDP. There was something like a factor of 13 between the amount of money in circulation and the volume of production. Have we not reached the end of the age of marginal economics, in a sense? Have we looked for a value—possibly related to the net use of energy—on which that type of financing could be based? The crazy inflation of transactions at the height of the period of exuberance invalidates much of the economic theory that we have been working on since 1929.

Adrian Coles: Wow! That was a pretty wide-ranging question.

There is an opportunity for a greater concentration on ethical banking. The Co-operative Bank, for example, has just merged with the Britannia building society to create what they have termed a super-mutual. They perceive a huge opportunity for an ethically based agenda, and the Co-operative Bank has always reported that a large number of its customers go to that bank because of its ethical and green credentials. The last building society to be created in the United Kingdom was the Ecology Building Society, which generally will not lend on the security of ordinary three-bedroom, semi-detached houses. People have to have a house that makes a specific contribution to the environment before qualifying for a loan with that organisation. There is now interest in developing more organisations of a similar size.

Owen Kelly might be able to talk a bit about ethical investment funds.

Owen Kelly: You will be aware of what President Sarkozy announced yesterday. That was an interesting development, which was characterised in the media as "measuring happiness" or something like that. Behind it were interesting ideas about sustainability.

I was talking to an academic yesterday about how fund managers and other investment managers are increasingly looking for ways to demonstrate to investors that they adhere to the set of environmental and sustainable principles whose name escapes me at the moment. Therefore, things on the buy side, where people are making decisions about where to put money, are beginning to move in that direction, although I am not sure whether it is quite the all-encompassing approach that might ultimately be needed. However, such considerations are becoming more salient in the industry.

Paul Chisnall: We should not assume that financial innovation has no benefit for social or environmental purposes. Financial innovation can be a factor for bad, but it can also be a factor for good.

The Convener: Three members want to come back into the discussion, but I ask them to keep their questions as brief as possible—we have already been going for about two hours.

Ms Alexander: My questions are for Scottish Financial Enterprise. This is our inaugural evidence session for this inquiry, and we are attempting to examine the causes of the financial crisis. Your written submission stresses the global aspects of the crisis, but it makes no mention whatever of its Scotland-specific dimensions.

In Britain, we are now sitting on the biggest losses of any country in the entire world from direct shareholdings in banks. The paper loss is in excess of £3 billion. UK Financial Investments is managing 70 per cent of the RBS and 43.5 per cent of Lloyds Banking Group, but it is not managing stakes in Barclays, HSBC and the other high street players. Why does Scottish Financial Enterprise have nothing to say about the management and strategy of Scotland-based banks and their contribution to the position in which we find ourselves, with the largest direct shareholdings in the world?

Owen Kelly: It is not quite fair to say that we have nothing to say. We are talking about the RBS and HBOS, but the phenomenon was international and was happening to banks all around the world. The committee may choose to delve into the causes of what happened at the RBS and HBOS with other witnesses, but those causes have been pretty well rehearsed in other inquiries, and Paul Chisnall has already listed them.

Are there uniquely Scottish aspects to what happened? I personally find it hard to find them. One can even consider the major decision to take on ABN AMRO, but it is well known that Barclays was right in there bidding until the last minute. Even the crucial decision that is now seen as being perhaps the origin of some of the biggest problems that the RBS has faced was not something that it was pursuing on its own. I am not sure whether I have answered your question.

11:30

Ms Alexander: With respect, I do not think that you have. Scottish financial enterprises are a question for the board of SFE, which is an organisation to promote the Scottish financial sector. Over the past 10 years, it has been powerfully effective in lobbying Government on how to improve Scotland's competitiveness. However, what do we find in the past year? The

RBS has had £15 billion in equity and £5 billion in preference shares, £25 billion in capital instruments and £50 billion for the toxic asset protection scheme, which takes us to £95 billion of taxpayers' money in the past year alone. Moreover, the toxic asset figure could go much higher. If we also add in the £11 billion for HBOS, which is comparable to the entire funding for the national health service in Scotland in one year, we find that your largest and second-largest members have been the recipients of three times the entire budget of the Scottish Government in one year, but you produce only a four-page submission that has nothing to say about why Scottish-based institutions are uniquely in the position of having direct Government shareholdings of that scale. I think that people will find that simply fantastical.

