# ECONOMY, ENERGY AND TOURISM COMMITTEE

Wednesday 11 November 2009

Session 3

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## ECONOMY, ENERGY AND TOURISM COMMITTEE
**29th 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 GAVE EVIDENCE:**

Rudolf Heaf (Nationwide Building Society)
Jeremy Peat (David Hume Institute)
Tony Prestedge (Nationwide Building Society)
Alison Robb (Nationwide Building Society)

**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 11 November 2009*

[THE CONVENER *opened the meeting in private at 09:37*]

11:04

*Meeting suspended until 11:29 and continued in public thereafter.*

## Financial Services Inquiry

**The Convener (Iain Smith):** Welcome to the public session of the Economy, Energy and Tourism Committee's 29th meeting in 2009. Apologies have been submitted from Marilyn Livingstone. I am pleased to welcome Dave Whitton back to the committee in his role as substitute member. I am sure that he will enjoy the session that we are about to have—probably more than he enjoyed the one that we had in private.

We move to our banking and financial services inquiry. We have two panels of witnesses today. I am not sure whether one person can be called a panel, but for our first panel, I welcome Jeremy Peat, who is director of the David Hume Institute and a member of the Competition Commission. He is also a former group chief economist with the Royal Bank of Scotland. I ask him to say a few words about the current situation in the Scottish economy and the Scottish financial sector.

**Jeremy Peat (David Hume Institute):** I will be brief. I note that anything that I say is in a personal capacity. The David Hume Institute, being a charitable body, has no collective view and I am not speaking for my trustees. I am certainly not speaking for the Competition Commission in any way. Therefore, what you hear from me will be my views and should be taken as such.

On the economy and the financial sector, I simply note that the recent period has certainly been the most difficult story for the United Kingdom and Scottish economies in the large number of years for which I have been watching both. The impact of the banking sector collapse has been dramatic across Scotland. We cannot overstate its impact on all aspects of economic life and on individuals. What happened was a traumatic shock and one that very few people anticipated, although we were all aware of the global imbalances in the economy. They existed when I left the Royal Bank of Scotland four and a half years ago. However, no one would have forecast the dramatic impact that resulted from those imbalances and from the decisions and activities in the banking sector and the economy.

The period has been difficult globally and particularly for Scotland, given the importance of the banking sector and of what were the only two really large private sector companies in Scotland. That is where we start from, and it is important to consider where we might end up.

**The Convener:** Where do you think we will end up? What is the future for RBS and Lloyds Banking Group in Scotland? Do you have any views as to how the financial sector will develop? Is there any good news on the horizon, or is it all bad?

**Jeremy Peat:** The prospects for the economy and the financial sector are still riddled with uncertainties. We have seen an upturn in markets and there is an anticipation of an upturn in UK gross domestic product, perhaps in quarter 4 or in the first half of next year. However, there are major risks to the economy and the banking sector. You have no doubt heard evidence on and read about the extent of the bail-out that has taken place. That has, temporarily at least, stabilised the situation, but a lot has to be done to ensure that the credit markets function properly; that the institutions are stable and appropriately supportive of the business sector and individuals in the economy; and that that is done sustainably, rather than in a manner that brings back the imbalances that were the prime cause of the major collapse.

The best scenario for next year is that we start recovery in terms of output; that, by later next year, unemployment begins to stabilise; and that we have a slow and long-drawn-out movement back towards the overall level of output in the economy that we had before this nasty episode. I do not believe that there will be a rapid upturn, particularly given the state of the public finances and what must be done over an extended period to get them back to stability. We must keep a watch on the financial sector and ensure that no further traumas occur and that we use the period to look carefully at regulation of the financial sector and the extent of competition and the scope for enhancing the competitive market in the banking sector.

We must not forget that the financial sector in Scotland has components other than banking and that several of them remain very successful, with high and well-deserved reputations. We must ensure that those elements of the sector continue to instil confidence in the economy. We must continue to respect those sectors and we should not focus all the time on the downside—on banks. There are positive stories elsewhere in the financial sector.

**The Convener:** I am sure that we will come back to some of those issues later in the session, as well as to some of the competition issues to which you referred.

You said that, when you left RBS four years ago, there were already signs in the system that there might be problems on the horizon, although not to the extent that happened. Will you expand a bit on those comments?

**Jeremy Peat:** Well, we are talking about a different environment. I had 12 years as group chief economist at RBS and I do not think that I could have chosen 12 years more carefully. I was very fortunate to start in 1993 and leave in early 2005. I experienced that period when the UK and Scottish economies were both going well, and RBS was growing very rapidly and was a successful institution.

What I was referring to in my earlier comments was being aware of the global imbalances and the extent to which the United States, the UK and Europe were consuming on the basis of savings in China and elsewhere, and the extent to which the private sector and individuals were consuming and buying more assets than they had a sustainable basis to do. There was a need to correct those imbalances, and it was never clear exactly how that was going to happen. Monetary policy was kept very loose for a long time, which exacerbated the growth of the imbalances, and something had to be done to correct them.

At the time, the expectation was that tightening monetary and fiscal policy would correct the imbalances, perhaps with exchange rate adjustments between the Chinese currency and the dollar and other currencies. The hope was that that would lead to the imbalances being corrected without requiring any major trauma. Frankly, the economy had been so successful in macro terms for so long that there was a degree of complacency on all sides that that could be achieved. That was proved to be complacency, and the extent of the trauma was dramatic. Certainly, nothing like what happened was anticipated at the beginning of 2005. I was not aware of fault lines within the institution, but I was aware of the imbalances across the global economy.

**Rob Gibson (Highlands and Islands) (SNP):** Good morning—it is still morning.

You talked about enhancing competition in the future. We are obviously interested in looking at how the free-running market has worked in the past. At a recent meeting in Inverness, Stephen Hester said that he considered those conditions to be abnormal, and that the new normality is going to be different. That suggests that constraints will have to be put on financial institutions. What kind of constraints do you think are required to enhance competition?

**Jeremy Peat:** I am a believer that competition is the first best solution to making markets work, and that regulation is generally the second best—it is the option that one adopts when competition is not working properly and cannot be made to do so. I should emphasise that I am not talking about unfettered market competition; I am talking about market competition in which it might be necessary to adjust prices and the way in which the market operates to take account of societal demands and preferences. However, heavy-handed regulation of a sector as complex and large as the financial sector is unlikely to be the solution.

At this stage, it is important to consider with great care whether there is any scope for breaking banks into utility banks and casino banks, to use the jargon that is derived from John Kay's paper, or to make use of living wills, as they are now called, so that one has the means whereby, in the event of a trauma, banks can be separated so that one does not have to use public resources to bail out the casino elements while making sure that the utility elements survive for the sake of their customers, particularly small businesses and individual consumers. It is important to consider that element.

It is also important to examine the extent of competition across utility banking areas in particular to find out whether there are constraints on the growth of that competition and whether any interventions can enhance competition in the different markets. The regulator can then at least be less heavy handed because the market, with an enhanced degree of competition, will take most of the strain.

I have seen what the European Union has come back with and I have read a number of the contributions to the debate. It is necessary to take seriously what Mervyn King said at Prestonfield house three weeks ago and to take seriously considerations of how competition in the market for lending to small businesses and individuals can be increased in Scotland as much as, if not more than, it is elsewhere.

**Rob Gibson:** We might come on to that shortly.

Much of the abnormality of the past—if we accept that there was abnormality—was due to encouraging investment by banks through racking up debt. We must drill into how much social utility was in banks' actions in the real economy. When we talk about constraints on institutions, should we particularly consider ways that will ensure that the actions that banks take will pay back into the real economy?

**Jeremy Peat:** Obviously, that is an important question, but it is difficult to answer. The Basel II regulation framework, which attempted to constrain lending in relation to capital assets and took many years and many great minds to develop, did not work; it failed. It proved to be a recipe for individuals to find ways to get round the constraints that it was supposed to impose. That is an example of how regulation, even from the greatest minds over a long period, will end in tears. One does not want to find more and more detailed and complex regulatory answers, because they will fail as well in the fullness of time and will not provide the answers that we want.

On societal value, the market needs to be set to operate within a context that will, hopefully, lead to its yielding the results that you are looking for. I do not believe in strong interventions so that one requires certain individuals to get money and certain individuals not to get it on the ground of anything other than genuine creditworthiness within the market context that operates. As a matter of principle, my preference is a market-driven approach with the framework and context set in such a way that it fits in with society's attitudes and preferences.

**Rob Gibson:** You used the word "hopefully". Surely we are trying to get past that word; surely we are trying to get a degree of certainty. Will the G20 proposals on banking regulation help us?

**Jeremy Peat:** I have not looked at those proposals with enough care to give you a firm answer to that question. However, I am certainly not yet convinced that regulation without some means of breaking between the investment banks and the retail banks will lead to the outcome that you seek. I think that the risk will remain that dangers will flow from investment banks into retail banks, which leads to the requirement to bail out the whole entity or let the whole entity fail. Neither requirement is satisfactory. I do not believe that regulation in detail will be the answer. I am afraid that I think that there is some other way of leading to the outcome that, in the event of utility banks or utility elements of banks failing, those can be secured for society without intervention through the public purse and elsewhere to save elements in which there has been inappropriate behaviour and which do not impact on society in anything like the same way.

