ECONOMY, ENERGY AND TOURISM COMMITTEE

Wednesday 18 November 2009

Session 3

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ECONOMY, ENERGY AND TOURISM COMMITTEE
30th Meeting 2009, Session 3

CONVENER

*Iain Smith (North East Fife) (LD)

DEPUTY CONVENER

*Rob Gibson (Highlands and Islands) (SNP)

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*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)

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Jeremy Purvis (Tweeddale, Ettrick and Lauderdale) (LD)
David Whitton (Strathkelvin and Bearsden) (Lab)

*attended

THE FOLLOWING GAVE EVIDENCE:

John Crompton (UK Financial Investments Ltd)
Michael Kirkwood (UK Financial Investments Ltd)
Irmfried Schwimann (European Commission)
Sam Woods (UK Financial Investments Ltd)

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Stephen Imrie

SENIOR ASSISTANT CLERK

Katy Orr

ASSISTANT CLERK

Gail Grant

LOCATION

Committee Room 4

Scottish Parliament

Economy, Energy and Tourism Committee

Wednesday 18 November 2009

[THE CONVENER *opened the meeting at 10:34*]

Financial Services Inquiry

The Convener (Iain Smith): I welcome everyone to the 30th meeting of the Economy, Energy and Tourism Committee in 2009, in the slightly unfamiliar surroundings of committee room 4—we are not usually allowed into this one.

There is just one item on today's agenda: the banking and financial services inquiry. We have two panels of witnesses. I have some difficulty with the idea of one person forming a panel, but I welcome Irmfried Schwimann, who is an official in the European Commission directorate-general for competition. I thank you for coming from Brussels today to give evidence to the committee. If you wish to make any opening remarks, you may; we will then open the discussion up to questions from members.

Irmfried Schwimann (European Commission): Perfect. If I may, I would like to state in a few words what we have been doing, why we have been doing it and what the outlook is going to be, with a special emphasis on Scotland, because I suppose that that will be most interesting to you here.

The European Commission conferred on the European competition authority certain anti-trust, merger control and state aid powers. In respect of the last of those, it is seeking to ensure that the state aid that member states have granted to companies is not causing undue distortion of competition. If you look at the financial crisis and the €3 trillion being pumped into the system, which is roughly 30 per cent of the European Union gross domestic product, you can imagine why we are concerned that there might be distortion of competition and why we are looking into that closely and judging the short, medium and long-term impact.

I would say that the crisis started about two years ago—it is often linked to the Lehman Brothers case, but I believe that it started much earlier and that Lehman was just the trigger point when the trust went out of the system. When the crisis started with Northern Rock, and with IKB Deutsche Industriebank and Sachsen LB in Germany, we had the impression that faulty business models were being used and business decisions that were not particularly wise were being made. When Lehman happened, the situation clearly changed; trust went out of the system and we had a systemic crisis that called for different reactions and responses from the regulators, supervisors and competition authorities.

In the first phase, which was a rescue phase to keep the financial system afloat and avoid a meltdown, our role as a competition authority was to support financial stability and give clarity on the rules of the game. It was clear that the huge amounts of money that were put into various institutions and schemes would be a problem in that they would distort competition between banks that were aided and those were not, and between the member states that had more money and those that had less to support their financial systems.

We have moved away from the rescue phase and into the second phase, which we often call the restructuring phase. We are now trying to ensure a return, of the system and individual banks, to normal market conditions—always making it clear that normal does not mean pre-Lehman, because that was not really normal—that take account of the reassessed situation and risks and necessities, with increased capital requirements and so on.

We also need to ensure that market distortions that have arisen because of the state aid that has been granted are addressed in the restructuring phase. We have to address moral hazard during that phase. Some of the behaviours that we have seen in the banks came about because the banking sector had the impression that whatever risky decisions the banks made, they would be bailed out. That is also an issue that we want to address.

We have tried to behave predictably, so we have produced guidance on how we will deal with guarantee schemes, recapitalisation schemes and the impaired and toxic assets that appear on banks' balance sheets. We want to make it clear ex ante how our state aid assessment will be done in those cases.

The final part of the restructuring phase, and probably the most important, is what we call the restructuring communication, which sets out clearly what conditions and modalities we will assess when we look at the individual restructuring plans of the companies that have to present them.

The approach is based on three fundamental principles. The first is that the banks that have received state aid must be made viable again in the long term without state support. That means that they must revisit and reduce systemic risks in their business models. They must also demonstrate that they have changed their strategies to achieve viability in the long term, even in adverse economic conditions. We stress-test the business models of the banks that become our clients to determine whether they would be able to survive without state support, even in adverse economic conditions. Clearly, that has an effect. Non-viable business entities or parts of banks must be sold off—if one part of a bank is the problem, we will seek an orderly winding down and divestment of the viable business entities.

The second big principle is that banks that have received state aid, and their owners, must bear a fair proportion of restructuring costs. That is intended to address the issue of moral hazard and to make clear to people that investing and having a stake in a bank carries a risk, such as having to pay for some restructuring. Burden sharing is guaranteed by the price that we ask the company to pay for the state support—the guarantee, the recap and the impaired asset relief—that it is receiving, and by the ban on dividend payments; we oppose the use of state support to pay dividends to owners. That reflects our aim of ensuring that the burden on taxpayers is limited and that a fair share of it is carried by owners and banks.

The third element is the requirement that measures be taken in the restructuring to limit distortions of competition resulting from the aid that has been received. If a bank is able to remain strong or to grow in a business segment using a certain business model because of aid that has been received, that is clearly a distortion of competition vis-à-vis all the banks that have received no aid. We often look for divestments in those areas where a bank has been able to preserve a strong market position because of state aid. We also request a ban on acquisitions, so that a company cannot use state aid to acquire new companies or stakes elsewhere, and other behavioural restrictions to address distortion of competition. For example, a bank may not be a price leader in a particular market segment.

Clearly, the committee's interest relates to the Scottish market—and I am aware that I have already spoken for longer than five minutes. We have dealt with three state aid measures in the financial services industry in Scotland—those relating to the Dunfermline Building Society, Lloyds Banking Group and the Royal Bank of Scotland. On 3 November, if I recall correctly, RBS and Lloyds announced the measures that they are taking to address our state aid investigations. The college of commissioners has approved Lloyds Banking Group's restructuring plan; I can mention that now, as it happened about an hour ago. I expect that in an hour Neelie Kroes, the Commissioner for Competition, will hold a press conference on the decision, which was taken with decisions on KBC and ING. RBS's plan is still subject to assessment by the directorate-general for competition.

Both Lloyds and RBS have made announcements in the press. Lloyds has announced that it will divest Lloyds TSB Scotland, which represents about 16 per cent of the Scottish personal current account market. RBS has announced that it will sell its NatWest branches in Scotland, which represent about 6 per cent of the Scottish small and medium-sized enterprise market. Other measures are attached to those; I am happy to provide details if the committee is interested.

10:45

We think that the divestments I have described will have a strong pro-competitive impact on the Scottish market because, if you look at those companies' market share—Lloyds Banking Group has 47 per cent of the Scottish personal current account market—a new entrant into the market should be positive for competition and for consumers as it will increase choice.

We are aware that Lloyds and RBS play a very important role in the Scottish economy in respect of lending to the real economy and jobs, and we have tried to ensure that the lending commitments that have been given by both banking groups vis-à-vis the Treasury are being honoured. In any case, the divestments that have been agreed will not take place tomorrow; they will probably start to take place from 2010 onwards. We have insisted that lending capacity should not be reduced and we are hopeful, given the interest of other parties in entering the United Kingdom market—that clearly includes the Scottish market—that there will not be a credit crunch in the future. There might be a hiccup in the intermediate period until a buyer is found, but I think that that can be addressed quite well.

I will stop at that point as I do not want to monopolise the discussion. I am happy to take any questions.

The Convener: Thank you. That is a helpful introduction.

Can you explain in a bit more detail what the Commission's involvement was in drawing up the proposals that the Royal Bank of Scotland and Lloyds Banking Group made on 3 November?

Irmfried Schwimann: The Commission does not impose anything in relation to how the plan looks in detail; the member state would come to us with a proposal. The parameters have been set out clearly. We look very closely into the business models of the banks, their balance sheets and where the problem has come from to assess whether the plan that has been put on our table addresses our concerns about their long-term viability. We want to know whether the entity that will come out in the end is an entity that will be able to survive and operate in the market without state support.

We also consider whether the proposals address our concerns about burden sharing; we want to know whether the bank and its owners have made a sufficient contribution to carry a sufficient part of the restructuring costs. If they have not, we invite the member state—the member state is our interlocutor; it is never the bank, although the bank is usually sitting there—to improve the plan in that respect. If, for example, we have the feeling that some viability problems have not been addressed sufficiently, we will insist that they be addressed.

In the case of impaired asset relief, if we have the feeling that the price that has been paid for relief is not adequate because the valuation was not done correctly, we will insist on improving the price. We are talking about taxpayers' money, so we must be clear that the price is adequate.

Finally, in respect of the distortion of competition, we look for divestments in areas where the company has a strong market position that it has been able to maintain because of the aid it received, to allow a competitor to enter that core market of the company.

We have a clear idea of the size of what we would like to see, but we do not necessarily impose exactly what we would like to receive from the company. Clearly, the discussions often continue. We tend to get to know a company quite well in the negotiations and we have a good feeling for where we think an effort should be made and where it should not. Clearly, it is not only about divestments—the examination of those three areas will in many cases, but not always, mean that structural divestments will be made, but often behavioural commitments will also be necessary to address our concerns.

We are getting to know companies very well. We are screening their balance sheets and business plans and assessing whether the assumptions on which their stress testing is based are realistic. We often tell the parties that their assumptions about unemployment figures or house prices are not realistic and that they should do a better calculation. There is an intensive and technical interaction between us and the member state. However, we cannot insist—as we do in merger control—that we want X, Y or Z to be divested absolutely.

The Convener: The Commission does not hold bilateral talks directly with the banks—your discussions are with the banks alongside the member state.

Irmfried Schwimann: Our interlocutor is normally the member state, which chooses whom to take along. In the case of the UK, the banks always come along; in other cases, only the treasury and, sometimes, the national bank come along. The member states are our official interlocutors but, because member state representatives do not always know in detail how a bank is structured, it makes sense to have the experts there as well.

The Convener: So the proposals that were announced on 3 November had been through a number of negotiations between the Commission, the member state and the banks before they were finalised. Were they very different from or roughly in line with the initial proposals by the member state?

Irmfried Schwimann: It is clear that it is the prerogative of the college of commissioners to make the final decision. The Commissioner for Competition alone does not have that power—it is a collegial decision. That is why we must add the caveat that all announcements are conditional on the college's final approval. On 3 November, it was clear that the cornerstones of the agreement were fairly fixed, but there is always the odd detail to be settled. Although the announcements were made, were clear and were negotiated with us, the odd i may need to be dotted before the college makes its final decision.

The Convener: You mentioned that it will be announced today that the college of commissioners has approved the proposals relating to Lloyds Banking Group but that the proposals for RBS are still under discussion. What issues are still being considered in relation to RBS? When do you expect an announcement to be made?