Owen Kelly: The situation is not unique, though, because there is Northern Rock. Moreover, all banks benefit from what the Government has done. I do not for a second deny that those banks have been engulfed by what has happened, but they are still standing because of Government intervention. The RBS in particular has good and well-developed plans that you will hear more about from Stephen Hester when he comes. I therefore do not quite see what you think we ought to have done. As I said, if you want to argue that there is a uniquely Scottish problem that has to do with culture or whatever—I am not sure what—then I personally would resist that argument on the ground that the RBS in particular was a fully multinational, internationalised company that was exposed in exactly the same way as Citi, which was also a big recipient of public funding, although not from our Government. Further, while accepting that all businesses are different, I think that UBS is another worldwide financial institution that has suffered.

Ms Alexander: But UBS, HSBC, Barclays and the Standard Chartered Bank are not Scottish. I am just inviting the Scottish financial trade body to give us some indication of what it was about the strategy and management of Scotland-based banks that led to their requiring a scale of intervention that means that its two largest members have had more direct Government aid in the past year than the entire budget of the Scottish Government times three. SFE has produced a submission for us that does not mention that or seek to explain it.

Owen Kelly: My answer is that it was overreach. However, that was a common problem or factor in all the banks that got into such trouble—it was the same with UBS, Citi and others. If you wanted an answer to the question of what the problem was at the RBS and HBOS, I would say that it was overreach. On your comparison with the devolved Scottish Government's budget, the funding that came from the UK Government was obviously investment to bring back stability. Yes, it was a huge sum of money, but that was the case on a worldwide basis—huge sums of money have gone into stabilising the banking system, because of the difficulties and the misconceptions that we have discussed. I do not for a second suggest that it is not the case that massive things have gone wrong.

I come back to a point that I made earlier, which is that our members are not just the RBS and HBOS—the Clydesdale Bank, for example, held up pretty well. HSBC and Barclays are in different positions because all banks are different, but a common factor in what went wrong for all the banks that got into significant difficulties is overreach. Actually, HSBC has lost considerable sums through its subsidiary in the United States because of involvement in the sub-prime market. Each bank has its own story to tell. You might want to pursue the idea that, because those two banks were affected, there is a uniquely Scottish issue, but I do not think that that would lead to anything particularly useful.

Ms Alexander: I dwell on the fact that people will find it extraordinary that Scottish Financial Enterprise has not dealt directly with any of the Scotland-specific aspects of what was undoubtedly a global crisis.

Another Scotland-specific aspect to which there is no reference in the submission is the impact of consolidation on the market. The evidence from the US on that impact is overwhelming. In investment banking, there has been the disappearance of Bear Stearns and Lehman Brothers, Merrill Lynch has been taken over, Citigroup is in difficulty and international players such as UBS are on the ropes. All that has led to immense consolidation in the US market, but also to extraordinary profits for JP Morgan and Goldman Sachs. They have had so-called stellar years, driven by huge profits and very high margins. I am therefore worried by the complacency about the impact on Scottish retail banking of a comparable consolidation in the market, which does not even merit a mention in your submission. Based on the evidence from investment banking consolidation in the US, that is a huge issue.

Owen Kelly: I agree. One irony of the process has been that the institutions that remain—it is not quite the last man standing—are fewer and larger, which raises challenging questions about antitrust and other issues, particularly in the United States. We have touched on competition in the retail market here. As I understand it, competition considerations were waived by the UK Government when the acquisition of HBOS took place. However, I know that Lloyds Banking Group is aware of its responsibilities under competition legislation in the UK.