**Rob Gibson:** So there has to be international agreement.

**Jeremy Peat:** It is clear that there needs to be international agreement, although one could envisage a situation in which the utility elements are regulated and considered within a domestic framework, and the investment activities of perhaps 20 or 30 major banks could be considered within an international context. That may be the way forward.

11:45

**Lewis Macdonald (Aberdeen Central) (Lab):** You described your perception four years ago of global imbalances and then of the crisis that unfolded. What is your view of the interventions mounted by Government when the crisis began to unfold, first in the United States and secondly here?

**Jeremy Peat:** It will be several years before we can get a firm view of what happened but, frankly, the interventions that took place in this country became absolutely necessary given the circumstances that pertained. If we had allowed two or three large banks to founder totally, it would have been catastrophic for our economy for an extended period. The intervention was necessary.

The operation of monetary policy through interest rates and quantitative easing was and remains appropriate. It is necessary to maintain QE in a low interest rate environment for an extended period. It is also necessary to maintain a relatively loose fiscal stance until we are out of this mess, or until there is a strong probability that we are heading out of it in a sustained manner.

The policy options that were implemented were appropriate. The interventions were necessary given the circumstances that pertained. It would have been better if we had never got there, but we did and it all came rapidly down the pike and no one foresaw it in order to intervene earlier. It was handled relatively well through macro policy and interventions, given the circumstances.

**Lewis Macdonald:** We have heard it said that the British financial sector and the wider economy were 48 hours from closedown. Do you agree with that view?

**Jeremy Peat:** I have no inside information from direct contacts, but the view that I formed from speaking to numerous individuals and looking at the circumstances is that that is correct. If action had not been taken over those two days, something catastrophic could have happened.

**Lewis Macdonald:** You mentioned QE and other fiscal and monetary policies, which are important. As regards the structure of the financial sector in Scotland, the choices facing Government now relate to the disposal or otherwise of its shares, about which we will hear from UK Financial Investments, and Mervyn King's proposition that the sector should be split. Those are substantial interventions in the market and the subject of substantial Government decision and policy. In relation to the Scottish financial sector, what is your view on the decisions in those areas that will most benefit the wider sector that you described?

**Jeremy Peat:** It is unfortunate that the insurance arms of RBS, for example, have been fingered for disposal. I do not believe that the competitive state of the insurance market is of the same level of concern as the competitive market for retail banking and small business banking. I am not quite sure why RBS is being required to sell those arms in the same breath as it is being asked to revive Williams & Glyn and set up different businesses for small business and personal banking.

What matters is that we get the sector back on an even keel. We have to accept, however, that even when that happens, we will have lost from Scotland two big headquarters of two very large institutions. Whatever happens to RBS, the centre of gravity has shifted from Edinburgh to London. The same will apply to the Lloyds HBOS group inevitably. If parts are hived off and bits are sold in Scotland, their head offices will not have anything like the same broader impacts on the Scottish economy that having the head offices of RBS and previously the Bank of Scotland and then HBOS had. We will lose that impact, which I saw as terribly important. However, the first priority has to be well-functioning credit markets for individuals and small businesses so that when demand picks up, the appropriate supply is there to match it within a reasonably competitive framework. That is crucial but, come what may, we are likely to have lost a great deal of the wider benefit of having two major head offices here, and I worry about that.

**Lewis Macdonald:** I am particularly interested in your analysis of RBS, which you know exceptionally well, and your view that, come what may, the centre of gravity of RBS will inevitably move from Edinburgh to London whatever divestment strategy it follows in future. Can you enlarge on that a little bit?

**Jeremy Peat:** You must ask Stephen Hester about that because I am an outsider now.

My firm impression is that the top executive team—the chief executive and the main board directors—is based more in the City of London than it is at Gogarburn. When I was at RBS for those 12 years under George Mathewson and, for a period, Fred Goodwin, it was clear that the centre of gravity was in Edinburgh. At the morning meetings, the majority of the top team were at the videoconference table in Edinburgh, and a small number were in London. I suspect that if we had a view of the same meetings now, we would see the reverse of that.

It does not matter where the individuals live, to some extent. What matters is that the result of having the head office here is a demand for high-quality lawyers, accountants, architects and actuaries. There is a top-grade financial and other business service sector in Scotland that starts with meeting the demands of RBS and HBOS head offices and is then available to the rest of the Scottish business sector. If, as a result of a shift in the centre of gravity, the purchasing decisions and inputs come primarily from London, there is a risk that the legal and accounting sectors and so on will have less of a scale and quality in Scotland than would otherwise have been the case. I would regret such a gap.

Likewise, having large numbers of senior executives from those institutions in Edinburgh gives rise to demand for other services, which raises quality and adds to people's desire to come and work here. There was a time when people could readily have a high-level career in Edinburgh. If the centre of gravity shifts, that opportunity is diminished. People might go in and out of jobs, but the opportunity to develop their careers is not there. People from those institutions have no doubt gone out and started their own businesses elsewhere in financial services, or spread into other businesses, and their talent and skills have been adding benefit to the Scottish economy. Graduates from universities knew in the past that there were good careers to be had here, but now, because of the loss of the head offices, those opportunities might again be diminished.

**Lewis Macdonald:** If, in the case of RBS, we followed the proposition of splitting the utility banks from the casino banks, would that not increase the risk of a transfer of effective leadership from Edinburgh to London?

**Jeremy Peat:** That is a very interesting point. I must admit that I do not envisage a scenario in which there is anything like the same scale and quality of demand for services over the next few years as there was in the early 2000s; that time has gone, and will not emerge again, whatever happens with selling off parts of the business or otherwise. However, there is something to be gained if three, four or five institutions that are providing retail and small business banking services have their head offices in Scotland, such as Tesco Bank, for example, and we do not just have the branch networks, as the fear was during the 1982 Monopolies and Mergers Commission inquiry, and the call centres. Institutions with genuine head offices are much to be preferred over institutions whose whole top management team is in London.

We must remember that RBS and HBOS had the only two really substantial head offices in Scotland. There are no other companies of anything approaching the same scale. It is important to try and get something out of what happens with the reorganisation of the banking sector in Scotland, but we cannot expect things to get back to the same state that they were in previously.

**Ms Wendy Alexander (Paisley North) (Lab):** I invite you to speak about the strategic outlook for RBS, in the first instance, following the European Commission's divestment decisions.

**Jeremy Peat:** I am no more than an observer now. I have deliberately not had significant contact with RBS since I left. When one leaves, one leaves.

RBS still has many fine parts. One has to remember that what went wrong was in a limited part. It was a combination of taking on those nasty toxic assets through some particular elements of the institution—largely based in Connecticut—and the purchase of ABN AMRO, which added to that problem at exactly the wrong time.

I was with a Barclays person last night, and I nearly said to him, "I do wish you'd won the battle for ABN AMRO," but I did not do that. He should be saying, "There but for the grace of God go I." The ABN AMRO deal was the worst of all possibilities, and not many people disagreed with that at the time—although the RBS board apparently did. On top of that, there was the taking of toxic assets through particular elements of the organisation, and the combination of those two things led to the traumas that we witnessed.

What is left is a strong retail, commercial and corporate banking story, with very strong insurance capability. What was built up by George Mathewson from 1991, through to the time of the NatWest takeover and beyond, was a very strong, effective and customer-oriented banking institution. We must not forget that. The rise of RBS was something that I was very proud to be associated with at the margin. It was more than just growth; it was growth of a well-founded, consumer-oriented bank. We must get back to that, and parts of it—the retail banking and the commercial and corporate banking—are still there. Those elements must form the basis for a successful RBS going forward.

I do not know what that means for investment banking, but I do not want further developments in investment banking to muddy the water for what matters, in my view, for Scotland, Scottish business and Scottish consumers, which is getting the other elements back—through RBS, HBOS, Lloyds, Tesco or whoever we want. I want that back in the right way, delivering the right supply of credit, so as to oil the wheels of the Scottish economy again.

**Ms Alexander:** You have referred to the emphasis that John Kay and Mervyn King place on the need to support and protect utility banking.

**Jeremy Peat:** Yes.

**Ms Alexander:** According to both their definitions of utility banking, a large-scale insurance presence would not be part of it. You have also expressed some anxiety about the consequences for RBS of the forced divestment of its insurance assets. Could you explore that tension for us?

**Jeremy Peat:** This needs further investigation, but my judgment is that the insurance arms do not bring the same risks to the utility banking element that the investment banking elements do. Insurance companies in Scotland have come through the situation extremely strongly, and they are well regulated. Sir Sandy Crombie will wax lyrical about the way in which they have been managed.

**Ms Alexander:** But not AIG, for example.

12:00

**Jeremy Peat:** No—but that is because of how AIG got involved in elements of investment banking on the assets side. The bulk standard insurance elements do not involve anything like the same risk of major debt transfers and of major corrosion of utility banks that comes with investment banks. One might be able to set them up in an arm's-length way that minimises the risks.

I agree that they are not a necessary part of a utility bank. However, they have provided a risk offset for RBS, because their cycle tends to be different from the straight banking cycle. When well managed, they can provide a buffer against the ups and downs of the economy. Although I understand worries about the interface between investment and utility banking and the European Commission's proposals to increase the extent of competition in retail and small business banking, I do not see how the logic from either of those directions leads one to require that the insurance elements of RBS be disposed of.