Irmfried Schwimann: The discussions relate to the complexity of RBS, which has been part of the asset protection scheme and has, therefore, received asset relief, which Lloyds has not. The valuation of impaired assets is extremely complicated. We have had to ensure that the price that was paid for the APS is okay. It is merely a timing issue—it was not possible to finish that work at the same time as the work on Lloyds Banking Group.

There were some open issues. As you can imagine, discussions are tense and we move forward more quickly in some areas than in others. You must appreciate that the amount of aid received by RBS is much greater than that received by Lloyds, ING or KBC, which is itself quite big. Each case is different. In some cases we are able to move more quickly because information is received more quickly. It is easier in some cases than in others to reach agreement on specific divestments, which makes it easier to cut the deal.

It is clearly RBS's responsibility to state what it has stated. There has not been a counter press release that says that that is all wrong, which indicates that the cornerstones have been agreed with us, but one has to await the final decision and see what the details are.

Rob Gibson (Highlands and Islands) (SNP): It has been reported that the chief executive of RBS, Stephen Hester, has said that the disposal of Williams & Glyn's was uncontroversial and that he understood the arguments for increasing competition on the high street, but that the other disposals—its insurance interests, for example—were

"more controversial in what they will accomplish".

Have you taken that into account in determining the package that RBS would have to accept to gain the college's acceptance?

Irmfried Schwimann: We look at various elements in considering a restructuring plan, one of which is the organisation's viability. We ask the bank to shed all the areas that have been part of the problem. Another element is the impact on or distortion of competition. If a bank is asked to divest something in its core market where it has a strong market position, that would come under that heading.

Other divestments come under the heading of burden sharing. We all have an interest in state money being repaid as quickly as possible. Divestments that are not necessarily part of the bank's core business and are not necessary for its viability might reduce its balance sheet and induce no danger for its operations. They can raise money to repay state aid. There has been a similar issue in the case of ING, in which we reached a similar conclusion. In other cases, because of their business model and because insurance is part of their core business, banks will keep that insurance and have to divest different things.

We must consider each case individually, but we consider things under three headings, the first and most important of which is viability. We do not want banks that are unable to stand on their own feet. In addition, we cannot have banks that have been weathering the crisis without any state support being put in a worse position, and we cannot have taxpayers continuing to pay for the sins of wrong business decisions. The idea is to share burdens. Banks must divest something in order to pay back money as soon as possible.

Rob Gibson: In the case of RBS, is there a conflict between having to pay back money as soon as possible and thinking about a business that is broad based?

Irmfried Schwimann: Being broad based and being viable are two different things. Part of RBS's problem is that it had a very expansionary policy. Sometimes, its decisions to buy companies in Europe might not have been the wisest. Perhaps its decision to expand away from its core business model into other areas might not have been the wisest decision. Would not it be better to get back to the core of the business, concentrate on that and do what one can do best?

Rob Gibson: Did not the problem arise in investment banking rather than in insurance?

Irmfried Schwimann: Investment, especially in the United States, is clearly an issue and we are considering it. We are not saying that the problem arose in insurance—that would then have to come under the competition distortion heading; we are saying that we want the bank to pay back money. We are talking about around €45 billion of recapitalisation and around €200 billion or €300 billion of asset relief. That is an enormous sum—indeed, it represents the biggest amount of state aid in the whole crisis in Europe—and it is fair that a certain price is paid for it.

We are clear that we must ensure that the RBS that comes out of the process is viable and can compete, render services and lend to the real economy and be its anchor. Banks are not just companies; they have an intermediate role that is necessary for the overall economy. To make it possible for banks to fulfil that role for the benefit of consumers, we must ensure that they return to viability and do not depend on state support.

11:00

Rob Gibson: You are attempting to create payback for the banks as the price for gaining viability. When does the European Commission cease to be involved? When does the bank come off the books at the directorate-general for competition?

Irmfried Schwimann: It will come off once the restructuring is finalised. I hope that we will have the final decision on Lloyds today and the final decision on RBS in the not-too-distant future. A number of commitments will be written into that decision. A technical issue is involved in that we have two procedural possibilities. If we open proceedings formally, we can have a conditional final decision: we can say that we think that something must be done and that if you do not do it we will come after you again. If we do not open proceedings formally, we must ensure that the final decision is unconditional, so that all the necessary commitments come from the member state.

The commitments that we have from member states include a timetable for restructuring. However, one of the specificities of the crisis is that we have been much more flexible on the timing for divestments. In normal state aid procedure outwith the financial crisis we would ensure that the divestments or restructuring needs would last no longer than 18 months or two years, but in the context of the crisis, when there are many divestments on the market and it might be difficult in present market conditions to find a buyer, we thought it reasonable to extend the two-year deadline to five years. That, too, depends on various negotiations with different companies about what must be done, but a timetable will normally be attached. Once it has all been done, the company is off the hook.

We also want to ensure that, after five years, the bank does not just say that it is sorry but the process has not worked. We have therefore adopted a process from the merger world and insisted that if it is not possible to sell a particular business in the timeframe that was agreed with the company, a divestiture trustee will sell the business for the company. That will provide an incentive for the bank to do things itself; it might get a better price if it does things on its own initiative.

Rob Gibson: So we can safely say that you will be involved until the companies come off state aid?

Irmfried Schwimann: Yes.

Ms Wendy Alexander (Paisley North) (Lab): You have been very helpful in sharing with us the rationale for the requirement to dispose of the insurance operations of RBS. If I understand you correctly, that would fall into the area of burden sharing.

Irmfried Schwimann: Yes.

Ms Alexander: Great. In that context, you said that you were keeping RBS's United States assets under review. Can you expand on that?

Irmfried Schwimann: The problem is that the case is still running, so I cannot go into the detail of the various divestments or beyond what has been in the press. I am sorry about that.

Ms Alexander: Let me approach the same issue at a strategic level. We are trying to get an understanding of the EU's strategic vision for banking. I note that the European Commissioner for Competition, speaking recently in Amsterdam, said that the European Commission was

"trying to build up solid banks".

What is the Commission's definition of a solid bank? Is it the so-called narrow bank, with the retail and investment functions separated?

Irmfried Schwimann: It is important to make the point that the Commission is neutral in a number of respects. We are neutral in respect of ownership. It does not matter in the end if a bank is owned by the state behaving like a market investor or privately, as long as no undue state resources are used and decisions are made on economic and not political terms—although that is more of a German problem.

Likewise, we are indifferent on business models. We do not say that banks can be only retail banks and cannot have bank assurance business models. We leave that to the market, because we strongly believe that, in the end, the market knows better and is able to choose the best business model. In all cases, we look at what the problem was and whether any viability issue has come from a particular part of the industry. For example, if a business model involves long-term lending being financed by short-term funding, there is a problem that needs to be addressed. We are not trying to influence business models in a particular way, because there is not one best business model—business models must be adapted to the situation.

Each of the various aspects will be and is being scrutinised. We look at the retail and wholesale parts of a business; if there is an insurance part, we consider whether that would be viable on its own. If the aid has caused a distortion of competition in a particular area—you mentioned investment banking—we must look at that. We are not imposing anything on banks all of a sudden; we are looking at the various aspects to see how we can remedy the problems that have arisen.

Ms Alexander: You may not have an implicit business model in your head for banking, but we are trying to understand the rationale for the choices that you have made. It is clear that you are tilting RBS in a certain direction. You could have chosen action on insurance, as you did; action on the bank's US assets; or action on its investment banking operations. Because of the scale of the public resources that are involved in the institution—the public holds 84 per cent of shares and has an economic interest of 70 per cent in RBS—I want to understand your rationale for trying to tilt the burden-sharing element in a certain direction. What is shaping your thinking about those choices now and in the future?

Irmfried Schwimann: It is difficult to look at the three elements that I have enumerated. If there is already a huge divestment for viability reasons and it brings in money that could help with burden sharing, that may have an impact on how big the burden-sharing element must be. However, you cannot sell one element twice.

We begin by looking at the three elements. We do not impose a particular method of burden sharing. Often the member state tells the bank that it needs to do certain things to pay back more quickly the state aid that it has received. We would have certain measures in mind because we know the company, but very often other proposals come, which we consider and decide are acceptable because in the end they bring the same result.

We would not be so flexible on the viability issue because, when we identify the problem, that is what we want to tackle. We would not be so flexible on the distortion of competition, either, because, if we see that a company has been allowed to stay strong, we want something to happen. However, it is not always possible to tackle distortion of competition without endangering the viability of the bank, so sometimes we have to go for a more general balance-sheet reduction. We have to work on a case-by-case basis.

Ms Alexander: Indeed. You suggest that the burden sharing that has emerged was agreed in dialogue with the member state and RBS. In advance of the announcement on 3 November, there was much speculation, with the bank saying that there was a red line around its US assets. The burden sharing that has emerged is on the insurance assets, not the US assets—or at least not most of them. Was the burden-sharing element agreed in dialogue?

Irmfried Schwimann: The decision is not out yet, so we are speculating a little.

Ms Alexander: Sure, but does the proposal represent the burden sharing with which the member state was most comfortable?

Irmfried Schwimann: All we have is an RBS press release. We have to put the issue into perspective. We are not going up front with anything concrete before we have the decision, so we have to wait for the decision. However, to answer your question, we are in negotiation with the member state, with the bank present, and we will have to come to an agreement. Because the decision will have to be unconditional, all the restructuring commitments will have to be spelled out clearly by the UK Government and accepted by us in our final decision. I do not know exactly what you want to find out. Is it the negotiation part that you are worried about?

Ms Alexander: I just want to know whether the disposals were agreed in dialogue. It is reported in the media that RBS is unhappy with the disposals, but you tell us that they were agreed in dialogue and they were the best of the options on burden sharing. I am trying to understand that.

Irmfried Schwimann: I can imagine that the bank is unhappy, as are all the banks that are subject to forced downsizing after all the aid that they have received, and I can understand why RBS tells you that it is unhappy. However, we have to put that into the context of the amount of aid that it has received. To be coherent, not only within the UK but within Europe, we must have a consistent policy and equal treatment across all the cases—and there are quite a few. That is why negotiations take longer in some cases than in others.

Ms Alexander: I have two quick questions on unrelated matters. First, you made it clear that the interlocutor is the member state. The Scottish Government made no representations of any kind to the European Commissioner for Competition on the matter, and it said that it had not done so because you had not opened a formal investigation. If you had received representations from the Scottish Government, would they have been heard or listened to?

Irmfried Schwimann: We receive both formal and informal letters, complaints and representations, and we take that all into consideration. The issue with informal procedure is that there is always room for parties to appeal if they think that the procedure was not right. I am not suggesting that you do that, but it is open to you. Our normal interlocutor is the Government of the member state concerned, which can choose who it draws into the talks with us. However, evidently, we would consider with interest any representation that a third party makes or any information that it provides. I am not saying that we would not look at it.