There clearly is an issue, just as there is an issue about how we encourage new entrants to the banking market. How will Tesco play? It is clear that its ambition is to expand its range of products and become a full service bank, which will have an impact on competition in the market. I do not know whether the committee will have time to speak directly to representatives of Barclays or HSBC, but they are pretty competitive banks that are competing aggressively for business in the personal and commercial spaces. I do not diminish the importance of the competition issues, but there is not an exact read-across between investment banking in the US and the competition framework and legislation that apply to retail banking in the UK.

Ms Alexander: I have one final and perhaps related question. Does either Scottish Financial Enterprise or the BBA have a view on whether it was right for the ex-chief executive of the RBS to seek to hold on to a £16 million pension pot, despite a bail-out in excess of £95,000 million for his organisation in the past year?

Owen Kelly: That has been a very public process, and the board and others who were involved have given their accounts of it. We do not have a view on the scale of that remuneration, because that was a matter for the board, and the board should be accountable for that, as it has been. Having said that, whatever one’s view, I believe that the focus on an individual and what has happened to that individual is not the right location for our consideration of the issues. I absolutely understand and indeed sympathise with the views of those who think that the remuneration was excessive and so on, but I do not think that we can deal with the real problems that we face by focusing on one individual who has arguably made some personal financial advantage from the situation—or the other individuals who, to put it simply, have been paid well.

Paul Chisnall: The clear opinion of the public and the markets is that the payment of the discretionary element of the pension was perhaps not the best of decisions. It is, of course, only one element. The Walker review of corporate governance has tried to examine some of the incidents that have discredited financial services and in fact has recommended that boards should be required to focus much more carefully on and disclose discretionary elements in pension benefits for executive board members and senior executives. It is another case of examining the mistakes of the past to ensure that we do not revisit them in future.

Gavin Brown: Mr Coles mentioned councils, many of which had their fingers burned by Icelandic banks. Why have they taken their money out of building societies?

Adrian Coles: I recently put that very question to members of the London branch of the Association of Local Authority Treasurers Societies. It was quite clear that local authorities were utterly traumatised by the experience of losing money with the Icelandic institutions and the treasurers who lost that money were quite rightly crawled over by elected representatives, the Audit Commission and the local media. As a result, they, like many other elements of the system that I have mentioned, have become utterly risk averse. The one safe place where local authorities can invest their money is the debt management office, which is an arm of the UK Treasury, and the data show that there has been a sharp reduction in local authority investment not only with building societies but with the banking sector and a sharp increase in investment with the debt management office. Local authorities are pursuing the policy even though, as a result, they will lose considerable interest income at a time of tight public expenditure constraints. What matters above all for the treasurers who went through that very traumatic period is security and if they earn a very tiny amount of interest income as a result, so be it. I totally understand their attitude.

Gavin Brown: I am curious whether our witnesses have a personal view on whether the Federal Reserve should have saved Lehman Brothers.

Adrian Coles: It is a matter of balance between the system’s safety and security and moral risk. We saw another example in the savings retail market, in which institutions from countries such as Iceland were competing heavily for retail deposits. If depositors had had access to full information about credit default swap rates, they would have realised that the professional market felt Icelandic banks to be pretty dodgy well before they went under. However, the financial services compensation scheme says that wherever you invest, your money will be safe.

It is a difficult question. On balance—and despite the huge consequences that the failure to bail out Lehman Brothers has had—I feel that it is good to indicate to the markets as a whole that banks can fail and will not always be bailed out. It makes people more careful and ensures that they look more carefully at the institutions that are doing the lending.