**Ms Alexander:** I turn to competition issues in the retail banking sector. Last week, when we had representatives of the Office of Fair Trading with us, we dwelt on the report that was produced on the back of last year's merger between Lloyds TSB and HBOS. The Secretary of State for Business, Enterprise and Regulatory Reform asked the OFT to keep under review the three core utility banking areas in which there were competition concerns: personal accounts, small business banking and mortgages. Last week, the committee was troubled by the fact that there was no mention of work on small business banking in the OFT's financial services plan, even though it acknowledged that in the Scottish market between 60 and 80 per cent of both new entrants and small businesses, defined as businesses with a turnover of under £15 million, are concentrated in two banks.

Given the concerns that exist and, in particular, the duopoly in small business banking that we have in Scotland, has enough been done to preserve competition in the three core markets of personal accounts, small businesses and mortgages? What more might Governments in Scotland and the UK urge UKFI to think about in relation to those core areas of retail banking?

**Jeremy Peat:** As a member of the Competition Commission, I must pick my words carefully. I commend to the committee a speech by Peter Freeman, the chairman of the commission, at the David Hume Institute about two weeks ago. I am waiting for the final version, but it will be on our website soon and I will pass a copy to the clerk to the committee. In his speech, which was made on the day of the EU announcements, Peter Freeman dwelt on their implications for banking from a Competition Commission perspective. I have huge respect for Peter and urge members to read his speech.

Members should be aware that there are two ways in which matters can come to the Competition Commission: first, as a result of a merger situation and, secondly, following a request for a sector review. Both involve referrals from the Office of Fair Trading. When the proposed merger between Lloyds TSB and HBOS was announced, the OFT said that it raised issues and should be investigated by the Competition Commission. However, ministers can issue intervention orders in the public interest, which they did in this case. Their intervention was challenged by an action group, which appealed to the Competition Appeal Tribunal. The CAT found against the group and for the secretary of state. That is why the merger was not referred to the Competition Commission, which cannot, therefore, give a view on it.

There is also the possibility of a sector review. I understand that in the past month George Osborne has repeated that, if the Conservatives are elected at Westminster, they will seek a banking sector review from the OFT and, thence, the Competition Commission. That would provide us with an opportunity to look at the particular elements of the banking sector that Wendy Alexander has identified.

If one wants to look very thoroughly at the way forward on competition, a sector review is the way of doing so. It would not be rushed; it would be in-depth. However, for that to happen, the OFT has to make a reference to the Competition Commission. I am sure that the Competition Commission would be pleased to pick up the reference if it was so requested. That is the way that we can have an in-depth look at the issue.

I lived through the Cruickshank inquiry, and I am aware of the MMC inquiry from back in 1982. My judgment, from being on the Competition Commission for nearly five years and from being involved in Cruickshank, is that the issues are so complex and difficult that such investigations need to be carried out thoroughly and should not be done at pace without thinking carefully. Because competition issues are important to the elements in Scotland that Wendy Alexander selected—perhaps more so than in the rest of the UK—in-depth investigation is desirable.

**Ms Alexander:** That is incredibly helpful. I have a final general follow-up question. Given your fears that the centre of gravity is shifting from Scotland, in part because of forces that are beyond our control, how do you define Scotland’s future place in the UK financial services industry? What areas should the committee focus on in considering that future place?

**Jeremy Peat:** With my David Hume Institute hat on, I organised four seminars for Jim Murphy, the Secretary of State for Scotland, on key sectors. Members were invited to all of them, and I think that Wendy Alexander attended one. Two or three weeks ago, we had a seminar on financial services, which Benny Higgins and Ben Thomson spoke at and Sandy Crombie chaired. There was a lot of discussion about issues such as regulation and the Kay-King thesis, but we were also reminded of the strength of other components. Going off to dine at Walter Scott & Partners reminded one that there are still highly regarded elements of the financial sector. We need to get some elements of banking back on a sound footing, supporting the economy and, preferably, providing a focus for the requirement to have in Scotland a strong support-service sector.

At the same time, we must ensure that Government—by which I mean the Governments here and at Westminster—does everything that it can to ensure that the rest of the financial sector in Scotland is acknowledged as important and that constraints on its development or activity are addressed. No one is seeking funds to be ploughed into the rest of the financial sector, but we must acknowledge its importance, work on its skills development and the infrastructure that is required, and ensure that it is supported. I am utterly convinced that the financial sector will be a critical and successful component of the Scottish economy for decades to come. We must acknowledge the strengths that exist and start shouting that, just because two banks have had difficulties, it does not mean that the Scottish financial pre-eminence has gone away.

**Christopher Harvie (Mid Scotland and Fife) (SNP):** My first question is an historical one about regulation. You take a generally critical view of regulation from Government, but surely non-executive directors are a form of regulation on a limited company. In your judgment, why was it that, although a first-rate group of non-execs—including Peter Sutherland from the European Union, Steve Robson from the Treasury and Jim Currie from the customs and revenue side—was on the bridge at RBS at the time, your successor Stephen Boyle said exactly a year ago that possibly only one or two people in the entire RBS set-up knew about the extent of the securitisation problem?

**Jeremy Peat:** That is an amazingly good question and one that I find very difficult to answer. I would love to know the answer.

The ABN AMRO deal is a classic example. Speaking at the time of the deal to informed people in Edinburgh, including ex-RBS executives and others, I did not find a host of people saying, "This is a cracker"—quite the reverse. The general view initially was that it was a cause for concern, and it became more of a concern as the economy and the financial sector ran into choppy water. When the American corporate banking element, which was a critical part of the deal so far as RBS was concerned, disappeared, it became even more of a concern, but the RBS board sailed calmly through as if there were no worries.

Peter Sutherland and the others are highly experienced and well-regarded individuals. Why did they not question what was happening? I do not know. It is clear that the strength of character of at least one individual might have had some influence, but non-executives have significant responsibilities and it was a strong non-executive board. It raises the question of whether that form of governance and shareholder-related oversight can be made to work.

We now have a very strong and experienced senior independent non-exec on the RBS board. Can he and the others gain some traction in decision making on the board? It did not work last time around, but I do not know why.

**Christopher Harvie:** Can I ask a parallel question about another bank, HBOS, which is obviously also in our sights? After the collapse of Lehman Brothers, the merger with Lloyds TSB was arranged, with the Prime Minister apparently taking a leading role along with Sir Victor Blank. At the time of arranging the merger they seem not to have been fully informed, let us say, about the nature of the HBOS loan book, which was to blow up in their faces within a couple of months. That seems to me almost a parallel to what happened at RBS. You cannot go any higher than the Prime Minister, leading bankers and figures from the FSA itself in that ambience, yet they made a decision that seems almost as catastrophic as RBS's with regard to ABN AMRO.

**Jeremy Peat:** I read with great interest the evidence that Robert Peston gave to the committee recently, when you touched on this point with him. I have no knowledge of what Victor Blank knew or did not know. The difference between HBOS and RBS was that HBOS's problems emerged from its working very hard to buy an increased market share across a lot of mortgage and personal banking at the same time as it took major risks on commercial and related property by taking equity risk. That was a deliberate policy from within that bank on both fronts.

Given the way that such assets pile up, that approach led to an accumulation of toxic assets, because the bank was trying to expand very fast in both directions and was taking significant risks on both fronts. That is a different causation of the pile-up of bad debt, but I assume that the policies would have been discussed by the board. It should have been aware that risks were being taken on those fronts and should have sought to be kept in touch with the impact that that was having on the bank's balance sheet and the risks that were being developed. I am not sure that anyone in any of the banks knew how big the debts were. If we go back to the RBS rights issue at £2 a share, I do not think that anyone there had any understanding of the calamitous scale of the debts, and I suspect that the same applied at HBOS.

**Christopher Harvie:** Yet the attempt by Paul Moore to raise the issues in respect of risk management was answered by his sacking.

**Jeremy Peat:** I cannot comment on that because I have only read what was in the papers—I have no direct knowledge.

12:15

**Christopher Harvie:** To turn to possible future arrangements, there is the question of the financing of energy enterprise in Scotland, particularly in respect of renewables and with alliances with continental finance and the like. It is the issue that confronts us as the Economy, Energy and Tourism Committee.

Is the pattern of investment banking at all appropriate for the financing of energy enterprise, given that the collapse in 2008 was heralded by the payment of massive bonuses in the previous two years, a scenario which now looks like people descending to the lifeboats and heading away from iceberg territory before the ship hit?

Helmut Schmidt, the former German Chancellor, put it very grimly when he said:

> "I divide mankind into three categories. The first is us ordinary folk, who as children stole apples or stuck supermarket chocolate bars in our pockets, and that's about it. The second sort have minor criminal tendencies.

The third are investment bankers, up to now more or less licensed evildoers."

It is difficult not to disagree with him, given the huge bonuses that were paid more or less Ex und Hopp, as the Germans say, which means that you get them and then you clear off.

Is the investment banking model appropriate to provide the highly technologically structured investment that is required for energy enterprise, which I believe is the one thing that will save our economy? For that, the skills of Rhenish capitalism—a type of technology-sensitive capitalism—are required more than those of casino capitalism. The type of financing that is required just does not fit into the retail sector. It lies somewhere between the retail sector and the investment banking sector. We must get this right. How would you advise us to go about doing that?