11:15

Ms Alexander: An issue that has emerged is the conditions that the EU might want to attach, albeit via the member state, in respect of to whom the assets can be disposed. As you know, there has been some discussion about the issue, particularly with respect to RBS. What conditions have been specified about who will be able to bid for the assets? How have those conditions evolved? There is some concern that the conditions have changed, so it would be helpful if you could take us through them.

Irmfried Schwimann: Again, I cannot really talk about something that has not been finalised, but our aim in respect of all those aspects is that we do not want an outcome that is less competitive than before.

We are also looking at all these state aid divestments with a merger eye, if you like. In that respect, we are thinking about not enabling more concentration in the market afterwards than there was before. There might be provisions that limit the number of potential buyers, because we do not want to have more concentration in the market than before. The outcome should be a more competitive market rather than a less competitive one. That is why we are trying to address the issue.

For the same reason, we are also trying to be very careful with, for example, the price leadership ban. The rationale for the ban is that we do not want to enable a competitor to outcompete others with state money. However, we have to be careful because, if there are too many price leadership bans, there might not be any competition at all, as everybody will say, "Ah, I cannot be better," and the consumer will pay a much higher price. We must be very careful how best to target these measures, which have a reason on the state aid front but might be stupid from a competition point of view.

Ms Alexander: It may be helpful if you can write to us on where things stand on that.

I have one final question. As you will be aware, the small business banking market in Scotland is highly concentrated: between them, Lloyds and RBS are estimated to have in excess of 75 per cent market share. There is concern among the small business community in Scotland that the proposed divestments do not fully address the absence of competition in small business banking, particularly in the Scottish market, in which the concentration is much higher than in the UK as a whole. Is the Commission satisfied that it has fully addressed a market concentration of 75 per cent in small business lending in Scotland?

Irmfried Schwimann: That concentration is not the result of the Commission's action—we would not want it to be there. One reason why we wanted to look for a divestment that is sufficiently attractive to get new entrants into the market is to address that issue and to have a new competitor enter this very concentrated market.

Our intention was not to look at balance-sheet reduction without looking at what will be divested, but to have a stand-alone viable business that is sufficiently attractive for a new entrant to go into the market and address that issue.

Ms Alexander: I put it to you—others may wish to pursue the issue—that the evidence does not demonstrate that the divestment of Williams & Glyn's branches south of the border or, indeed, Lloyds TSB branches north of the border, will tackle the concentration in small business banking in the Scottish market. That issue has puzzled some observers in this marketplace when they have examined the divestment strategy.

Irmfried Schwimann: I note that, and I understand completely where you are coming from, but what we can do is always limited, too.

The Convener: I seek final clarification of the point about competition in the market. What level of market does the Commission consider—is it Europe-wide, national or sub-national? Would you consider the market in Europe, the UK or Scotland?

Irmfried Schwimann: The level is national.

The Convener: It is UK-wide.

Irmfried Schwimann: The Lloyds and HBOS merger did not fall within our jurisdiction because the two-thirds rule applied—two thirds of their turnover was in the UK market, so the merger did not fall within our jurisdiction.

The Convener: So the lack of competition in the SME market in Scotland is not a consideration for the European Commission because the market is not sufficiently large.

Irmfried Schwimann: Oh—is that what your question was about? I am sorry; I misunderstood.

The first consideration is clearly the UK market, but we also considered the—

The Convener: Sub-national market.

Irmfried Schwimann: Thank you—I did not know what term I should use. I must be politically correct.

We wanted especially to ensure that any divestment was well distributed all over the UK and was not limited to one part. One always strives to do better—that is for sure—but at some point we must decide that we cannot go on for ever, as that would not be good for the company that is in limbo or the situation in the markets. We will achieve something that is coherent and comparable across all the cases that we have, although cases cannot be compared one by one and some cases have more possibilities than others.

Stuart McMillan (West of Scotland) (SNP): We have received written evidence from the Confederation of British Industry Scotland that said:

> "Scottish based firms must also be encouraged to benchmark their performance against international peers and continue to seek to win business overseas, so a global perspective remains critical."

Surely the divestment of businesses—particularly of the insurance arms—will limit RBS's potential to regain a strong foothold in markets, especially internationally.

From what you have said, I am a wee bit unsure about the purpose of divestment. Is the aim to have a sustainable bank at the end of the process or to pay back taxpayers' money as soon as possible? If the latter is the case, surely that will remove some of the bank's prospects of long-term sustainability.

Irmfried Schwimann: First and foremost, our concern is the bank's long-term viability. Otherwise, it will quickly have to request further state support. We must ensure that the outcome is that the bank can stand on its own feet in adverse economic conditions and compete without state aid.

In normal conditions, we operate the one time, last time principle, which means that one approach can be made, but if a second approach is made the company will go into liquidation. However, we are not applying that in this crisis because the crisis has some implications

The action that we take is to ensure that the outcome is a viable business. That is the first consideration. The second consideration relates to two things: burden sharing—repayment as quickly as possible of what is, in the end, the taxpayers' money that we are all responsible for—and removing the distortion of competition that was created by the aid that the entity received. Given that the aid enabled the company to stay strong in the market, to the detriment of others whose better business strategies and decisions allowed them to compete without state support, the distortion of competition must be addressed.

To answer the question, the viability issue is the most important. We would not ask for divestments to deal with burden sharing if they endangered viability. In some respects, viability considerations limit what can be done on the other two strands. Therefore, we might not always get as much as would seem adequate under the burden sharing or distortion of competition headings because to do so could endanger viability.

On the first question, I do not really see how the divestment of the insurance branch would endanger the viability of a bank. It is true that having an insurance branch might be convenient and provide a good source of income. Indeed, a number of banks have found that income from their insurance operations has not been affected by the financial crisis because insurance runs on a different business model. However, an insurance operation is not really necessary for the viability of a bank.

If we are talking about a bank's SME or corporate customers that want to use the bank's services abroad—I hope that I have understood the question correctly—it is not absolutely necessary for them to have access to the bank's own insurance branch, because many other insurance companies would be happy to offer their services. Even if the bank's operations overseas are downsized, people can still use networks other than their own bank's network. In downsizing the bank, we need to concentrate on getting the bank back on to a viable footing so that, after the restructuring process is finished, the bank can grow again in a healthy way.

Stuart McMillan: In the case of RBS, its insurance businesses were, and still are, successful and profitable. Selling them off in order to pay back money to the taxpayer might be fine in the short term, but in the longer term the bank will have no continual income from those operations. That is why I query the sustainability and viability of the divestments.

Irmfried Schwimann: When we look at viability and the bank's business model, we take all that into consideration. Often, there is a bit of a smokescreen behind the arguments. If a bank needed an insurance arm to be successful on the banking side, I would have all sorts of questions about the viability of its business and whether it is using double leverage. One huge problem in the crisis is that banks have used their capital requirements for both operations. We will not let that happen in the future and will insist on an end to double leverage in which a bank operates both businesses. Your argument must be approached with a lot of caution because, if the only way that a bank can stay in the market is through its insurance operations, it has a major problem with viability and should really be looking at restructuring its banking business.

Stuart McMillan: Convener, I have one final question, but I would be grateful if I could ask it later because I have been given the signal to go to the Rural Affairs and Environment Committee to move my amendment to the Marine (Scotland) Bill.

The Convener: If you are back in time, I will allow you to put your final question.

Gavin Brown (Lothians) (Con): The written submission that the Commission's directorate-general for competition provided to our committee was quite light and short. Because of the timing, the submission does not refer to the Commission's recent decisions. I make no criticism of that, but it would be useful if the committee could be given a list of the principal measures relating to the decision on Lloyds Banking Group and to what is, at this stage, a proposal about RBS. In addition, it would be good to have the justification for each of those measures and the impact that the Commission thinks they will have. Because of lack of time, I do not propose that we should go through all that today, but could that be provided to the committee? It would be extremely helpful to have that.

11:30

Irmfried Schwimann: I think that we can provide something like that. In any case, once the decision comes out, it will spell things out clearly. We set out the reasoning behind our decisions extensively and clearly because, after all, our views on whether a certain measure is adequate or not can be challenged in court. The fact that a decision has not yet been reached on RBS makes things a bit difficult; Lloyds is another story and I think that we can get out something about that a bit more quickly.

Gavin Brown: I appreciate that discussions with RBS are on-going, but do you have a target date for reaching a decision?

Irmfried Schwimann: There will always be hiccups in the procedure, and we try to be as quick as possible, but I do not think that I can say anything about timescales.

Gavin Brown: I realise that you have answered various members' questions about RBS's insurance division and that, at this stage, what has been suggested is still only a proposal. However, the justification for the decision to sell off the division was what you called burden sharing—in other words, the ability to raise money to repay the state aid. I suppose that it all depends on the sale price, but does the Commission have a view on how much money might be raised by such a sale?

Irmfried Schwimann: No.

Gavin Brown: Okay.

Irmfried Schwimann: It is not really our business. Obviously we know what the sale would mean in terms of income, balance sheet reduction and so on, but it is not up to us to sell the business for the bank.

Gavin Brown: I appreciate that, but you said that the sale might allow the state aid to be repaid faster. If the insurance market does not grow at the desired speed and the bank is unhappy with the sale price that it might get—you said that it could take up to five years for a sale to go through—is there not a danger that none of that state aid will be repaid for those five years?

Irmfried Schwimann: Again, I do not want to pre-empt what will be in the decision, but we normally have the safeguard that, if the business is not sold within the divestiture period, a divestiture trustee will be appointed to sell the business for the company.

Gavin Brown: Is it impossible for RBS to repay the state aid without selling the insurance division?

Irmfried Schwimann: Given that, as far as state aid is concerned, RBS has received €45 billion in recapitalisations and €281 billion in asset relief, do you think that it is possible? I have my doubts.

Gavin Brown: Just out of interest, how many banks is your department dealing with Europe-wide?

Irmfried Schwimann: That question raises broader issues. About 20 banks are in the process of presenting their restructuring plans and there might be others to follow. A number of banks have been part of various guarantee, recapitalisation and impaired asset schemes in member states. At the beginning of the crisis, member states first tried to cope with the problem by introducing guarantee schemes. It then became clear that certain unsound banks had toxic assets on their balance sheets and needed recapitalisation. There were also other banks that, although they were sound and might not otherwise have had a problem, found themselves unable to lend to the real economy because their balance sheets were too tight. As a result, we issued a recapitalisation communication in which we distinguished between sound and non-sound banks and made it clear that the sound banks that would have been able to weather the crisis but needed support to fulfil their role of lending to the real economy would not be subject to restructuring. The others, which needed to recapitalise because of other structural problems, would be subject to restructuring. As time has moved on, some of the banks that claimed to be sound have turned out not to be, and they have become our clients. Some of the banks that come under the schemes and that will draw on guarantees will become our clients; some of them will draw on asset relief.

We have a number of banks among our clients, including some of the bigger ones, and there might be more to come. I do not know whether there will be 30 in the end, or only 20—we will have to see—but a number of big banks are in there. There are also some very big banks that are not there, for example HSBC and Barclays from the UK, Santander, BBVA and the big Italian banks, none of which have needed state support.