Paul Chisnall: I take on board Adrian Coles’s point about moral hazard, but my personal view is that the decision looks like an error of judgment. I cannot believe that the US Administration fully appreciated the immediate effects and repercussions of not supporting Lehman Brothers in the marketplace. We have talked about

Scotland, and some of the UK parliamentary inquiries have been about Northern Rock, but much more than any other single action, not supporting Lehman's has brought us to where we are. The immediate loss of liquidity in the market had a huge bearing on the events that followed. Having said that, you have to ask: "If not Lehman's, what next?" There is probably some sociological theory that suggests that, if Lehman's had been supported, a crack would have been found elsewhere in the market. If you were to ask me for a simple yes or no on whether it was an error of judgment not to support Lehman's, I would have to say that, yes, it was.

11:45

Owen Kelly: My completely personal view is that history will probably judge that it was the defining moment and the turning point. I agree with what Paul Chisnall said about the impact of the decision. Having been a million miles away from the decision-making process, I can only suspect that it would have been almost impossible to calculate the full implications of the decision. However, when people write books about it and analyse the situation in 10 or 20 years' time, the decision not to support Lehman Brothers will be seen as the point at which the dam broke. In that sense, if it made that happen sooner than it would otherwise have happened, it was probably the right decision.

The Convener: The follow-up question is this: are some of our banks too big to be allowed to fail? On that basis, should we change the regulation to prevent banks from getting so big that they cannot be allowed to fail? Does any of you have a comment on that?

Adrian Coles: The problem is that some banks are too big to be allowed to fail. The difference with Lehman Brothers is that it was not a retail deposit taker, so allowing it to fail did not result in ordinary individuals losing their savings immediately, as a direct consequence. The situation would have been different if the Royal Bank of Scotland had been allowed to fail and everybody who had savings with NatWest and the Royal Bank of Scotland had lost their savings. It would have been the wrong decision not to support retail banks with retail depositors despite the moral hazard point that I made.

It goes back to the point that I made earlier. Big is not necessarily bad; however, if we are dominated by a few large institutions that can never fail, we must ask whether the seeds of the next crisis are already being sown. The major characteristic of what we have seen over the past two years has been the privatisation of profit and the socialisation of loss, which produces some huge incentives in the marketplace that are not always welcome.

Paul Chisnall: If you asked the shareholders of some of those institutions whether they are too big to fail, they would say that they did fail. People have lost money and the banks have not been propped up without financial loss. The question is whether appropriate actions are being taken so that we can deal with the consequences for depositors in a more organised way than we have been able to in the past.

The Banking Act 2009 and some of the measures that are envisaged for the forthcoming bill are intended to put us in a position in which the regulatory authorities can take a clearer view as to whether they believe that there is a risk of an institution failing and have more policy options open for dealing with the consequence of that failure, including being able to ring fence the deposit base, pick that up and place it in a different position. For me, that is the nub of how we can ensure that we can deal with the consequence of failure in the future in a better way than we have in the past.

Generally, it is about focusing on ensuring that we can deal with the consequence of institutions failing and having better risk management and control. As far as I am concerned, that is the nub of what we need to do.

Owen Kelly: If there is an understanding in the market that an institution is too big to fail—or even if it is designated as such—that brings responsibilities, and, by definition, gives the institution a certain competitive edge. How that is squared with a fully competitive market is a question that is still out there.

However, we have to balance that with the fact that the extraordinary economic growth during the past few decades has been significantly underpinned and facilitated by the very fluid movement of capital on a completely international basis. If we want that to continue and to get even better, we need institutions that can do that. I do not know whether that inevitably leads to institutions that are too big to fail, but it is a very important function of our biggest international institutions and it must be retained.

Rob Gibson: At a meeting of the committee last year, we discussed with the Dunfermline Building Society whether it was able to ride out the perfect storm. Do you think that the FSA's approach to policing the Dunfermline Building Society and others like it needs to change? What was the policing like? Did it contribute to the Dunfermline reaching the point at which it collapsed?

Adrian Coles: It is clear that the FSA has some regrets with regard to its overall policing of institutions in the years leading up to 2007. Its internal audit report on the way in which it policed Northern Rock, for example, shows that there were some extremely lax episodes in its regulatory approach. It seemed to regulate Northern Rock in a completely inappropriate way, and it did not realise what was coming.