**Jeremy Peat:** Thank you for that nice simple question.

The future of low-carbon energy in Scotland is fascinating. Another of the seminars that I arranged for Jim Murphy was on low-carbon energy, and we had a fascinating discussion with a chief executive who is extremely interested in that sector. If we are to go further down the low-carbon energy route to carbon storage or whatever, financing will matter, but I do not believe that it will be provided through straight market financial funding for at least a number of years.

For the first years of such large-scale developments, the relevant Governments must decide that they wish to support them and therefore set up funding models that reflect the extent to which those developments are pilots and experimental in nature and the value of the carbon emission reduction benefits that are expected to be achieved. The right carbon price will have to be fed in and the right approach to financing will have to be adopted.

It is only at a later stage, once the pilots have been completed, a model has been developed and carbon pricing has been fitted into the way in which the market works, that one will be able to set such projects free and open them up to straight market financing. At that stage, one will need extremely high-quality corporate financing models, and there should be a degree of competition within those corporate banking models, which may be domestic or international.

I am not sure that investment banking is the answer. First, the experimentation must be done, using the right financing model, which accepts what I have referred to. When the model is one that the market can support, it will be possible to go forward to straight corporate financing. That is point 1.

The second point goes back to investment banking. I said that I had read Robert Peston's evidence, in which he mentioned a degree of surprise that heads of investment banking internationally had not picked up the phone to each other to discuss what to do about bonuses so that they would not be considered to be worse than Attila the Hun. I think that that was the phraseology that he used, and I have a degree of empathy with his statement. I find it extremely difficult to justify what is happening on that front at this stage.

I return to the point that I have made from the outset. I do not want to run the risk of whatever happens in investment banking damaging the utility banking sector and damaging our overall economy. Let investment bankers take their own risks with their own money. Let them play their casino games, but not at the risk of the banking that matters to individuals and businesses in Scotland and the rest of the UK, and not at the risk of our economy.

Let those investment bankers fail—moral hazard will require them to be allowed to fail and not to be bailed out—but do not let that failure lead to the economy collapsing or the supply of credit disappearing. We have to find a means whereby they can operate within their own space under their own terms and not have such a potentially devastating impact on our economy and the functioning of credit.

**Christopher Harvie:** I have one last point. At one stage, the amount of money being speculated on, even at the simplest level, was something like eight times the world gross national product. It seemed to a lot of spectators that that virtual currency had almost totally parted company from any notion of marginal utility or market value. Earlier, you raised the point about the pricing of carbon. Has it not reached the stage where we have to go back to Adam Smith and something resembling the labour theory of value to work out a basket on which value is based and in which carbon and energy play an enormous part? We have not got such a tangible measure to tether that type of activity to the achievement of utility solutions.

**Jeremy Peat:** The idealist in me says that we want the invisible auctioneer to operate, but in such a way that the market functions and prices are accepted as reasonable and realistic. There would therefore be a price for carbon that reflected a sound view of the benefits of reducing carbon emissions, and the market could be allowed to decide how to reduce those emissions. There would be no particular subsidies for wind farms here and carbon capture there; the process would be rational.

We intervene in prices if it is society's view, as it is now, that the prices in the market do not properly reflect values. However, intervening on an individual case-by-case basis leads to awful decision making. We should intervene to adjust the prices in the market and then let Adam Smith's auctioneer go to work with an oversight of regulation to allow for corruption and wrong dealing. We have to get the prices right and then let the market work.

**The Convener:** I am getting very wary of members saying that they are asking their last question because it usually means that they have two left.

**Stuart McMillan (West of Scotland) (SNP):** I am conscious of time so I will keep my questions brief.

Mr Peat, you mentioned earlier the perception that the centre of gravity in financial services is moving to London. With that in mind, how can we get the Scottish voice from the variety of sources here heard in the variety of locations down south, including Westminster, the FSA and the Bank of England, especially as the Bank of England has refused to come and speak to the committee?

**Jeremy Peat:** As far as the Bank of England is concerned, I have always taken the view that the monetary policy committee sets policy for the UK as a whole, so it is therefore responsible for ensuring that the UK and elements of the UK are reasonably satisfied that it is setting appropriate policy and taking account of variations across the economy. The original 1997 letter that established the committee refers to that spread. I have always been surprised that it has not been seen as appropriate for the governor of the Bank of England or one of his colleagues to discuss how he and they are operating monetary policy across the UK and therefore within Scotland, and to listen and hear.

I know that we are just about to get a new Bank of England agent in Scotland. Their work is first class in that they listen to business and everyone else, and report to the Bank of England. I am sure that economic conditions in Scotland are fully taken into account in the monetary policy committee's decisions, as other agents' are. I am satisfied that the system works.

I have never seen any reason why the governor should not give evidence to or have discussions with this institution, to show that he is discharging his responsibilities. However, it is not for me to say that the line that the Bank of England has taken is wrong—that is a decision for the bank.

We need to ensure that the Scottish voice is heard. If this committee provides the full and thoughtful report that I am sure it will, it will raise issues, some of which will be relevant to reserved policy. Such issues are not for the committee to claim on in full, but they may raise markers for those who have responsibilities more widely to think about. It is a difficult balance for the committee but I am sure that you will find the right way of managing it.

**Stuart McMillan:** My second question is probably unfair but I will pose it nonetheless. The situation seems to be changing from week to week. Where do you think that retail banking in Scotland will be in five years' time?

**Jeremy Peat:** That is a lovely question. It is totally unfair but it is very reasonable.

We have to consider various alternatives. Talking again with my David Hume Institute hat on, I have John Kay coming up in February to speak, and I want to hear what he has to say. I want him, as a member of the Council of Economic Advisers and as one of the most thoughtful people that I know, to talk about banking and its future in Scotland. He will bring the excellent paper that he has written. The situation has evolved, with what the European commissioners refer to and what is happening in Scotland.

I also want to think about co-operative banking and smaller banking institutions. We are trying to arrange a seminar on that front for early in the new year. What can we learn from, for example, the Airdrie Savings Bank? Is there any way of filling a part of the vacuum of competition by revisiting the model of building societies? One needs to consider that element as one possible part of the solution.

What we will see is a number of Tesco-type banks emerging, which may not have high street presences but will offer competitive products and will build on synergies with other elements of their activities. That will add to the competition within retail banking.

Small business banking and commercial banking are more difficult. We have always had limited competition in Scotland, and competition is now likely to be even more limited, which is why more thought is required about how we can enhance that competition and encourage entrants. I do not believe in forcing people in; I believe in setting the environment whereby people want to come in. In part, that will have to wait until the demand picks up, but one has to think about what one can do to get one, two or three more entrants into the small business banking arena and what I call commercial banking, so that the small and medium cap companies have options and there is a more competitive market.

**The Convener:** Do you have any suggestions about what Scotland needs to do to encourage new entrants into the market?

**Jeremy Peat:** Not particularly. We are flying blind to an extent at the moment because we have not looked carefully enough at the marketplace to see what the constraints are on entry and what might be achieved. We are also uncertain about what is going to happen in six or 12 months' time.

I am sure that one reason why demand for and supply of credit are limited is the uncertainties in the environment. Risks are higher. Companies are less willing to borrow and banks are less willing to lend because of those uncertainties. If we get through another six months and we are in a pick-up—an improved global environment—that may be the time when one can think seriously about how to take advantage of the improved environment and do something about enhancing competition. It is not ideal to try to introduce enhanced competition when demand is low and risks are high.

**David Whitton (Strathkelvin and Bearsden) (Lab):** Stuart McMillan asked the first question that I wanted to ask. You have spoken about your fear of the loss of influence, and Stuart asked you how we can make our voice heard in the monetary policy committee. Your thoughts are interesting—I am sure that that committee will listen to them.

If I picked you up correctly on the FSA and regulation—correct me if I am wrong—you talked about heavy-handed regulation not being the solution. I assume that you are not advocating light-touch regulation. There has to be regulation; it is just a case of what the regulation is. Bearing in mind both that and the Scottish financial sector, how can we influence what you think would be the proper type of regulation?

12:30

**Jeremy Peat:** There is no easy answer, but my view is that regulation of any type will work only if it works with the grain of the incentive mechanisms within the market. If you try to regulate against incentive mechanisms, they will win 19 times out of 20 against the regulation. That is why I say that heavy-handed regulation is not the answer. You build up more and more regulation and, if you are working against the incentive mechanisms, people find more and more ways of bypassing the regulation, as we saw under the Basel II model. You have to get the environment correct, the incentives correct and the context right, and then you can regulate at the margins. You must have the appropriate framework so that regulation has a chance to work.

**David Whitton:** How can the Scottish financial sector ensure that the regulation—heavy handed or otherwise—does not damage the industry here?

**Jeremy Peat:** I apologise for coming back to it, but we come back to whether one needs to achieve some break-up of banks between casino and utility, so that one can deal with a utility bank thinking of it as that and regulating it appropriately. One also comes back to whether competition is sufficient and the market is therefore working. Regulation is a poor second best to competition in the marketplace. When regulation was originally established at the time of the sale of the nationalised industries, it was seen as second best to competition. Let us get competition and then let us have regulation that pertains to specified elements of the financial sector where it has a chance to work.