Lewis Macdonald (Aberdeen Central) (Lab): It is difficult to argue with your comments that part of the Royal Bank of Scotland's problem was that it expanded way beyond its core business. That reflects what your commissioner said recently—that Royal Bank of Scotland was simply

"too big to operate and supervise".

Do you have a view on what went wrong with the Royal Bank and with HBOS in particular? I am asking not just about what went wrong within the banks, but about whether there was regulatory failure. You said that you would not need to be there had the European Commission made an input into the small business marketplace in Scotland, where a duopoly built up to provide 75 per cent of lending. Where do the regulatory failures lie? What can you say about the position of the banks?

Irmfried Schwimann: It is awkward for me to comment.

Lewis Macdonald: That is understood. Please say what you are free to say.

Irmfried Schwimann: HBOS's problem lay in its risky lending strategy, which I think has been addressed by taking over the much more cautious lending culture at Lloyds. RBS had an almost aggressive expansion model, which became its problem. There was also an issue of timing. RBS, together with Fortis, had just taken over ABN AMRO, but Fortis had problems at a time when the markets were not very willing, although that was not the only cause of RBS's problems. In a way, Lloyds is in a slightly different position—it took over the problem, but without necessarily having been forced to do so. For it, the problems came from elsewhere.

In some cases, it was to do with the business model; in others, it was to do with risky lending or an aggressive lending strategy in the case of HBOS. There was also a strategy of expanding in areas where that was not such a wise thing to do—that was the main problem in the other case. The result of the strategies that were employed was bad for the Scottish market, because of the level of concentration. Now, with the means that we have available, we are trying to instil some competition back into the market—we are hoping that the market becomes attractive enough to bring in new entrants and get some more competition here again.

Lewis Macdonald: Clearly, some bad strategies were being pursued, as you describe. Were there also failures of regulation? Does the European Commission have a view on the regulatory practices of member states?

Irmfried Schwimann: We do have a vision, especially my colleagues in DG internal market, who are preparing further legislation. That has been on the agenda for much longer than there has been a crisis. The aim is to improve crisis and risk management and co-operation on the part of the supervisory authorities. That is why there is a window of opportunity to come to a supervision arrangement that functions better, that provides much more and much better co-operation between the supervisory authorities and which involves the supervisory authorities beefing up their resources so that they can act as an adequate counterpart to the various players. A window of opportunity exists to improve all that, and there have been a number of other initiatives in the same vein. Remuneration policies are not necessarily something that we take into account or would request in a restructuring plan, but it is clear that if a company has a long-term remuneration strategy rather than one that focuses on short-termism, that indicates that the company has long-term viability. We are interested in remuneration policies from that point of view.

The roles are different. We are the ones who clean up the mess. Our colleagues on the legislative side look forward with a view to not allowing such a mess to be made again. Among the regulatory issues that we are looking into on a more global basis are supervision, increasing capital requirements through the overhaul of the capital requirements directive and corporate governance, which is an extremely important issue in some member states in particular, if we are to do away with the danger of political interference in the business that should not be there.

Lewis Macdonald: That is helpful.

In answer to one of Wendy Alexander's questions, you suggested that if, in future, third parties made unsolicited representations to you about some of those issues, such representations would be considered. I want to be clear about that, because it is an issue that I am sure that we will discuss. The "SME Access to Finance 2009" survey that the Scottish Government commissioned concluded that there was a duopoly, whereby more than 75 per cent of small business lending was concentrated in two companies. Did the Scottish Government make representations to you on the basis of that survey?

Irmfried Schwimann: No, but we, too, found that out. I must be fair—I do not know exactly what we received from whom, but I know that we were very much aware of that.

Lewis Macdonald: You were very much aware of that, but had you received formal representations from Government bodies on the survey, you would have taken them into consideration in producing your proposals.

Irmfried Schwimann: Sure. We receive informal complaints by competitors, and that is reflected in the decisions. We try to learn as much as we can on our own account, but any information that we get from third parties, from the market or from institutions is more than welcome.

Lewis Macdonald: Would such information be used in preparing proposals such as those that were announced on 3 November?

Irmfried Schwimann: Absolutely. We have also been in contact with the UK competition authority to get a feeling for the competitive impact of certain measures on the market, so we do not just sit in Brussels doing our thing. We talk to the relevant bodies.

Christopher Harvie (Mid Scotland and Fife) (SNP): I congratulate you on the lucidity of your presentation and your answers; it compares favourably with the answers of some of the British authorities that we have interviewed.

I have a question on a straightforward factual point of information. When you spoke about consulting the British authorities, you mentioned the Treasury. Did the bodies that you consulted about particular examples of problems in the system include the Bank of England and the Financial Services Authority?

Irmfried Schwimann: They were not represented in the delegations. I suppose that there would have been some co-ordination at home, but it is people from the Treasury who form the delegations that come to see us.

Christopher Harvie: Given the enormous change in the powers of the FSA that was contemplated, would it not have been useful to try to interrogate the FSA, because it was the body that represented the financial world in London and was responsible for controlling it? I find that state of affairs baffling and think that many of the problems might have had their origins there.

11:45

Irmfried Schwimann: Yes, but I wonder whether interrogating the FSA would have changed the assessment of where we want to go in order to reinstall liability. Getting to the causes was one thing, and we have been quite thorough in looking into that. We have many teams working on all the various cases so it could well be that there have been contacts with the FSA because we do interact with the national banks and the supervisory authorities, but we cannot prescribe who the British Government puts into its delegation. We do read what is out there and have quite good knowledge of the situation and the problems that have been caused.

Christopher Harvie: If several of the great Munich banks got into difficulties, would you assume that you would go to the Bavarian landesbank while you were making inquiries?

Irmfried Schwimann: The landesbank issue is different, because they would have been aided by the Land. The state and the treasury would be present, but because the money would have come directly from the Land or the Kommun, those bodies would decide on the membership of the delegation, together with the finance ministry. The structure of the German banking market means that there is a different picture there than here.

We have about 55 people in the case teams representing about 22 nationalities. We follow closely what is happening in the press, and we have quite good interactions with member states. We do not take for granted everything that people tell us; we do check things.

Christopher Harvie: This comes out of my regular reading of sensational literature, such as the *Financial Times*. The speed with which transactions were carried out and strategic decisions taken, particularly in the field of financial instruments such as derivatives and the like, could mean that decisions to change strategy were being taken several times a day. You are dealing with a timespan of possibly five years to try to clean up what resulted from that situation. Meanwhile, the investment bankers who were responsible for much of it will have pocketed their bonuses and cleared off to their tax havens. Will there always be a group of people who are looking for justice and not finding it?

Irmfried Schwimann: You referred to the timeframe and the legislation on derivatives. That is a different story; there will have to agreement in the European Council and Parliament in order to go through with legislation. What we are doing falls within the exclusive powers of the Commission in relation to state aid decisions.

What has been very different from normal or pre-crisis times is that we have had to be very quick, especially during the first rescue phase. We would get a phone call, always on a Friday afternoon or evening, to say that we had to make a rescue decision before Monday opening or there would be a huge problem. We have had to be very quick, but also very flexible, while making it clear that the bill will be presented at some point. When we took a rescue decision and agreed that aid would be paid out, we also made it clear that, after six months, the company would have to come back with a restructuring plan and that, depending on the amount of money that the company received, more or less in-depth restructuring would be needed.

The challenge for our state aid work was that all the cases were running in parallel and we learned of them only during the crisis. We also had to adjust what we were doing to take account of the special situation of a financial crisis. We had to be flexible on process but firm on principles, because we could not throw overboard the valid principles of state aid control, which seeks to ensure that there is no distortion of competition via state support, but we had to ensure that we did not stand in the way of preventing the world from collapsing. That was the challenge.

The next challenge is that we have to be consistent and coherent in looking at the plans to restructure various big European banks, but each case is different, so we cannot take a one-size-fits-all approach. Nevertheless, there has to be a coherent policy and strategy across all cases and all member states. You can imagine that, if Mrs

Merkel sees that we have been more lenient with a UK case, she will be on the phone immediately to complain about that, so we have to be careful.

We will not have five years to remedy things. We have to make the decision now and we cannot change it afterwards, so we have just one shot at getting it right. If it becomes clear in the years to come that there has been a complete change in the situation and some things that we thought possible are actually impossible, the member state would have to come back to us and we would have to consider a revision, but we have only one shot, and that is it.

Christopher Harvie: There are two areas in which one senses a leakage in the notion of bringing the various factors together in a collective way. You have already alluded to the first of those. When you are dealing with the controversial takeover of a firm such as ABN AMRO and you are dealing with Fortis and Santander, you are dealing with three different financial jurisdictions, which is complicated in one sense. However, I want to mention another complication before I fall silent, and that is one that we see in today's FT. The systems that are directed through tax havens have themselves adapted to cope with the checks on them by European and national authorities. The problem probably now lies less in the tax havens than in the trusts from other protected jurisdictions that invest in them.

Helmut Schmidt put it rather beautifully when he defined criminals by saying that there are boys who steal apples, there are minor hoods, and there are investment bankers. I wonder whether there is a problem of definitions, or a problem with jurisprudential approaches to fraud, around elements that constitute not legitimate finance but sophisticated forms of criminal enterprise.

Irmfried Schwimann: A lot of work and thought is going into that as well, but it is not within DG competition's remit. We have powerful tools, but tools to act on those issues are not among them. However, I know that other colleagues in the Commission are thinking about such things and trying to find solutions. It is not a new problem. For example, the Parmalat case happened years ago.

Christopher Harvie: We recollect the Bank of Commerce and Credit International, and the man who investigated it, Sir Fred Goodwin.

The Convener: At that point, we will move on to Marilyn Livingstone.

Marilyn Livingstone (Kirkcaldy) (Lab): I have a supplementary question on what you said in response to Christopher Harvie's question. You said that decisions will be taken now and they will not change. It is likely that the college of commissioners will change in the months ahead. Does that rule out a rethinking of the proposals for RBS and Lloyds by any new competition commissioner?

Irmfried Schwimann: It depends on when the final decision on RBS comes out. The present college of commissioners will be in office until 30 November, after which we will have a caretaker Commission, which can usually act only on current affairs. All the competition cases are current affairs, so there is no limit to what the competition commissioner can propose to the college on those. However, any proposal for new legislation and that sort of thing would certainly not be current affairs. It would not be possible to consider such proposals in this period of dealing with only current affairs, but all the competition cases—including all the state aid cases in the crisis—can be decided under the caretaker Commission.

The line that has been set by the present Commission, with all the communications that have been adopted throughout the year, is clear guidance on how we will assess restructuring plans. That is the guiding light in all our assessments in the present crisis, and it will also apply in the college thereafter. All the cases that we are dealing with right now follow that guidance, and I would be astonished if the policy changed completely. We hope that we will have finished a number of cases before the old Commission leaves, given the need to get out of the crisis and to get legal clarity and certainty into the markets. It is not that we do not want a new commissioner whom we do not know to do the job; it is that we want to get out of the crisis as quickly as possible.