The arguments in relation to the regulation of the Dunfermline Building Society are more balanced. It is clear from the submissions to the UK Parliament's Scottish Affairs Committee that the FSA and the Dunfermline hold different views—indeed, those views flatly contradict each other—with regard to the messages that the FSA says that it gave to the Dunfermline and the messages that the Dunfermline says that it heard. You need to get the FSA people and the Dunfermline people here together to try to get to the heart of that. It will be difficult; I was not in the Dunfermline boardroom or in the FSA offices when those conversations took place, so it is difficult for even a fairly well-informed outsider such as me to take sides.

The FSA has reacted by publishing a consultation document on what it calls a building society source book, which was promised in Lord Turner's letter to Alistair Darling in response to Mr Darling's request for an explanation of what had happened with the Dunfermline. We have some problems with that, as it seems to penalise the vast majority of the remaining prudently and conservatively run building societies for the past failures of one or two large societies that no longer exist. One area that we need to examine, which is worth further consideration by the committee, is whether the regulatory backlash now risks intensifying the recession. The demands for greater capital and greater liquidity, for example, make firms too pessimistic and will damage the recovery.

In summary, it is hard for me to judge the competing claims of the Dunfermline and the FSA, as they directly contradict each other. It is clear that both institutions made significant mistakes, but it is very difficult to apportion blame between them for what ultimately occurred.

The Convener: I will follow up on that point, because the BSA hints—well, it is more blunt than a hint—in its submission that it feels that the building societies have perhaps borne a larger share of the burden for the failures of others than is justified; and that the future regulatory regime is more onerous on building societies than it is on some of the other institutions. Can you expand on that issue and offer some thoughts about how it might be addressed?

Adrian Coles: In particular, we take the view that the financial services compensation scheme is funded on an unfair basis. Building societies have generally, although not universally, as I keep emphasising—I acknowledge that the Dunfermline and one or two other societies have tarnished the reputation of building societies—pursued a more prudent lending model. Their arrears are, proportionately, about two thirds of those of the mortgage sector as a whole and they have a more prudent funding model: they get a much lower proportion of their funding than other institutions from the wholesale markets, which is where the difficulties emerged. The funding of the financial services compensation scheme, however, is based on how much retail funding you have, so those institutions that funded themselves relatively safely from the retail markets are required to contribute disproportionately to the funding of the compensation scheme. Last year, building society deposits were reduced by 63 per cent solely as a result of their contributions to the compensation scheme to bail out institutions that behaved far less prudently than the building societies. That seems utterly unfair.

When building society managements have explained that issue to their annual general meetings—which are annual general meetings not of shareholders but of customers—the result has been considerable anger on the part of customers that their mortgage rates are higher and their savings rates are lower because of the mistakes that were made by imprudently run institutions. We are very pleased that the FSA has committed itself to a fundamental re-examination of the funding mechanism for the compensation scheme.

Christopher Harvie: For about the past 25 years I have taught economics students in Germany as part of the international economics programme of the University of Tübingen. Feedback from the students is that they are delighted to get out of the rigour and extremely narrow orientation of the mathematical types of economics focusing on algorithms and so on, and into the world of Adam Smith and of real people working in real situations. It worries me intensely that we are producing people for whom economics is about burn-out or get out—hopefully with a big bonus—rather than about relating what they are doing in the financial sector to real human and economic needs, and I mean economic in the broad sense. What is the panel's opinion on that?

Adrian Coles: Good gracious. I have two economics degrees and I have worked in the—probably more real—world for the last 30 years, since I got those degrees. Economics is taught as an academic subject. I have probably learned more about economics since I left university than I did during the four years that I studied it.

Paul Chisnall: My only comment is that you would need a pretty thick skin for the past two years not to have had a humbling effect.