**David Whitton:** You have spoken almost longingly about the Airdrie Savings Bank model. Lloyds TSB is getting rid of the TSB side and there has been talk that companies such as Tesco or Virgin might take it over. Would you care to offer any thoughts on who the likely buyers of TSB might be?

**Jeremy Peat:** No, I would not like to offer any suggestions.

I am saying that I would love alternative models of banks to emerge. Airdrie Savings Bank is an example of a particular type—a co-operative banking and old building society model. Can such banks exist in a niche within the system? Can there be different models that address different markets in different ways, so that there is choice for consumers and customers? Can a sector be built up that is not dominated by two or three large players but has a number of players, some of which are—as I suggested to Mr McMillan—building on synergies, some of which build up from the bottom and some of which are elements of larger financial institutions?

There is no reason why we should not have a proliferation of different types of players, making for a variety of choice, particularly for households and individuals but also for small businesses. We should consider whether, at the moment, we are encouraging and setting a context within which such a proliferation can thrive.

**The Convener:** That leaves us with an interesting thought for some of the future evidence sessions in the inquiry. I thank Jeremy Peat for his very helpful and thoughtful contribution. I suspend the meeting briefly to allow the panel to change.

12:34

*Meeting suspended.*

12:35

*On resuming—*

**The Convener:** I welcome the members of our final panel for today, who are from the Nationwide

Building Society. Tony Prestedge is group development director, Alison Robb is divisional director, group strategy and planning, and Rudolf Heaf is interim managing director of the Dunfermline Building Society. I should record that I am a member of the Nationwide Building Society by virtue of having a current account, a mortgage and some ISA savings with the society, but I hope that that will not influence my questioning.

Would you like to make some opening remarks?

**Tony Prestedge (Nationwide Building Society):** Thank you very much for the introduction. I am one of the board directors and was heavily involved in the transaction that led to our acquisition of the Dunfermline Building Society. With me is Alison Robb, who is accountable not just for strategy and planning but for legal matters. She led the detail of the negotiations with the management team as well as the members of the tripartite group as we went through the transaction. Rudolf Heaf was the interim managing director of the Dunfermline after the transaction, which happened very quickly, but he is now the operations director for our regional brands, which include the Dunfermline.

I ask the committee to remember that when we acquired the Dunfermline, we acquired a subset of the business rather than all of it, so we are able to comment only on the components that we acquired: the retail liabilities, the prime assets and the retail franchise. I also ask the committee to respect the fact that it will be hard for us to speculate about past management decisions—good, bad or indifferent. In addition, and as we have made clear in advance, it is a point of record that the Nationwide Group is now in its closed period. We are due to announce our annual results the week after next, on 20 November. As a result, although we can talk about financial information that is in the public domain, we are limited in what we can say about our financial performance over the past six months.

Beyond that, we look forward to giving evidence and having a constructive debate.

**The Convener:** I will start by asking you to look ahead at how you envisage the business—both the Dunfermline Building Society brand and the existing Nationwide Building Society brand in Scotland—developing. Our inquiry is meant to be about looking forward just as much as, if not more than it is about looking backward. As someone who comes from a town that has both Nationwide and Dunfermline branches, I ask this: what prospect is there that that will still be the case in three years' time, when the requirement to have no compulsory redundancies or branch closures comes to an end?

**Tony Prestedge:** I will give you a perspective on that, to which Rudolf Heaf will add.

I was greatly encouraged by what the person who gave evidence before us said, in that we genuinely believe that it is of value to have diversity in competition. That is a position that the Nationwide Group has taken quite strongly, because we believe that we offer core competition to one, two or three major players among the banking institutions.

When we were considering acquisition of the Dunfermline, we were clear about the fact that the Nationwide Group and the Dunfermline are very different businesses, in that the Nationwide is a full-service banking institution that offers a full range of facilities, including full money transmission and current accounts. The Dunfermline—or the parts of the business that we acquired—is principally a residential lender and residential deposit taker. That is why we were able to give the three-year commitment to employment for branch employees. Our intention was and continues to be to maintain brand difference.

However, that is about how the businesses perform commercially. Thus far, members of the Dunfermline have shown great loyalty to the business, for which we are extremely grateful. It continues to trade highly successfully, so at the moment we have no plans to integrate the brands. We genuinely believe that there is a difference between a traditional building society model and the one that the Nationwide Group offers, which is similar but different to the banking environment, and that members value different things. We have many members who choose to transact with us in both institutions.

I will ask Rudolf Heaf to provide more detail on the operational specifics.

**Rudolf Heaf (Nationwide Building Society):** When we made the acquisition, the Nationwide already had a big presence and membership in Scotland, including the convener's good self. We acquired 300,000 new members through the Dunfermline.

We moved the focus to the mortgage and savings business and away from where it was previously. For example, we launched a vast range of good fixed-rate savings products, and we re-entered the mortgage market; the Dunfermline moved out of it in the latter part of last year.

As Tony Prestedge said, we have a loyal membership and we have seen it grow. Consumers have demonstrated their confidence by keeping their funds with us when, during the pre-acquisition period, consumer confidence was somewhat dented, resulting in a number of customers taking their money away. There has been a strong increase in terms of the lesser outflow of funds and the flow back into the mortgage market.

Another important element for us is the loyalty of the employees. When Nationwide came along, about 500 employees of the Dunfermline had been having an intriguing time in the pre-acquisition period.

If you consider the employees and the membership, we have a much more solid business to move forward. Additionally, Scottish customers who came to us through the Dunfermline are now able to acquire a wider range of products. We see moving the focus back to the mortgage and savings products and having a competitive range as being very important.

**The Convener:** Could you give a rough indication of the size of the Nationwide's business in Scotland before the takeover?

**Rudolf Heaf:** Yes. The Dunfermline has around 300,000 to 310,000 customers, and the Nationwide has about three times as many.

**The Convener:** In Scotland?

**Rudolf Heaf:** Yes.

**The Convener:** How many branches does Nationwide have?

**Rudolf Heaf:** Nationwide has 43 branches and the Dunfermline has 34. Through its branches and various offices, Nationwide has approximately 450 employees, as does the Dunfermline, so the Nationwide has as a group, approximately 1,000 employees in Scotland.

**The Convener:** What is the management structure for the existing Nationwide network in Scotland as distinct from the Dunfermline?

**Rudolf Heaf:** We have two areas in Scotland—east and west Scotland—and they are managed by area directors who report to our divisional director of branches for the Nationwide. That is how the Nationwide side works. It has primary branch employees and area offices in Glasgow and Edinburgh, for example.

On the Dunfermline side, half our employees are in our 34 branches, and are managed by a head of retail, who manages the retail business, and myself as interim managing director for heading up the operations and the other 250 employees who work in Caledonia house, which is in Dunfermline.

**The Convener:** I have one final question before I open the session up to other members. Mr Prestedge said that the Nationwide has a different model to the traditional building society model. What do you mean by that?

**Tony Prestedge:** We have a similar model in terms of funding, being more than 70 per cent funded, and we have limited demand on the wholesale market. So the organisation's operation looks very similar.

First, on the risks that the business takes, we absolutely do not use members' capital to acquire assets that we have not originated for ourselves. Secondly, we are clear that our asset base will predominantly be in the prime mortgage market and not in any other element. The Dunfermline had over time acquired assets in the sub-prime and part-prime markets, but we did not acquire them as part of the transaction. We have not traded, and are committed to not trading, in that way.

Nationwide itself is 50 per cent of the building society sector. We have a business that is worth circa £200 billion. If we exclude Co-operative Financial Services, our next nearest competitor is the Yorkshire Building Society, whose asset base is below £30 billion. The Nationwide is therefore the only fully geographically spread mutual organisation in the UK, with around 1,000 branches.

We also have a product proposition, which means that we have a full service banking offer through a current account, and full ATM and money transmission that many other building societies are unable to sustain because of size and scale, as much as anything else. The way we interact with the consumers is broader. The risks inherent within the business are no different to those in any other.

12:45

**The Convener:** In layman's terms, would you describe the Nationwide as a sort of mutual bank rather than as a traditional building society, in that the range of services that it provides is more akin to that of a bank?

**Tony Prestedge:** In fairness, it is quite hard to ascribe such a label to the business. We are a building society. We are supervised as a building society, and the rules by which we are governed are those in the building society acts, so we have all those limitations. Because we are a bigger organisation, we can afford the scale of technology and transaction facilities that are required to build a broader range of products than most other building societies can offer, although some of them do offer those products. However, that does not mean that we would judge ourselves to be a mutual bank. For me, the difference between a bank and a building society is about the ownership structure and the risks that the organisation takes rather than about the services that it deploys for the consumer.

**The Convener:** That is helpful. Thank you.

**Rob Gibson:** I think you mentioned that you are not involved—as the Dunfermline Building Society was—in commercial real estate lending operations.

**Tony Prestedge:** We are involved in commercial real estate as a group. What I said was about the shape of our balance sheet. We have always been clear that the extent to which we will expose our balance sheet to specific markets is significantly smaller. For example, we would never expect more than a quarter of our residential lending to be in assets other than prime and we would never expect commercial lending to make up more than 30 per cent of the balance sheet. When we look through the risk lens, although we do transact in those markets, we consciously size the extent of the risk that we are prepared to take, based on the total quality of the asset base that we have and the capital that is available to us to put behind that.

**Rob Gibson:** I understand what you are saying about the prime domestic mortgage market. How much of that was in the buy-to-let sector, in your case?