Clear guidelines have been established during the crisis, through existing case practice, and future cases will probably follow the same line. Clearly, all the cases that will have to be decided before the end of the college will be decided—a college decision will be made and that will be that.

Marilyn Livingstone: So you do not think that the change of commissioners will in any way delay the RBS decision.

Irmfried Schwimann: I think that Commissioner Kroes would like to finish that within her term.

Marilyn Livingstone: On a different topic, in the past, Senator Obama was an outspoken supporter of repeal of the Glass-Steagall Act in order to separate out retail banking—which we have been discussing—from the more riskier elements. He said:

> "Instead of establishing a 21st century regulatory framework, we simply dismantled the old one,"

thereby encouraging

> "a winner take all, anything goes environment that helped foster devastating dislocations in our economy."

However, lately, the United States Administration has not seemed to want to go that far with its reforms, although key United Kingdom players have been making the case. How does the Commission see the debate progressing and how does it think that a common global framework can be achieved when there are such fundamental differences between countries?

Irmfried Schwimann: One positive aspect of the crisis has been the fact that, for the first time, there has been some co-ordination and discussion of the issues at G20 level, which has not happened before. The discussions that are taking place in Europe on a more co-ordinated approach or more co-ordinated supervision would not have been possible before the crisis. Although we always think that the process does not go quickly enough, we have made some headway.

Although what is happening in the G20 is not going as far or as quickly as we would all hope—it never does—at least the countries are talking and there is some co-ordination of what we think that the future financial services world should look like. There is still a lot of room to work together further. The International Monetary Fund warns that there are still a lot of toxic assets on balance sheets that have not been cleaned out, and a lot of work remains to be done by all the countries that are involved—not just the European Union—to sort that out and to encourage banks to come clean, so that trust in the banking sector can be restored.

There is also clearly a difference of opinion as far as bonuses are concerned, with a distinction being drawn between the central European approach and the US approach. Sometimes I wonder whether that is not a little artificial, because people should be paid well for what they do well—the problem is that they have been paid well for what they have not done well. We need to look at incentive remuneration structures that favour longer-term policy in companies, rather than the short-term bonus culture that we had previously. We will not tackle the issue using competition instruments; it might be tackled through company law, corporate governance and so on. A lot of work is being done in the area.

12:00

A general feature of the crisis is that there is a need for change not only in how business models are structured but in what investors expect of their investments. Is it really sensible to expect two-digit growth rates every year? That may be one of the reasons why risky business strategies were adopted in a number of cases. We may need to consider whether the greed that we have seen here and there is the right way forward. However, we cannot tackle the issue through competition law enforcement.

The Convener: What can be done at EU level about issues such as bank bonuses? There are already squeals from the British financial sector about the UK Government’s proposals to tighten regulation and to introduce new rules on bonuses. The sector claims that that will harm its competitive position. You said that the issue relates more to legislation than to competition, but there is a negative competition issue in play. Does the EU have a role to play in ensuring that there is consistency across Europe, to prevent the very large banks that still exist playing the card of claiming that their competitive position will be harmed if regulation is introduced in this country, with the result that regulation does not happen?

Irmfried Schwimann: My colleagues in DG internal market and services have initiatives on the company law side—on directors’ remuneration and so on. The present debate will feed into that. The UK has a code that sets out what the remuneration structure should look like, to which we refer every once in a while when looking at restructuring plans. We can take the code into account in that respect, but we cannot impose it on anyone.

If we want to have a coherent policy across Europe, there must be coherent action across Europe. With 27 member states, that is not always easy. If we want to have more ethics in the area, the process must be driven by Parliaments. National Parliaments could influence the European Parliament to drive the debate. I know that the Commission would like to move in that direction. As you know, the decision-making process is difficult, but if we want to have a coherent line across member states, the only real answer is some sort of regulation. We cannot really tackle the issue with the tools that we have.

The Convener: Stuart McMillan has managed to make it back from his other commitments.

Stuart McMillan: The submission that we have received from UK Financial Investments Ltd is interesting, and I am keen to hear your opinion on what it says. Paragraph 8 of the submission states:

> “It is worth highlighting that our view of the causes of the crisis is that it was a truly international crisis—and that we do not see any specific causes or problems which were specific to Scotland.”

I am sure that we can accept that. It is, therefore, legitimate to ask what the European Commission did wrong and what was wrong in the UK system to allow banking in Scotland to get into its current situation.

Irmfried Schwimann: What do you mean when you ask what the European Commission did wrong? I just want to understand what exactly you mean.

Stuart McMillan: Sure. Following on from the previous question on light-touch regulation, was the Commission further back in keeping an eye on what was going on in each of the member states, or did the Commission have its finger on the pulse?

Irmfried Schwimann: The discussions that the Commission launched to improve supervision and the rules of the game have been taking place for a long time now. The financial crisis has given some members a window of opportunity and much more motivation to pursue that goal. Before the crisis, I do not think that member states perceived any need to act. It was very much a time of self-regulation, and the view was that we should not interfere, because the markets know best. That was the mantra that the industry and member states expressed to the Commission. It is true that the Commission, as a political institution, could have been more forthcoming in proposing legislation—one always knows better afterwards—but it would not have been easy to do that in the climate of the time, when light-touch regulation was favoured and better regulation meant less regulation in the minds of member states. The sentiment then was very much, "Go away. We will all do that ourselves. In any case, Brussels, we don't want you. We know best, so go away."

The financial crisis has shown that the European project has added value. We were able to weather the crisis in good fashion because of our co-operation possibilities. The European Central Bank clearly concentrated on the euro zone, but the non-euro member states also profited from the ECB's liquidity provision. That is a clear sign of the added value that Europe can bring, as is the co-ordinated way in which we tried to tackle the crisis. Each member state had its own specificities and problems, and had to be free to tackle them; nevertheless, there also had to be a coherent approach in order not to export the problems of one member state into another. The Irish scheme at the beginning of the financial crisis sucked funds out of the UK and into the Irish banking system. We intervened to say that that was not possible and it had to stop. That made it clear even to critics of the Commission that our role adds value.

The issue of regulation and supervision has been on the agenda for some time. It was not followed up, because there was no perceived need to do so. However, I think that the need is now perceived better. It is important that we do not lose that momentum, now that things seem to be going better, and that we continue to pursue what we have started. Although budgets are still looking awful, the banks are making profits again, so the danger is that we loosen our efforts to make a real change for the better and to ensure that what happened will not happen again.

The initiatives that we have on the table are not necessarily new, but they have been revived to ensure that we have proper EU-wide regulation for dealing with deposit guarantee schemes. When the bank runs happened, everyone was up in arms because of the queues in front of the banks and the fact that there was no coherent, well-functioning system across Europe. That situation has been addressed, and there is now a supervision aspect that we hope will improve how companies are supervised. The tightening of rules in the capital requirements directive and so on should also address matters.

Clearly, the crisis was a wake-up call. We managed not to go under, despite the danger of our experiencing a meltdown. However, we need to drive the process to the end to ensure that we get there.

What did we do wrong? Maybe we were not persistent enough, or perhaps we should have been more insistent. I doubt that we would have had a chance in the conditions before the crisis to move towards more regulation, but the atmosphere has changed.

Stuart McMillan: To go back to my earlier question about RBS, it could be claimed that RBS is being punished by being forced to divest. Do you agree with that assessment?

Irmfried Schwimann: In all the cases that we are looking at, we want to avoid that element of punishment. We are considering the dimension of aid received and putting that into the context of the downsizing that is necessary under the various headings that I spoke about. If a company has received less aid and has not participated in the asset relief scheme, its situation is slightly different from that of a big company that has had a huge amount of recapitalisation and asset relief.

One must always look at the situation in terms of the aid that the company has received, the things that it has been able to do because of the state and the impact that that has had on the company's competitive situation. I do not think that it is in anybody's mind to punish anyone. That is very much the sort of thinking that went along with old-fashioned state aid control, which we do not apply at all in the context of the present crisis. It is true that you will hear people say that we are out for people's scalps, but that is not the case. The theory would not stand up if one compared all the cases.

The Convener: Thank you for participating in this session, Ms Schwimann. It has been a long session, but that is because the information that you have given us has been extremely useful.

I know that you have to catch a flight back to Brussels, so I will not detain you any longer, but it would be extremely helpful if you provided further written information on the decisions around Lloyds Banking Group and RBS when it becomes available.

12:12

Meeting suspended.

12:16

On resuming—

The Convener: On our second panel, we have representatives of UK Financial Investments Ltd, which is the body that represents the taxpayer on the boards of the Royal Bank of Scotland and Lloyds Banking Group.

I invite Michael Kirkwood to introduce himself and his colleagues and make an opening statement.

Michael Kirkwood (UK Financial Investments Ltd): I am a non-executive director on the board of UKFI. On my left is John Crompton, who heads the market investments team at UKFI, which is responsible for those investments that are not wholly owned. On my right is Sam Woods, who is seconded from the Treasury and is the chief operating officer of UKFI.

As I am sure that you are all aware, UKFI was set up by the Government last November, to help to restore the banks—with Government support—to financial health and to return them fully to private sector ownership.

Although we are wholly owned by HM Treasury, and are based in London, close to the markets, it is important to us to keep in regular contact with the operations of both banks in Scotland, including the RBS headquarters, and we have had helpful discussions with other members of the Scottish Parliament.

We are currently responsible for the Government's investments in RBS and Lloyds Banking Group and maintain stewardship of the Government's holdings in Bradford & Bingley. We will soon take on management of Northern Rock, when that bank has completed its restructuring.

In managing those investments, we have two fundamental objectives. The first is to manage them commercially while creating and protecting value for the taxpayer; and the second is to return the banks fully to private sector ownership and ensure that, over the long term, the liabilities of Northern Rock and Bradford & Bingley are paid back in full.

We operate alongside HM Treasury, which retains responsibility for policy decisions for the financial sector as a whole, including those concerning economic growth and financial stability, and is also monitoring the lending commitments that you were discussing earlier. We also operate alongside the existing regulatory bodies, which retain their current roles, such as ensuring that competition is maintained in the banking sector.

Over the past year, UKFI has worked with RBS and Lloyds as an active and engaged shareholder. Some of that work is set out in the strategy that we published earlier this year. The boards of both banks have been substantially overhauled. We have been involved with both banks in developing and articulating their strategies to build long-term value and in reforming their risk management practices. We have also driven through the most fundamental remuneration reforms in any of the large banks in the world. All bonuses other than those of the most junior staff are paid over three years and are subject to clawback, and no discretionary bonuses are paid in cash.

Finally, we have engaged extensively with other minority shareholders in debating current investment issues, promoting active engagement, and developing the future shareholder base, which will be important as we seek to reduce the taxpayer's investment. Rebuilding the confidence of existing and potential shareholders is essential if the banks are to attain a full market valuation for their shares. There has been a marked resurgence of investor confidence in the two banks. Since the trough, the taxpayer's notional losses have been reduced from around £26 billion in January this year to well under £10 billion.

We would be happy to answer members' questions.

The Convener: Thank you very much for your opening remarks, which are helpful.