Owen Kelly: I certainly agree with Paul Chisnall, but the question raises an interesting point, to which I have given some thought before and which goes back to the point about culture. The issue was also referred to in the Walker review on governance. Further to our earlier discussion about language and so on, I think that the banks and the financial services industry need to think about how they bring the right breadth of issues to the table. It is quite easy to focus on what is sometimes an extremely narrow area of interest and expertise. That can be a good thing sometimes, but it needs to be tempered by a deliberate structural effort. For example, in France there is a requirement to have a philosopher on every board—I think that that sounds great. Walker makes some mention of the need to bring out that breadth. That should help us to avoid the kind of systemic and system-wide misunderstanding and incomprehension that have led us to where we are.

The Convener: As someone with half an economics degree, I thank Adrian Coles, Paul Chisnall and Owen Kelly for what has been a lengthy but interesting evidence session. I am sure that we could go on for hours more, but in fairness to everyone we should now draw the session to a close.

We will continue with our scene-setting evidence sessions at next week's meeting, for which Rob Gibson will be in the chair. I will suspend the meeting for a few minutes while we allow the witnesses to depart.

11:59

Meeting suspended.

12:05

On resuming—

Energy Inquiry

The Convener: Item 2 is the Scottish Government's response to our energy inquiry report. The item was on the agenda for last week's meeting, but I suggested that members should have a bit more time to consider the response.

There will be a parliamentary debate on the report, which might take place on or around 30 September, although that depends on the Parliamentary Bureau, and it has not yet considered the matter. There is a committee debate slot before the October recess, which I think we are well placed to get. I invite members' comments on the response.

Rob Gibson: It is interesting that the Department of Energy and Climate Change is consulting on a new grid access regime, which is important to us. The Office of Gas and Electricity Markets is undergoing considerable structural change and it would be interesting to find out how the DECC views that.

The Government has flagged up an issue that we must keep under review. If our economy is to make a strong recovery, companies that are developing renewables in Scotland will have to play a key part, so transmission charging is important. From the information that we have, it does not appear that National Grid is prepared to consider models that Scottish and Southern Energy and Scottish Power put forward. Will the committee stress that we want better solutions on grid access from Scotland and the north of England?

The Convener: Yes, we will. One of the clearest findings from our inquiry was that the access and charging regime that currently operates in the UK is not conducive to renewables development. If progress is not being made in the direction that we sought in our report, we will want to follow it up.

Lewis Macdonald: A number of issues arise from paragraphs 133 and 134, on heat mapping and heat initiatives. I was bemused to discover that the Scottish Government's heat mapping pilot is being undertaken with Highland Council. The issue has currency throughout the country, but if we accept that combined heat and power is particularly appropriate in urban situations, Highland Council seems an odd choice of local authority partner for the exercise. I welcome the exercise, but I am bemused by the choice of perhaps our most rural authority as the partner. Can we find out why ministers made that interesting choice?

Rob Gibson: Surely most people in Highland live in towns.

Lewis Macdonald: That is true. Nonetheless, Highland Council is not the obvious, intuitive choice, although I welcome the council's enthusiasm for the work.

Gavin Brown: I request that the convener writes to the minister on the issue of fuel poverty to check what the Government's view is, because we were told previously that it is committed to eliminating fuel poverty by 2016, but the Government's response states that it is committed to eliminating it

"so far as is reasonably practicable by 2016."

I would like clarification of what the minister means when he uses the term

"so far as is reasonably practicable".

The Government is either committed to the target or it is not; I am not sure that there is a middle ground.

My second issue is that in paragraph 115 the committee requested a report from the permanent secretary this year on energy efficiency in the public sector. The answer outlines what the Government is doing and all the rest of it, but there is no response to that direct request. Is the Government prepared to respond to that request or is it saying that it is not responding to it? The request has not been addressed either way.