**Alison Robb (Nationwide Building Society):** That sector is a very small percentage of our business. For us, it is not a member business. It is written though our subsidiary the Mortgage Works and was previously written through UCB Home Loans. Buy-to-let business forms only a single digit percentage of the total lending that we do throughout the group and on our total balance sheet.

**Rob Gibson:** It represented a greater proportion of the Dunfermline Building Society's business.

**Alison Robb:** Absolutely. It was a much more significant proportion.

**Rob Gibson:** Are we expecting to go back to a normal banking situation in which 90 per cent mortgages are the norm? What is your basic offer at the moment?

**Tony Prestedge:** Do you mean through the Dunfermline within Scotland?

**Rob Gibson:** Yes.

**Rudolf Heaf:** As I said, before the acquisition, the Dunfermline had, in the main, moved out of residential mortgages. We moved back into fixed-rate and tracker mortgages in June and reintroduced them for existing customers in August. We have a loan-to-value maximum of 85 per cent through the Dunfermline brand, and the rates for the fixed-rate mortgages or whatever are as competitive as they are in our other businesses, including the wider Nationwide.

Nationwide's overall risk appetite is at the lower end of the spectrum and that is what we are adopting in the Dunfermline under the new management.

**Tony Prestedge:** We are clear that the Dunfermline is a retail brand and that it therefore focuses principally on deposit taking and prime residential lending through the branch network and the call centres that are available for that. Clearly, we continue to trade in buy-to-let in Scotland, but we do that through our Mortgage Works brand rather than through the Dunfermline, because it is important to us that we understand the totality of the risk in that market throughout the entire organisation and not just on a geographic basis.

**Rob Gibson:** How do you view the risk in that market at the moment?

**Alison Robb:** Do you mean in the overall buy-to-let market?

**Rob Gibson:** Yes.

**Alison Robb:** As Tony Prestedge said earlier, we have not acquired any buy-to-let business. The business on our balance sheet is business that we have written ourselves, either though the main Nationwide brand or through the Portman Building Society, which we acquired two and a half years ago. The performance of that business is strong. The arrears in our overall buy-to-let portfolio are below the Council of Mortgage Lenders average, and that average is not for buy-to-let but for the market as a whole.

**Tony Prestedge:** For a long time now, the Nationwide's buy-to-let operation has focused on people we consider to be professional buy-to-let landlords who are committed to the market, have acquired a portfolio, have built up equity and are focused on rental yields that are based on our decisions. The buy-to-let market is very different from the prime residential market, in that part of the risk decision must include the income associated with a property independent of the individual's income.

Moreover, for some time now, we have not traded in the new-build buy-to-let market—in other words, properties that have been built for speculative development—because the value of such property is much more exposed to fluctuations. As a result, the risks inherent in our portfolio—and, as a consequence, the arrears levels—are lower than those in the buy-to-let market as a whole.

**Rob Gibson:** So are banks rather than building societies investing in new-build buy-to-let properties?

**Tony Prestedge:** Banking institutions with a broader balance sheet need to consider the risks that are appropriate to them. Because we are a retail building society, not a bank, and have not diversified into the corporate or investment banking markets, our risk decisions are based on the balance sheet that we have. I am unable to comment on others' risk decisions because I do not have access to those markets.

**The Convener:** I call Wendy Alexander.

**Ms Alexander:** Can I just ask a couple—

**The Convener:** I am sorry—I have just been reminded that Lewis Macdonald has to leave for an engagement at 1 o'clock. I ask him to put his questions first.

**Lewis Macdonald:** Thank you, convener, and I apologise. I will have to leave very shortly. I declare an interest as a member of the Nationwide Building Society prior to its merger with the Dunfermline Building Society.

At the end of his evidence, Jeremy Peat alluded to the prospects for the mutual sector in general, building societies in particular and your own organisation specifically as a result of Government divestment of banks that have recently been taken into public ownership. Do you believe that the mutual sector can add diversity and strength if Northern Rock, for example, or other parts of the publicly acquired banking sector are disposed of? Would such a move strengthen building societies such as the Nationwide or would it dilute your focus on the retail market?

**Tony Prestedge:** I will try to answer that with reference, first, to our view on diversification in the market and, secondly, to the importance of diversification to the Nationwide itself.

We genuinely believe that well-run building societies—which we believe that the Nationwide is—add to diversification because they have a much higher level of retail funding and, consequently, a much lower exposure to the wholesale markets. When the credit crunch happened and the interbank lending markets closed, the mutual institutions were much less exposed to risk. Because of that, we have also continued to benefit from our long-built relationships with residential and retail depositors.

Secondly, under the Building Societies Act 1986, we are required to have a much greater quality of liquidity, which means less exposure, and to hold higher levels of capital. As a result, our business model is inherently lower risk.

Finally, because the organisation is not answerable to shareholders, it is driven commercially not by profit maximisation—after all, we are not required to fund dividends or support equity markets year in, year out—but by profit optimisation. In other words, can the organisation be capital self-sufficient? Can it generate sufficient returns on the risks that it is taking? I genuinely believe that, with such an approach, we end up with a business that is more focused on the consumer and whose risks are more aligned with the consumer's interests.

As for your question about diversification in the market, you will have noticed that the Building Societies Association has called very publicly for Northern Rock's remutualisation. I support that call, because the move would be good not only for the mutual sector but for the industry as a whole. Of course, we are not party to the commercial dynamic associated with that transaction or its various drivers—for example, public investment in the organisation—but the fact is that the Treasury will need to balance return for the taxpayer with value for the membership. Nevertheless, I support the call for Northern Rock's remutualisation.

The Nationwide already has a network of 1,000 branches, a membership base of circa 15 million and a retail balance sheet of circa £200 billion. It is hard to speculate without knowing the detail of any firms that might come on to the market for sale, but my expectation is that we do not need to diversify our organisation any further in that way. We would never do so in a way that brought greater risk to our balance sheet for our members' capital. There is an onus on the Nationwide to make its members feel confident that their board is deploying their capital in a way that does not take risks. That is why, when we looked at the acquisition of the Dunfermline, although we acquired the prime residential book—which is performing extremely strongly; its arrears quality is in line with that of our own residential book—we chose not to acquire the commercial, the buy-to-let and the sub-prime books. It would not have been in our members' interests to have done so.

I apologise if that is an evasive answer. It would be wrong to rule out any opportunities that may arise, but we do not seek inorganic transaction as a way of exploiting the business. We have sufficient scale to trade successfully without needing to do that.

**Lewis Macdonald:** That is very clear and helpful. Correct me if I am wrong, but the conclusion that I draw from that is that in supporting the remutualisation of Northern Rock, you are looking for Government to come to an arrangement with current depositors and borrowers that would result in—if the economics allow it—the creation of a standalone mutual, as opposed to its absorption by the Nationwide or another existing mutual.

**Tony Prestedge:** If the economics allow that. Clearly, I cannot comment for other mutuals, whether in the building society sector or elsewhere; that would be a decision for their boards to take independently.

**Lewis Macdonald:** That is very helpful.

**Ms Alexander:** My question is very much in the same vein.

Virtually every commentator thinks that Scotland needs more competition in banking. I want to probe the role that the Nationwide could play in that. Could you use the Dunfermline brand to deepen your overall banking presence in Scotland?

**Tony Prestedge:** When we acquired the business in March this year, we had—and we continue to have—a clear belief that there is value in having a Scottish brand. At the moment, we are working through what the business plan looks like on that basis by engaging the membership. We have found it interesting that the membership values having a Scottish brand—it is telling us that very clearly—but equally, members of the Nationwide, two of whom we have heard from today, value being members of the Nationwide Group. We will explore what is the right way to deploy brands in Scotland. At the moment, we have the benefit of having both brands. Over time, we will seek to exploit a broader banking proposition through the Dunfermline brand, if that makes sense.

However, we are only six months on from the acquisition of the Dunfermline and in practice it took us three to four months to work out how best to run the organisation, so we are still at a formative stage. Over the past 12 to 24 months, we have taken conscious decisions to merge with two regional businesses in the UK—the Cheshire Building Society and the Derbyshire Building Society. The acquisition of the Dunfermline shows that we believe that there is value in having national as well as regional diversification, which members and customers value in a different way. We will seek to exploit that over a period of time.

**Ms Alexander:** I have another couple of questions.

It is in the public domain that the Nationwide purchased £2.3 billion of retail deposits and a further £1 billion of the prime mortgage lending book that you mentioned. On the face of it, the Nationwide put £3.3 billion or £3.4 billion into the takeover, but through the financial services compensation scheme you received from the Government £1.6 billion of funds towards that transaction, so it appears that the Nationwide's net input was about £1.7 billion and that the Government's was £1.6 billion—half and half, in other words. Is that about right?

**Alison Robb:** I will explain the position. The Dunfermline had mortgages—outstanding loans to customers—amounting to around £1 billion. The other half of the balance sheet comprised about £2.5 billion in savings. On the day of the transaction, we took on the obligation to repay savers on demand their £2.5 billion.

The £1.5 billion from the Government was purely the balance between those two figures. We could take in £1 billion from the customers, but we had to give back £2.5 billion to the savers if they required it. In effect, the gap was purely down to the fact that we were taking on more in savings balances than people required in mortgages. The discount that we received during the transaction was £68.5 million against the asset value. That, in effect, was the contribution from the Government.