I want to ask about how the regulatory arrangements work. It was generally agreed that the tripartite arrangements involving the Treasury, the Bank of England and the FSA were unclear and a bit undefined and that that contributed to the problems that emerged in the sector. How do the addition of UKFI to the arrangements and the role of the European Commission, which we discussed earlier, help to clarify the situation? Do they make the situation more complex?

Michael Kirkwood: UKFI has no regulatory responsibility. As I have said, we are an active and engaged shareholder. We act as a commercial intermediary between the Government and the market in order to realise good value for the taxpayer. As an engaged large institutional shareholder, UKFI would be expected to be aware of and to consult the management of the banks—which are indeed managed by their management and their boards—on issues that have caused problems in the past, such as their strategies, governance and risk management. That is what we do. We do not amplify, supplement or replace anything that is currently the individual or collective responsibility of the tripartite authorities.

Sam Woods (UK Financial Investments Ltd): I have a small point to add to that. It is a statement of fact that the relationship between the Government and the banks has become more complex through the financial crisis because the Government has taken ownership stakes that it did not previously have. There is also, of course, the relationship with RBS through the asset protection scheme. UKFI was set up to ensure that the shareholder interest and the protection of value for the taxpayer as shareholder did not get lost amid all the other competing interests, regulatory and otherwise, that are in play.

The Convener: Perhaps that can be expanded on. What happens if there is a conflict between your role in protecting the interests of the shareholder—everyone around this table and everyone else in the country is a shareholder—and proposals by the Treasury, the Bank of England or the FSA on regulating the institutions in which we are the majority shareholder.

Michael Kirkwood: Our responsibility would be to discuss that with the ultimate shareholder, which is the Treasury. The Treasury is the leading authority of the tripartite authorities; the other two authorities report to it. We make regular representations to the Treasury on all aspects of the taxpayer's substantial investment in the banking sector.

Sam Woods: Ultimately, it is unlikely that there would be such a conflict with the regulatory objective. However, if we found ourselves in a position of extreme conflict, the chancellor could use the power that he reserves to direct UKFI. If that arose, it would be a serious issue and the board would have to consider its position. The whole idea of UKFI is to put a bit of grit in the machine to ensure that the protection of the taxpayer's interest as a shareholder does not get lost.

The Convener: How does the relationship with the European Commission work? Has UKFI played any part in putting forward the proposals that the Commission has considered on divestments from the major banks?

Michael Kirkwood: No. That is the Treasury's responsibility. We have consulted the Treasury and we have informed it about certain aspects of the discussions with the Commission.

The Convener: In your view, are the proposals that are on the table, particularly in relation to RBS, in the interest of shareholders?

John Crompton (UK Financial Investments Ltd): It was interesting to hear your previous witness, Irmfried Schwimann, talk about that process, in which we were not directly engaged. It was clear from listening to her testimony and reflecting on the process as we have seen it that the purpose of the Commission's exercise is not to defend or create shareholder value but to ensure that banks that have received state aid to some degree assessed by the Commission are affected to an appropriate degree as a result. Our concern as a shareholder is that the effects of the disposals in the case of RBS, for example, might be managed in a way that minimises the impact on shareholder value. We hope that the four to five-year timescale that RBS is being given to sell assets will enable it to get a fair price for the assets. If it were asked to dispose of them quickly, it is likely that it would get a less good price. The Commission's findings and rulings around this crisis are not designed to build up shareholder value.

The Convener: As the majority shareholder of RBS on behalf of the taxpayer, do you think that the deal that is on the table from the European Union is not—or may not be—in the best interests of the shareholders.

John Crompton: It is simply not a deal that has been designed to create shareholder value; it is separate from that. The arrangements that have been put in place around the deal, such as the time that RBS has to execute its side of the agreement, are reasonable.

Sam Woods: It is, in effect, one of the costs of the support that the Government has provided. You need to look at it in the round, rather than considering specifically whether the state aid stuff on divestments is good for RBS.

The Convener: I am just trying to establish whether the divestments that have been required by the European Commission weaken the ability to get the taxpayer's money back.

John Crompton: I think that Mr Hester would tell you that had the Commission not told him to make these divestments he would not have gone out and done so himself. I do not think that I can say any more about it than that.

The Convener: I am sure that we will ask Mr Hester those questions next week when he comes before us.

Rob Gibson: I want to ask about your involvement with the Royal Bank of Scotland. RBS has recently been described by Paul Myners, the City minister, as

"the worst managed bank this country has ever seen".

How has UKFI improved RBS's management and corporate governance?

12:30

Michael Kirkwood: The entire board of RBS has been reconstituted in the past year. It has been reduced and replaced. New management is in place and the management team below the level of the board has brought capable people into key positions such as risk management. We have engaged with RBS on that and on its strategy and compensation practices. Those practices, not just in RBS but in the industry as a whole, were generally regarded as a contributing factor in some of the poor decisions that were made and the poor practices in the banks in the past few years.

Rob Gibson: Is the board of RBS any more diverse than its predecessor?

Michael Kirkwood: I would have to put the two side by side to address that.

John Crompton: From our perspective as a shareholder, the board of RBS is much more effective as the central point of governance for what is a large and important institution. We are comfortable with that. That goes for the performance of the new chairman and the board that he has assembled. One point that makes it more effective is that it is a smaller board and so can debate issues in a much more intimate way than the previous fairly large board was able to do. It is also a board that has no excuse or reason for complacency whatever about the state of the bank that it manages. It has come in to fix a very troubled situation and, in our view, it is doing an excellent job. It is also a board that combines a significant amount of banking and financial sector expertise with meaningful expertise from elsewhere in the business sector.

Rob Gibson: A criticism of the previous board was that its non-executive members did not play the role that they might have done in having an overview of RBS's activities. Is the range of backgrounds and experiences of the present directors any different from that of the previous directors?

John Crompton: That is a very fair question. One question that the historians of the RBS episode will no doubt puzzle over for a long time is how a board that, on the face of it, had several highly capable people who had performed well in similar board situations at other companies failed to perform. We do not have a single obvious factor that we can change to ensure that the new board performs better. In our view, the most important point was that a new board was needed. We thought that it would be helpful if it was smaller and that it should have broad-based expertise but include considerable and deep expertise in the financial services sector. Beyond that, we cannot say much more, other than to report to you in our shareholder role that we believe that the board as now assembled is performing well.

Sam Woods: In our engagement with the board on new appointments, we have tested that point explicitly. We have considered whether the people who are coming on are the sort of people who will be able to provide challenge. We have focused on that as one of the criteria.

Michael Kirkwood: The question is not whether the aggregate qualifications of the outgoing board and the incoming one differ materially. RBS had extremely distinguished and prominent people on a board that failed to provide adequate governance for the company. The question is not who is on the board but what they do when they are on it and the tone that the chairman sets in challenging, probing and questioning and carrying out the fiduciary responsibilities for the shareholders and depositors in the bank. I suspect that the current board is extremely motivated to do things differently from the outgoing board.

Rob Gibson: Will the measure of that be whether RBS is out of state aid in four years' time, having maintained its position as a major international bank? What will the criteria be?

Michael Kirkwood: The criteria will be that RBS is back where it rightly belongs, in the hands of the individual and institutional shareholders, and is fully valued for the enterprise that it will become when the strategy is implemented.

John Crompton: I will be a bit more explicit on the goals. The board has endorsed a set of goals that it expects to be delivered by 2013, which relate to the profitability of the bank, its ability to earn a return on equity in excess of 15 per cent, the capital strength of the bank and various other measures that should translate into a significant creation of value for the taxpayer as shareholder as well as a reinvigoration of a major financial institution and the return of that financial institution to a leading position in the national and global markets in which it competes.

Rob Gibson: Given those tasks and goals, have you been able to recruit senior management to replace those who were there before who can build to achieve those ends?

John Crompton: We have contributed to, and the RBS board has overseen effectively, the renewal of the management team over the past year. That started in October 2008 with the appointment of Stephen Hester, who has proved to be an energetic and effective chief executive. He, in turn, has recently recruited a new finance director, whom we regard as a world-class finance director with extensive experience. Together, they constitute the executive director component of the board. There has also been quite a lot of change at sub-board level through the management structure, which has been driven by Mr Hester. We regard that, too, as auguring well for the bank's ability to achieve its goals. It is not a case of target setting and hoping; in our view, the board is directing real change in the organisation.

Rob Gibson: You have been able to recruit world-class players despite the bonus constraints.

John Crompton: The short answer is that, within the framework in which the bank has been allowed to operate, yes, the board has done that.

Ms Alexander: Earlier we heard interesting testimony from the European Commission that its proposals have been agreed by the member state in the shape of the Treasury. We have heard from you that you are the agent of the Treasury, and we have also received the strategic vision of the RBS board, into which you had some input. In the light of that, it is fair to ask you, as the principal shareholder, about your strategic vision for RBS post-3 November. What sort of bank do you want it to be—retail, investment, home or overseas? What is your vision for the bank?

Michael Kirkwood: I will ask Mr Crompton to answer that question more fully. I stress that that is very much something that the RBS board should review—mindful, nevertheless, that the competition authorities have predetermined certain things for it.

John Crompton: As it seeks to build out its business from here, RBS will seek to be a leading global financial institution that is active in a number of different business areas that it believes will provide it with both diversification of earning streams and growth, which it believes—and we agree—will drive shareholder value while, at the same time, providing a degree of safety through diversification of risk.

The primary businesses of RBS will be its UK activities, which range from retail banking, through SME and commercial banking, all the way up to large-scale corporate banking, and a global corporate and investment banking business that seeks to serve large-scale corporate customers with a range of products beyond lending products, including various risk management and financing products. Attached to that global banking and markets business are markets-based businesses that generate the product and serve the investors who are its ultimate providers.

I have described the vertical business in the UK and the horizontal business around the world that serves major, large-scale corporate customers. The other major geographical market in which the bank will be active is the United States, where, in addition to substantial global banking and markets businesses, RBS has a large super-regional bank—a bank that is involved in retail and commercial banking in multiple regions, primarily on the east coast of the US but also in the mid-west to a degree. That is the core set of businesses that RBS expects to go forward.

Ms Alexander: How do you expect RBS to be a leading global financial institution when you have restricted it to position 5 in the bond market? Surely that hobbles its ability to be an investment bank on the global stage.

John Crompton: The restriction was agreed with the European Commission; it certainly had nothing to do with us.

Ms Alexander: Your principal shareholder is the Treasury. We have just heard that the member state agreed to the package in its entirety.

John Crompton: We manage the shareholding that the Treasury has given us to manage. Discussion of issues relating to regulation by Brussels is dealt with directly by the Treasury, so we were not party to the agreement. As a former and, perhaps, future participant in the investment banking industry, I do not regard RBS being allowed to retain a top five or top 10 position—it is capped at position 5—in a market that includes a significant number of players as a statement that it must move into the second division in that area. It is a statement that RBS cannot chase the number 1 position as an end in itself and that, although it can be a major player, it must not pursue size for size's sake.