The Convener: That is a valid point. In respect of the energy efficiency section, we were clear that we were seeking the publication of the energy efficiency plan this autumn. We have been told that there will be another draft energy efficiency plan, which is not the same thing by any manner of means.

One of my general issues with the Government's response is that, while complacency is probably too strong a word for it, there is a lack of urgency in some of the responses. The responses are that the Government is doing things, but the committee identified matters to which it felt a little more priority should be given and on which a little more urgency was required. I am not sure that the Government's response suggests that it has taken on board the committee's concerns about the lack of urgency that has been shown on some issues.

Lewis Macdonald: I agree. I refer in particular to paragraphs 122 and 131, in which we raised concerns about consents and the planning process and pointed out the scale of consent refusals in the past two years, but the Government seems to have paid no heed to those points and has simply said, "We are happy with what we've done, and that is an adequate answer." That does not seem to be an adequate answer. The Government's failure to turn the rhetoric of support for renewables into approval of projects is a profound weakness in the response.

Christopher Harvie: I will raise points under both paragraph 138, on supporting the oil and gas industry, and paragraph 140, on newer, emerging technologies.

I have just got wind of a development in Germany, where Volkswagen intends to mass produce miniature gas-turbine-powered CHP plants for use in blocks of flats. That could fit in with our expertise on gas turbines, particularly in the North Sea, and our experience through groups like Aggreko in producing miniature and transportable power plants. We could be in a position to submit a good bid for a partnership. Stefan Buettner has all the details if you need them.

Lewis Macdonald: That is a good point. Christopher Harvie will recall that in Aberdeen—

Christopher Harvie: I was not there.

Lewis Macdonald: What we saw there was similar, as the plant that we visited was a relatively small-scale CHP gas plant.

The Convener: The difference is that the size of the plant in Aberdeen meant that to make it economically viable it relied to an extent on part of the building being a public building, because the swimming pool and leisure complex was a key aspect, whereas Chris Harvie is referring to a smaller plant that would be viable in itself. That is interesting.

Christopher Harvie: The idea is that Volkswagen could turn its car plants over to producing those CHP plants.

The Convener: The housing in German cities is perhaps different from the housing in Scottish cities, which might make such a development less viable here, but it must be worth considering.

Lewis Macdonald: Going beyond heat mapping, we need to see a positive response from the Government on how it is investing in CHP to make it happen.

Marilyn Livingstone: I have questions about paragraphs 146 and 147. Paragraph 146, on the clutter in the training sector, asked about the support that is being given to the energy industry to promote job skills and take economic opportunities. I would like to know about the timescale for that, because we asked for it to be addressed by the summer of 2010. Why are only the Scottish Further and Higher Education Funding Council and Skills Development Scotland involved? The issue reaches further than those two agencies alone, so how will the Government bring in other agencies?

In paragraph 147, we asked for

“a boost in the resources available”

for modern apprenticeships. We know about the commitment to 7,800 new apprentices in 2009-10, but I would like to know about the forward planning on modern apprenticeships, not just the information for one year, because we asked for more than that.

12:15

The Convener: On paragraph 146, I was struck that when we pointed out

“the institutional clutter in the skills and training sectors”,

we were told that a newly formed body would examine the clutter. That is adding to the clutter rather than reducing it.

Marilyn Livingstone: Other agencies would also need to be consulted.

The Convener: I assume that the joint skills committee of the Scottish funding council and Skills Development Scotland would discuss matters with other agencies, but we can seek clarification on that.

Marilyn Livingstone: And on timescales, please.

The Convener: Does the committee agree that, as part of our budget scrutiny, we should take evidence on modern apprenticeships, and perhaps on funding for energy efficiency measures, to which we referred in paragraph 108?

Members *indicated agreement*.

The Convener: My intention is to write to the minister asking for further clarification on the points that have been highlighted, preferably before the debate on 30 September—or whenever it is—so that we can include them. Is that agreed?

Members *indicated agreement*.