13:00

**Ms Alexander:** The Government's contribution to the acquisition was between 40 and 50 per cent. We have established that the Government gave you £1.6 billion towards a transaction in which you handed over £3.3 billion.

**Alison Robb:** We were taking on an obligation to repay customers. The Nationwide had absolutely no obligation to repay those customers. We had to take the cash to enable us to repay those customers.

**Ms Alexander:** The numbers speak for themselves. Adrian Coles, from the Building Societies Association, came before the committee. Tony Prestedge has said that the Nationwide now accounts for 50 per cent of the market, and I have no doubt that your trade association at some level represents your views. Adrian Coles said about the FSA consultation document:

"The demands"—

that were being made by the FSA—

"for greater capital and greater liquidity, for example, make firms too pessimistic and will damage the recovery."—[*Official Report*, *Economy, Energy and Tourism Committee*, 16 September 2009; c 2389.]

Is that the Nationwide's view?

**Tony Prestedge:** The trade association represents a whole grouping of a sector—in excess of 50 building societies, many of which have different demands.

From our perspective, the demands that are being placed on us for additional capital are lower than the capital levels that we currently hold, so capital is not the principal issue for us in terms of our risk appetite. The issue that we have, and are likely to have over a period, is the type of capital that we are able to hold. At present, building societies are able to raise capital only through two sources: retained earnings and permanent interest-bearing shares. Because PIBs are not deemed to be loss bearing in the first instance, under the current rules—which are being consulted on—they are not judged as being capital of a sufficient level of quality in terms of the overall capital that businesses hold. That means that building societies are at risk of being at a disadvantage in relation to the banking sector in their ability to raise capital. I imagine that Adrian Coles was talking about that.

The FSA has already started constructive discussions with the whole industry—of which we are a part—through which we are attempting to identify new instruments to counteract that imbalance moving forward. If the problem of the imbalance cannot be solved or the permanent interest-bearing shares, as currently described, are not allowed to contribute towards the tier 1 capital threshold, the building society sector is at risk of being at a disadvantage. We are not there at this stage because that is still in the consultation process.

**Ms Alexander:** I was simply making the point that the Dunfermline Building Society's lending was within the limits of diversification that were allowed under the Building Societies Act 1986 and the Building Societies Act 1997. It would surely be a dereliction of duty on the part of the FSA if it did not revisit the limits of diversification, given the fact that, technically, the Dunfermline Building Society was behaving within the rules. However, we have just established that you needed £1.6 billion to make the transaction work for an organisation that has 34 branches. I was deeply disturbed by the Building Societies Association's reservations about the FSA's consultation document. The experience of the Dunfermline Building Society, which was within the rules, surely requires the issue to be revisited, albeit that some details need to be resolved.

**Tony Prestedge:** We need to separate the two consultations that are going on. We have, thus far, not received any consultation document that suggests that risk or asset type within a balance sheet will be limited, because that would be about the level of capital that a building society held. I genuinely believe that the existing rules and the continuing consultation are appropriate, because the consultation proposals seek to limit the risks that businesses take by the nature and quality of the capital that they hold rather than by applying a binary control over the risks that a board can take.

The Nationwide chose consciously never to take such risks in the first place. We have never acquired assets that we did not originate ourselves—we have always been in control of the risk decisions in the business. Our board has always maintained a balance sheet that we feel to be proportionate to the risks that the organisation takes.

I did not hear the evidence that Adrian Coles gave, so it is difficult for me to talk about the specifics. My concern on behalf of the Nationwide's business and the sector is that all financial institutions need a way of competing on a like-for-like basis in proportion to the risk that they take. The capital debate that is taking place suggests that the tools that are available to building societies will be unlikely to count towards specific capital types. That could limit the building society sector's ability to compete, because it will be able to compete only on the basis of retained earnings, which could limit the building of diversification of competition.

I return to a point that Ms Robb made. The transaction that was undertaken—the net position in terms of cash receipts from the Government—involved the cash that was taken out of the Dunfermline Building Society when it went into temporary public ownership. It was not taxpayers' money that was transferred. The value of the transaction in terms of the net difference was circa £60 million. That is because, as is publicly known, that was in the range of what the likely capital shortfall would have been if the business had traded independently. When discussing the numbers, it is important to note that the net transfer was cash that the Government received when the Dunfermline business went into temporary public ownership and was transferred to the Nationwide Group. Members' money, not taxpayers' money, was transferred when the ownership arrangements were completed.

**Ms Alexander:** This is not the place to pursue the Building Societies Association's comment that the financial services compensation scheme is funded unfairly. You need not comment on that now, but if you have a view, you might offer it in writing.

**Tony Prestedge:** I planned to make the point, as I did to the Scottish Affairs Committee in London, that we believe strongly and have said publicly that the financial services compensation scheme is inherently unfair. I will use the Nationwide Building Society rather than the sector to give an example of that.

Funding of the compensation scheme is based on the retail deposit base. It is arguable that we have one of the lowest risk appetites in the UK and in the Scottish marketplace in that sense. The charge on us for the banking sector's failures has been £250 million. That is higher than the charge on major banking institutions because our savings base is higher. It is therefore clear to me that the system is unfair. I say that on behalf of the members of the Nationwide and others throughout the building society sector.

Building societies follow a low-risk, retail-funded business model. When other banking institutions fail, we should not carry a disproportionate risk. In any other marketplace, the risk premium for insurance is based on the risk. We are lobbying hard on that point. However that premium is designed in the future, it should be proportionate to the risk that is taken. Banking institutions take greater risk because they need to produce a greater return, so they should carry a greater proportion of the burden.

**The Convener:** As a member of the society, I will not comment on that point.

**Stuart McMillan:** I am not a member of the Nationwide; my wife and I decided a couple of years ago to leave the Nationwide.

I have a question about competition. You have said a couple of times that the Nationwide has about 50 per cent of the UK-wide market. Is that correct?

**Tony Prestedge:** That is the Nationwide's percentage of the building society market, which is sub-20 per cent of the entire market. The Nationwide's savings and lending bases have market shares of circa 10 per cent of the market as a whole.

**Stuart McMillan:** That clarifies the issue that I was going to ask about, so thank you.

**Christopher Harvie:** I have a general question. Why was it that the great change of building societies into banks was so disastrous overall? None of the building societies that changed remains as a free-standing institution. What do you attribute that to?

**Tony Prestedge:** A traditional building society, of which Nationwide is a good example, has limited diversification. The market is entirely self-sufficient when the rate of return that a building society needs is only about capital self-sufficiency, because it is not answerable to an equity market or a set of shareholders. When such a building society is converted to a public limited company that, rightly for that model, has institutional shareholders demanding equivalent returns to those of diversified banking institutions, that institution has no argument not to diversify.

The seeds of the failure for those building societies that converted were sown at the point of conversion. They would never have been able to make sufficient return to compete against global banking institutions. That is why the Nationwide board at that time argued strongly that the reality of conversion would be that independence would be lost over a period. That is also why some of the businesses that converted chose not to convert independently, but to sell themselves to maximise value for the owners of the businesses at the time. The kernel of the issue for the societies that converted is that they were forced to take risk in a relatively contracted market—that is, over a relatively short period—without an appropriate risk seasoning in their balance sheets.

There is always a risk when our sector answers such questions that it comes across as being pious or arrogant. I hope that it does not come across in that way at all—it is just that the facts speak for themselves. In my view, the issue is not that banking institutions are bad and building societies are good. There are different models and full diversification is healthy. Consumers will then make choices for themselves based on the types of services and products that they want.

**Christopher Harvie:** It seems that, in a sense, we will have to reinvent the building society as a form of targeted local financing for small savers, exchanging money for social purposes. Can you envisage the mutual building society structure being more widely applicable? For instance, in Scotland there are many projects on renewable energy, local renewables and insulation of houses. Can the structure be made more flexible without running into the problem that you sketched very ably of institutions being swallowed up by big anonymous forces?

**Tony Prestedge:** We of course would say yes, because we believe strongly in the marketplace. However, we should not be naive and believe that we can return to some form of Mainwaring banking that once existed because, absolutely, competition is good. However, competition reduces the margin that financial services businesses need to operate. Therefore, for a vibrant mutual sector to operate en masse, it is important that we engage in constructive debate with the authorities—the Bank of England and the FSA—on the tools and systems that are available to us. We argue strongly that, in European marketplaces, the mutual sector is significantly greater than it is in the UK. There have been far fewer conversions in the Spanish and French markets because the institutions that supervise those businesses have chosen consciously to develop tools that allow those businesses to fund themselves through the formats that are available to them. Preferential funding at appropriate commercial rates flows through the central banks in those environments. When conversion took place within the UK, a choice had to be made about the diversification of funding. The choice was made that full conversion to the private sector was the right response.

13:15

For the mutual sector to be vibrant, we need to maintain a clear focus on the risk dynamic within the business. Ultimately, that will determine returns over a period of time. We also need to build dynamism into the funding market as a whole. There is no sustainable business model that is simply about taking retail deposits and matching them against retail lending in any market—the markets are far too diversified and consumers are too demanding about price. The reality is that, when banking institutions are stabilising and are able to access wholesale markets, and when those markets are competitive in terms of sources of funding, the price that they are able to pass on to the consumer can be balanced. I do not believe that it is as simple as saying that the right model is to match retail lending to retail funding, as that, in itself, will not be competitive. The right model is to ask how to minimise or find the proportionate risk for the return; how to allow businesses to be as efficient as they need to be in order that they can become capital self-sufficient; and how to develop tools beyond those that are available today for the wholesale market. In addition, that wholesale market access must be proportionate to the risks within the balance sheet.