Ms Alexander: You do not think that the restriction has hobbled in any way RBS's ability to be a global player.

John Crompton: I would not use the term "hobbled". I would say that the restriction is consistent with RBS being able to be a major player in the global markets.

Ms Alexander: I am mindful of time, but I have a couple of other questions. Who oversees the lending commitments that the Treasury has secured from both Lloyds and RBS—for example, the commitment to lend £26 billion to small businesses?

Michael Kirkwood: The Treasury.

Ms Alexander: RBS indicated last week that it believed that it was time to rethink that lending commitment. What role do you, as principal shareholder, play as intermediary in the process?

Michael Kirkwood: We are not an intermediary in either monitoring or setting the lending targets, which are legally binding commitments that have been made by the investee banks, as we call them, to the Treasury to ensure that there is no credit withdrawal from the consumer and small and medium-sized enterprises. When RBS makes comments such as those to which you refer, it is presumably addressing them to the Treasury.

Sam Woods: An important point to note about the commitments is that they relate to lending on commercial terms and subject to market demand. There is a genuine question about what is happening with market demand. As you are probably aware, RBS says that its applications from SMEs are down by 37 per cent. In his statement—if that is the statement to which you are referring—Philip Hampton was pointing out that that is an issue. There are on-going discussions with the Treasury on the point.

Michael Kirkwood: As a former banker, I have always been slightly puzzled about how the lending commitments could work in practice, given the state into which we had got ourselves a couple of years ago. Because of cheap money and easy credit, the world was greatly overleveraged. That was true of families, households and companies—everything.

Big companies and everybody in general—including people in this room, no doubt—are in the process of contracting supply chain management, spending more sensibly and fundamentally reducing their requirement for funds. Big companies have been diversifying their borrowing away from banks and accessing the bond markets. The task that faces us, in that environment, is not an easy one, with consumers and companies heavily contracting their borrowing requirements so that they get net increases, if at all possible, in their exposure on commercial terms—unless people are chasing what I would describe as bad credits.

12:45

Ms Alexander: There has been much coverage in the Scottish media over the past couple of weeks about the HBOS daily overdraft charges on current accounts, which are now being introduced. Would that be appropriate for board-level discussion at Lloyds Banking Group?

Sam Woods: I am not familiar with the exact details of that, but it sounds like the sort of thing that would probably be discussed at board level. We would draw the line at that being an operational matter for the banks. We expect them to treat their customers fairly and ethically, both for good business reasons and for reasons of more general practice. We would leave that to the banks.

Ms Alexander: In June, when the pay package for the chief executive of RBS was announced, *The Scotsman* commented that it was “ill-judged, ill-timed, disproportionate”. Does UKFI have any regrets about the remuneration package that was agreed for the chief executive of RBS? Has that package been altered in any shape, manner or form by the events that took place subsequent to the announcement in June?

Sam Woods: We recognise that Stephen Hester is paid a very large sum of money and that our decision to support the board in giving him that package was extremely controversial. RBS is one of the largest banks in the world and it is going through an incredibly challenging period. He is paid in line with what the bosses of big banks around the world make. You could take the view that people at RBS should be paid less; we would disagree with that. We have tens of billions of pounds tied up in the company, and we cannot afford to allow it to become a place where bankers go if they cannot get a job anywhere else.

Turning to the detail of Stephen Hester’s package, I point out that 80 per cent of it is tied to performance, and any bonus that he gets will be deferred over three years, will be paid in non-cash and will be subject to clawback. He will have to hold on to the shares that he gets for five years. You asked about changes, and that was one change that we made—we pushed that period from three to five years, with his agreement.

The key point to note is that, for Stephen Hester to get anything like the sums that were being bandied about in the press in June, the RBS share price would have to get back to 70p, at which point the taxpayer would be sitting on a profit of £15 billion. We thought it important to align his incentives to ours in that way. That could be criticised as being crude, but I believe that it will be effective.

Ms Alexander: Since the package was announced in June, the G20 has met in Pittsburgh and the FSA has made various statements—and there were reports in the press on Monday about the future tearing up of contracts. I am trying to establish whether the package that was agreed in June is insulated from all those changes, or whether since June it has been materially impacted in any way by the changes that have been telegraphed.

Sam Woods: We expect the package to be largely in line with the regulatory developments since then. The regulatory debate has moved to where we had got to with RBS and Lloyds in February, particularly when it comes to bonuses and the broad principles of deferral and clawback. I cannot give you an absolute assurance that every single detail of the package will be absolutely unchanged—the FSA might wish to have a look at some things—but I certainly do not expect the contract to be torn up.

Stuart McMillan: The situation that we are in is new to everyone. Given the personal element to all of this—for instance, people might well be made redundant—is anyone on the RBS board a member or representative of a trade union?

Sam Woods: I do not think so.

Stuart McMillan: Lord Myners said that RBS was

"the worst managed bank this country has ever seen".

Is that comment fair, bearing in mind that only five years ago it was the world's fifth largest bank?

Michael Kirkwood: I do not think that it is necessarily for us to respond to that question, but certainly one has to draw some conclusions from the manifest outcome of the RBS situation. It has been our single largest bank rescue, while other banks have not had to be rescued at all. As a result, one can conclude only that things were not managed at all well there.

John Crompton: There is no question but that it is clearly a very bad management outcome.

Stuart McMillan: I fully accept that, but the fact is that for a long time the bank had a sustainable growth model. It is only in the past two or three years that the bank has failed. What do you think will happen to RBS's reputation as an institution?

John Crompton: Perhaps I should unpack that question a bit. If you were to write the history of the RBS episode with, perhaps, a little bit more perspective than we have today, you would probably find that a very important part would have to be an examination of how its growth model evolved over the past decade. When we looked into the issues that we felt most needed fixing at the bank, we felt that two major strands had gone awry. First, there was in the organisation a very strong cultural bias not towards value creation for the shareholder, but towards growth more or less irrespective of whether it was valuable. That can probably be seen in its acquisitive history—the way that it sought to grow through acquisition—and a culture in which balance sheet expansion was chased for its own sake.

On its own, such a risk-enhancing strategy might have been manageable. Hand in hand with that, however, was a thoroughly inadequate risk management structure, in which the processes for making risk decisions were simply not fit for purpose. We feel that those two elements are the primary drivers of the crisis that RBS got itself into. It is absolutely true that RBS's investment banking arm had typified those features over the past few years but, if you go back further into the organisation's past, you will probably see an excessive focus on growth, instead of value creation, without good risk management.

Stuart McMillan: But 10 years ago, RBS was not ranked in the world's top 10 banks.

John Crompton: Certainly not before the NatWest acquisition—you are right.

Michael Kirkwood: Speaking as a Scot, I believe that, in Scotland, a resourcefulness founded on a strong education system, a drive and a capability have caused the country significantly to outperform, given its size, internationally and in a number of sectors, including engineering, finance and medicine. However, that activity must be channelled and sensible.

The financial services sector in Scotland was—and, I hope, will be—something of which Scots can be proud, but a couple of rogues got in the way. We hope that the sector will be brought back to being a major contributor to the Scottish economy and a major employer and that Scots—who have for several hundred years been proud of their financial services—will again be proud of the sector.

Stuart McMillan: Given the constraints on pay and the league table situation, would it be better for RBS to exit the investment banking business?

John Crompton: The short answer is no. As I said, the league table point perhaps means scaling back what might have been an ambition for global dominance—I am not saying that that is true of the present management, but at least the situation tells them that they cannot aim to go there. For the reasons that I gave, members might imagine that we as shareholders do not see that as a particular problem. For us, untrammelled growth is not necessarily good.

The much more important issue that you raise is whether RBS will be able to attract and retain the people whom it needs if it is to maintain the business's position. For us as shareholders, it is important that RBS can do that, for two reasons. First, there is hundreds of billions of pounds of balance-sheet exposure to that business, which cannot go away overnight. Secondly, such business generates substantial earnings for the bank. The process of reforming risk management to the standard it should ultimately reach continues, but the initial steps that needed to be taken to withdraw from inherently risky businesses and apply better standards of risk management in the lower-risk businesses in which the bank is now involved provide a bridge from which the bank can move prudently to having fully world-class risk management processes.

Implicit in your question is the issue of whether the investment banking business could be separated and sold as a unit. My personal view—you should certainly ask Mr Hester the same question—is that the way in which RBS and other universal banks develop makes it hard just to chop off a segment and say, "This stuff belongs over there and can be sold separately." The business is all based on the fact that RBS has a large corporate lending client base, which is in turn based on the fact that it has medium and small corporate lending bases and a retail base. RBS is a universal bank in that sense, so it would be rather hard to chop off a chunk to sell.

Michael Kirkwood: "Investment banking" and "investment bank" are catch-all phrases. Over the years, their definitions have changed. If RBS is a client-focused organisation—I believe that that is the intent for the future—it is important for it to be capable of providing to its wholesale clients services other than just lending off its balance sheet. Consequently, its clients will look to it to trade and hedge their currencies, to secure other risks, such as interest-rate exposure, and to help them to access debt capital markets in which RBS has a strong position. Clients might look to RBS for various other services that are increasingly deemed to be in the investment banking world.

However, particularly when one gets into the equities business that is the strength of a handful of mainly Wall Street-based banks and some European banks, one perhaps needs to step back and ask whether one wants to be in that area.

Another issue, of course, is that investment banks engage heavily in principal trading, whereby they take positions for their own account very substantially beyond that which is necessary just to make a market for their clients. That would not, I imagine, be a sensible activity for RBS going forward.

13:00

Stuart McMillan: My final question is on shares. In evidence to the Treasury Committee of the House of Commons, John Kingman said that UKFI

"had not made any forecast of possible proceeds from sales"

of the Government's investments. Has there been any update on that situation?

John Crompton: No. We do not plan to make any forecast, not least because that might tell the market about our intentions and we would then get a worse deal for the taxpayers we represent.

Lewis Macdonald: I think that the implication of the answer to Stuart McMillan's previous question was that, prior to the acquisition of NatWest, the Royal Bank of Scotland was a properly scaled and focused institution that was doing what it did quite well, whereas the purchase of NatWest was the first symptom of an organisational bias towards growth above value creation that led things to go badly wrong. Likewise, some might argue, the Bank of Scotland operated with the appropriate scale and focus before its merger with the Halifax. Should RBS and Lloyds continue to operate in the wide range of areas in which they acquired an interest in recent years, or is some rescaling and reprofiling of the banks necessary for their future health?

Michael Kirkwood: John Crompton will deal with the bulk of that question, but let me make just one point. RBS had bulked itself up to having a balance sheet of £2 trillion sterling, which is humungous. Given the capital ratios that are now required or regarded as sensible, that is not a sustainable balance sheet so certain business activities need to be reined in and scaled back. In addition, requirements have also been imposed by the European Commission, as we have just heard. Pre-HBOS, Lloyds was clearly a pretty conservative and sensibly run bank. The contents of the HBOS portfolio probably took even Lloyds by surprise when everything finally unfolded.