Arbitration (Scotland) Bill

12:17

The Convener: The final item concerns the committee’s approach to stage 2 of the Arbitration (Scotland) Bill. We have received a letter from the Minister for Enterprise, Energy and Tourism indicating the outcomes of the discussions that he had over the summer with consumer groups and various legal stakeholder bodies with an interest in the area. We agreed that we would consider that letter to determine whether it addresses the points from our report that we wish to take up or whether we may still wish to lodge amendments to the bill on some matters.

I will pass on immediately to our expert, Gavin Brown, to find out what he has to say.

Gavin Brown: I am pleased that the Government went ahead with the two meetings over the summer. Nigel Don was able to go to one of them and found it productive.

The tone of the minister’s letter is helpful. On most of the points on which he has said that he will draft amendments, the direction of his proposals is entirely what the committee was looking for but, until we see the amendments, it is difficult to know whether we will accept, reject or want to adjust them.

I am still a bit uncertain about the Government’s response to some of our recommendations. Recommendation 2 relates to retrospective effect. The committee felt that retrospective laws were, in general, not a good idea. Section 33 will be amended so that parties will be able to opt out of retrospective application to existing agreements. Whether that is a good idea will depend entirely on the amendment. Will both parties need to agree to it? Will one party be able to decide unilaterally to opt out or will it be stuck with the new rules without agreement? It seems like a good movement, but our final response will depend on what the amendment says.

Recommendation 3 relates to the Arbitration Act 1996. Two or three sections of the 1996 act will still apply to Scotland and not be included in the bill. That will mean that almost the entire law will be in one act and two or three sections of applicable law will be in another act. Our view was that we should find a way of restating those sections in a schedule, if not in the bill itself, so that people who were looking for arbitration law would be able to pick up one document.

The Convener: That concerns the issues about consumer legislation, which is reserved, and the question whether the UK Government would agree to the rule being included in the legislation. We can write to the minister for clarification on that point, because he did not respond either in the debate or in the letter in a way that lets us know what the intention is.

Gavin Brown: Yes; we received no specific response on that point.

Recommendation 7 concerns confidentiality, particularly if the matter goes to court. Again, the direction of travel that the minister has indicated seems to be the right one, but I am concerned about the drafting of the relevant amendment.

With regard to the number of areas in which we said that things should be mandatory, the Government has taken soundings and decided to make them mandatory. We thought that the designation of rules 50 and 51 should be swapped around, and the evidence that we have received suggests that that has happened. Overall, therefore, I think that the Government's moves are positive. There are two or three areas in which the devil will be in the detail, but, other than that, I am quite pleased at what the Government has done.

Lewis Macdonald: The points that Gavin Brown raises will influence whether we need to consider the issue again when the amendments are published, because we know the broad thrust but not the detail.

Likewise, on the minister's response about the repeal of the model law and the consequences of that, he has indicated that a document will be circulated to audit the detail of the model law. It would be interesting to know what process is intended to follow the circulation of that document, and whether that will be taken into account by the minister in advance of him lodging amendments.

The Convener: I find it slightly odd that we received from the Government what is, in essence, a covering letter for a series of draft amendments that it will circulate to various bodies, but we did not receive the draft amendments. I was going to suggest that the committee should ask to receive a copy of the draft amendments that have been circulated, even if that is on a confidential basis. That would enable us to work out whether the amendments would meet our concerns, if they are agreed to.

I also suggest that we write to the Faculty of Advocates and the Law Society of Scotland to ask for their views on what the Government proposes. Those were the two key bodies that had concerns with the original drafting.

Once we have received responses, we can decide at the meeting before the meeting at which we will begin stage 2 consideration whether we wish to lodge any amendments. We hope that the Government will have lodged its amendments before our meeting on 30 September. We can certainly encourage it to do so.

Do members agree to those suggestions?

Members *indicated agreement.*

Meeting closed at 12:23.

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