**David Whitton:** Let us return to the issue of your staff and the takeover. At the time of the takeover, there were to be no compulsory redundancies for three years. Is there a voluntary scheme, and have you lost any staff?

**Tony Prestedge:** I will clarify the point and then ask Rudolf Heaf to talk about the operational detail.

We gave a guarantee that there would be no compulsory redundancies among branch employees; we did not give that guarantee for all employees, including those in the head office environment. Indeed, we made it clear that, for some central functions in which it was right to leverage scale for the business—principally the support functions—there may need to be a reduction in the number of staff. I ask Mr Heaf to talk about the specifics.

**Rudolf Heaf:** There are about 250 employees in the branch network and about 250 people working in the head office, in Dunfermline. When the acquisition took place and I was put in charge as the interim managing director, I reviewed the operation of the business and how the business sat within the wider group. I also sought to ensure that we retained the Dunfermline Building Society’s identity within the wider Nationwide group.

In June, we introduced new management structures but that did not result in any change in employee numbers. That was done merely to put in place robust management structures for the management of a business that, as we all know, went through a little difficulty just before. We then worked across the business, with the employees and the union, over a period of three months and on 27 August I announced some changes in the head office—not in the branch network, which, as Mr Prestedge said, was guaranteed for three years. We announced proposals to change the structures within the head office and to reduce the number of employees.

I stress that part of that was the creation of many new opportunities. Nationwide is strong on customer service and we felt that the customer service operation in the Dunfermline Building Society needed to be stronger. Therefore, we created a big number of new roles in Caledonia house as well as requiring restructuring that would mean that some people would have to leave the business. The number of people who have left the business since the acquisition took place is very small—at the end of August, in answer to questions, I said on record that that would be about 20 people. We recently got to the end of our consultation with those individuals, and about 20 people out of the 500 will be leaving the business.

**David Whitton:** Those 20 people are from the head office, not the branches.

**Rudolf Heaf:** Yes.

**David Whitton:** And is that voluntary or compulsory redundancy? It sounds to me as though it is compulsory. You targeted roles and said that they were redundant.

**Rudolf Heaf:** I will explain how we did it, if I may. We reviewed the roles and saw some that we no longer needed. We then consulted those individuals and took account of their preferences. A good number of those employees said, “I’m still a loyal employee and, although the job I’m doing now is no longer available, I’d like to do something else.” A good number of people moved into other roles. Although 20 individuals left, a number of them were pleased that it came at the right time for them, for example just before retirement. However, for some of those 20 it was not their choice to leave.

**Tony Prestedge:** There have been in the region of 20 compulsory redundancies. Some people have chosen to redeploy. We were clear that there would need to be redundancy as we integrated operations. Our commitment was always to the customer-facing employee base in the branch network.

We see the Dunfermline operation as one that services the Dunfermline consumer base but which, over time, may service a Nationwide consumer base or other parts of the operation. We have multiple operations around the UK, and many sites, of which the Dunfermline operation is one. All good organisations seek to minimise compulsory redundancy and to leverage the operations that are available to them. Over time, therefore, we will probably seek to move work into the Dunfermline site that might be about not just the Dunfermline operation. That is how one drives efficiency.

**David Whitton:** Were the terms and conditions of Nationwide staff and Dunfermline staff different? Is an attempt being made to merge those terms and conditions?

**Tony Prestedge:** They are different and we have not yet moved towards merging them although, as you might expect, we will seek to develop some level of commonality over time. Since 30 March, the Dunfermline employees have operated in a Dunfermline environment but as Nationwide employees who happened to be in Dunfermline, so we will want some commonality. Although there are inevitably some differences in the terms and conditions, there is not significant divergence. I am confident that we will be able to integrate over time, subject to appropriate negotiation, without that being in any way detrimental to the employee base. We have already done that with the Portman acquisition, when circa 2,000 people moved over as a result of the merger. We managed that transaction similarly, without significant issues for any employee, and we will seek to do the same here.

The one thing that was closed upon the transaction date was the final pension salary scheme. On that date, Dunfermline employees moved into a group personal pension salary scheme that was equivalent to the Nationwide scheme. That was because it would have been entirely wrong for Nationwide pension scheme members to take on the liability of a pension scheme for Dunfermline employees when there was insufficient capital to come with that scheme. In the same way as we chose not to take on the risk in terms of commercial lending or specialist assets, we chose not to take on the risk of the pension scheme. That is the one material change thus far, but it was made in advance of the acquisition rather than post.

**David Whitton:** One would hope, of course, that if the terms and conditions at the Dunfermline end are less than those enjoyed by the Nationwide end, you are moving up the way, not down the way.

**Tony Prestedge:** We operate not a geographic but a national pay system, on which we consult the unions. In a competitive marketplace it is in our interests to get the best employees at the right reward in the market in which they are operating, whether they are Dunfermline or Nationwide employees. That is what we will seek to do over time.

**David Whitton:** You say that you have just reviewed all this. Are you confident that you will need no further job losses at the end of the three-year period?

**Tony Prestedge:** It is absolutely impossible to answer that question when that point is two and a half years away. What I will say is that a Nationwide employee working in a Dunfermline branch site has a three-year guarantee. Nationwide employees working in our sites have no such guarantee. That demonstrates our confidence in our workforce and says, “We believe in a vibrant operation in Scotland.” We also believe that, if there is a requirement to reduce job roles because business volumes dictate it, we have two and a half years in which to do that. Any retail operation must have a sufficiently significant turnover, which means that we would attempt to address that. I do not mean to be evasive, but it is impossible, in any business, to predict what we may need to do in more than 24 months’ time.

**David Whitton:** I think that I am right—correct me if I am wrong—in saying that the Dunfermline was heavily involved in the housing association investment business. How have the takeover and the Dunfermline’s poor reputation as a result affected that? Has business reduced? If so, what are you doing to alleviate the impact?

**Alison Robb:** We acquired the housing association portfolio as a separate transaction—it was not part of the main transaction at 30 March—through a competitive tender process at the end of June. For a period, Nationwide did not own the Dunfermline housing association business. We have owned that business only since the end of June.

We acquired a business of just under half a billion pounds—about £450 million of assets. At the point of acquisition, a substantial pipeline of well over £100 million of business also existed. Several of those loans have since been drawn down. We continue to trade the portfolio as the Dunfermline management did and as the Bank of England subsequently traded it from 30 March to 30 June. We are running that in line with how it was run before.

The portfolio is high quality. As with all housing association transactions, the risk is relatively low. However, as in the sector as a whole, the margins on the portfolio are also low.

**Tony Prestedge:** The residential social lending portfolio provides a good example of the value of a mutual business. Residential social lending is much lower risk, but the returns are much lower. A mutual organisation can afford to make much lower returns, which is why we are the largest operator in that marketplace in the UK.

We are committed to that marketplace. However, the rate of return needs to be appropriate to cover the associated capital risk. As Alison Robb said, the market in Scotland has continued to grow for us in the draw-downs on the portfolio that we acquired and in the Nationwide book.

**The Convener:** I will finish by asking another question about statistics. You mentioned that the Nationwide has 50 per cent of the UK building society market. Do you have an estimate of your share of the Scottish market?

**Tony Prestedge:** The building society sector does not report geographically, so it is hard for us to predict our Scottish share. However, I expect that the percentage is much higher. Most building societies—absent Nationwide—tend to be more geographically focused, so I expect the proportion of the building society sector that is in Scotland to be skewed to Nationwide. Previously, the Dunfermline existed; another society is the Scottish Building Society. There are other sites, but I am sorry that I cannot answer the question specifically. We could ask the Building Societies Association to provide the information to the committee.

**The Convener:** That would be helpful—I ask just for information. The question raises the issue that the building society sector has traditionally been a relatively small part of the Scottish mix. That is partly for the historical reason that housing tenure was different and partly because of the strength of the old Trustee Savings Bank before it demutualised and was taken over by Lloyds. Given that, is there scope to extend the building society sector in Scotland? Can that be achieved?

**Tony Prestedge:** Such scope unquestionably exists. The issue is about how that extension needs to take place and how people choose to transact. It is worth remembering that the fact that institutions do not have a physical presence in Scotland does not mean that they do not have relationships with Scottish consumers, whether through the internet or by telephone. Competitive extension and competitive challenge can be provided without a physical presence.

That said, our experience of the Scottish marketplace is of vibrant markets, great consumers and fantastic employees. If any other building societies in England wanted to extend into Scotland, I am sure that—like you—we would welcome them with open arms.

**The Convener:** That concludes the questions. I thank Tony Prestedge, Alison Robb and Rudolf Heaf for their answers, which have helped with our inquiry. If we require factual information on issues that arise, we will get back in touch with you.

We will continue the inquiry next week with oral evidence from the European Commission’s competition directorate-general and from UK Financial Investments Ltd, which represents us—taxpayers—on the boards of RBS and Lloyds Banking Group. That should be fun.

*Meeting closed at 13:30.*

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