John Crompton: Perhaps I should just clarify my position on the first part of the question. It is not our view that RBS's purchase of NatWest was an unwise acquisition. Far from that being the case, NatWest was actually a very sound bank and RBS managed to create a lot of value through the combination of the two banks. I do not think that many people would dispute that.

My point was that the excessive focus on growth at the expense of other factors could be seen to go back quite some way. Perhaps a better example of an earlier and costly acquisition for RBS was its acquisition of Charter One, which was a mortgage-oriented bank in the US without a particularly strong market share in its own regional market. RBS paid quite a lot of money for that bank, which does not look like a particularly valuable asset in today's context.

Lewis Macdonald: When was that acquisition made?

John Crompton: Around 2003 or 2004—I may be wrong about that by a year or so, but it was certainly several years before the financial crisis. I just do not want to leave hanging the view that NatWest was not a fine institution and that its purchase by RBS was not a value-creating acquisition.

Looking forward, I think that it has been important for both banks to scale back on exposures that are outside their capacity to manage and which expose their shareholders—ultimately, the taxpayer—to undue risk. Both banks have been quite disciplined in identifying what are in effect non-core assets.

In the case of RBS, that process has gone hand-in-hand with its accession to the asset protection scheme. Lloyds has undertaken a similar exercise, even though it is no longer in the asset protection scheme. It has focused on its excessive concentrations and on areas where it has more exposure than it can afford to have, and has tried to reduce those concentrations and that exposure. It is very important for us that that work is done. It is probably at the top of our list of scaling-back activity.

Beyond that, because of the diverse nature of its operations, RBS has thought deeply about which businesses it wants to be in and which it does not want to be in on an operating basis as well as on an asset investment basis. In order to make its business more simple and manageable, it has already decided to exit about 20 countries in which it had acquired operations through the ABN AMRO acquisition. Of course, the measures that the European Commission is in the process of agreeing with RBS are likely to scale back its activities still further.

A similar process is under way at Lloyds, which is rationalising the activities that it acquired through HBOS. It has already made one or two sales in the asset-management area, and that process will no doubt continue.

Lewis Macdonald: On the employment implications of that restructuring, there have already been significant job losses in both institutions, and there is concern around some of the more recent announcements. How do you envisage future changes impacting on employment in those banks in the UK?

John Crompton: For somewhat different reasons, both banks have indicated that they will need to reduce costs. The job losses in Lloyds relate to the integration of two quite large businesses and the capture of the cost savings that that can generate. In the case of RBS, it is true to say that, the nickname of the former chief executive notwithstanding, cost control at that bank was not all that it should have been. I think that the new management of RBS believes that some of its operations are simply not as efficient as they should be, and is taking steps to manage that.

Further, both banks are coping with a global recession. In a recession, the volume of business that banks can do goes down and, like any other business, they need to adjust their cost base to reflect the fact that their revenue generation is lower, even putting aside the losses that they might be making on loan exposures.

I do not have precise numbers in front of me for what the banks have done so far or for what they have announced that they intend to do. However, it is clear that both banks are involved in substantial cost-saving programmes.

Lewis Macdonald: You mentioned the employment implications of reduced business. Do you feel that Lloyds and RBS are doing enough business in terms of lending to householders and small and medium-sized enterprises in Scotland and across the United Kingdom?

Sam Woods: Our impression is very much that both banks are open for business. Lloyds has opened 60,000 commercial accounts during this year, and its SME lending is up 12 per cent in the year to June. RBS has loaned £29 billion to businesses during the year, and its credit application rate is at 85 per cent, which is the same as it was before the financial crisis. I think that some figures are available for Scotland as well.

The big caveat is demand. As a shareholder, we have an interest in our banks being open for business and lending. As far as we can tell, they are, but there remains the question of demand.

John Crompton: I will make one additional point that demonstrates how a more viable institution can serve its customer base and the economy better. The Lloyds Banking Group management will tell you that the HBOS business that they bought had effectively shut down its lending activities almost entirely over the previous few months as HBOS management realised that they were running out of capital and were having an increasingly hard time funding the business, which meant that every new loan made their life harder. The Lloyds Banking Group had the opportunity to switch on the HBOS machine again, which took some months to do. Of course, management wanted to ensure that, when they switched on the machine, they did so using the Lloyds standards of risk management, not the standards of risk management that were employed by the previous management.

Marilyn Livingstone: I will follow up on a point that Lewis Macdonald raised. First, what role will UKFI take in ensuring that there is consultation with the workforce? If there is no trade union or employee representative on the board, what discussions will be held with the workforce? That is an important issue.

Secondly, where will the job losses fall and what input will you have in that? I come back to Lewis Macdonald’s point: if the axe falls on too many local jobs, that will have a huge impact on services to local communities, SMEs and those seeking a mortgage. Can you comment on that?

John Crompton: I will kick off on the specifics. Sam Woods might make one or two more general points.

The nature of our role as a shareholder—it is explicitly built into our mandate to manage these investments—is that we should not be involved in day-to-day management decisions. Those are decisions for boards. Cost cuts and job cuts are very much board-level issues, so we are explicitly not engaged in such discussions. Clearly, as—we hope—a responsible shareholder, we are very concerned that the banks take the appropriate consultation steps in respect of any job cuts that they have to implement. We would certainly expect the management and the boards to be held accountable for that.

On the specifics, both banks have indicated—I think in written evidence to the committee—the total level of job losses that they expect in Scotland. In the case of RBS, I think that the job losses are about 800 positions out of a total of 16,500 in Scotland. As I understand it, that is an on-going process. In the case of Lloyds, I believe that the job losses are about 900 positions out of a total of 23,500. I think that all those job losses precede the changes that the European Commission is mandating by way of branch sales. One would hope that such sales would not affect employment levels in the affected branches, but we are not in a position at this point to make any judgments about that.

Sam Woods: John Crompton is right that we are not here to manage the banks. It is very important that we do not get caught between the boards and management and their workforces, but we take an interest in what the unions have to say. We have had numerous meetings with all the unions involved in all the banks and our door is always open to them.

Marilyn Livingstone: I take it that you have an interest in the banks' strategy for where the job losses will fall, because that will have an impact on the service.

Sam Woods: We are, of course, interested in that from a service point of view, but in general, UKFI does not have a particular geographical bias, with the one exception being that we expect the banks to meet their UK lending targets.

Michael Kirkwood: These are very much responsibilities for the management and the boards of the banks as they decide how they want to run the banks in different areas and how efficient they want to be. Having said that, clearly the boards and the management are very mindful of the fact that they have one stonking big shareholder and that everything that they do is therefore very much more in the public domain than usual. If they were considering making a strategic or tactical move on employment, for example, that could result in adverse headlines, it would be reasonable for them at least to take a sounding from their major shareholder. However, it is important that I re-emphasise the point made by Sam Woods and John Crompton that these are management issues.

Marilyn Livingstone: We hear that SMEs are finding it difficult to access finance and that first-time buyers, in particular, are finding it difficult to get mortgages. If those are issues, surely UKFI should have an interest in them?

Michael Kirkwood: Sam Woods has the details, but I do not think that what you say is evidenced by the facts.

13:15

Sam Woods: On SME lending, the more interesting question is the one about the degree of concentration in the market in Scotland. The committee is understandably interested in that and has been considering it. If I understood Ms Alexander's comments correctly, our information is the same as yours, in that LBG and RBS each have 20 to 30 per cent of the SME market in the UK as a whole, whereas in Scotland, they have 30 to 40 per cent each for start-up businesses and 40 to 50 per cent each for the stock of businesses. As the OFT said to the committee, concentration is not the only competition factor to be considered, but it is legitimate for the committee to consider whether the situation is in the interests of consumers.

Having said that, I am also mindful of what the European Commission is doing and its comments earlier this morning. I believe that the divestments will have some impact on the situation. Also, we have seen considerable retrenchment by foreign banks during the financial crisis as people have pulled back to their home markets to some extent. One hopes that some of that will unwind over time.

Gavin Brown: A number of matters that are under discussion today are outwith your gift. Divestments are a matter for the EU and member states, and you described lending as a matter for the Treasury and the banks. You said that other matters are for the board, including vision and operational considerations in relation to jobs. With that in mind, what are the key factors that UKFI controls? On what factors will you be judged next year and the year after?

Michael Kirkwood: The critical factor is our working with the banks as an engaged shareholder to get them fit for purpose so that they can re-enter life in the private world as opposed to their being substantively publicly owned. We will also be judged on the ultimate outcome that we achieve for the taxpayer from the disposal of their unwilling investments, if you will, through the Government, in the banking sector. We will be judged not only on what we achieve in terms of price, but on the fact that we act without destabilising the financial markets and without creating any undue competition issues. Those are the things that we have to keep an eye on.

In the past year or so, we have been involved in talking to the banks about governance, compensation, risk and so forth in relation to their strategies. Our principal activities will now be more focused on developing a receptive shareholder base through a variety of mechanisms that do not destabilise the markets but achieve a good result for the taxpayer's investment of approximately £60 billion in the equity of the banking sector. By any standards, that is a humungous amount of equity to place. It makes the British Telecom privatisation look like a tea party.

We are taking every professional skill that we have accumulated in our small team and working with advisers and the market to develop a series of proactive—and occasionally reactive—opportunities to place the banks out in the market. Our remit is really to get them into shape and get them out. I wish it could be done as quickly as I said those words.

Gavin Brown: Do you think that you are too close to the Treasury?

Michael Kirkwood: Absolutely not. [*Laughter.*]

Sam Woods: Physically, yes, in that we are currently within the Treasury building. Frankly, that was a purely pragmatic choice. In November last year, with the financial crisis and the bank recap going on, we had to consider whether we wanted to spend the next three months worrying about information technology and desks. We thought, no—so let us free ride off the parent. However, we are moving out next month.

I have come across from the Treasury, so I have a feel for what the difference is. Two things make us different. First, we have the published framework document—it is an annex to the written submission that the committee has—which sets out clearly what our remit is. That is our lodestar in all our dealings with the banks and the Treasury. Secondly, we have a board that includes Michael Kirkwood, David Cooksey and various other experienced people. They were appointed to deliver our mandate and form views on what we are doing. Ultimately, John Crompton and I report to the board. Things therefore feel very different on a day-to-day basis.

Gavin Brown: I accept your point that it is a deal between the Treasury and the banks, but is there scope for the active and engaged shareholder to do or say more about lending commitments? The banks have said publicly, and some have said privately to me, that it will be impossible to meet the lending commitments. The main reason given is lack of demand. Potentially, there is a bad incentive for banks to start lending to riskier ventures so that they can hit the lending target, which is obviously one reason why we got into problems in the first place. Is there scope for you to do and say more about the lending commitments issue?

Sam Woods: If we saw any evidence of what you suggest we would be extremely concerned and would certainly engage on it. We do not see such evidence at the moment. The deal between the Treasury and the banks involved lending on commercial terms, and it is subject to market demand. That is what we expect to be delivered and it is consistent with our objectives. The constitutional choice has been made for that to be between the Treasury and the banks. Ultimately, we must respect that.

Gavin Brown: I think you said, when I was scribbling away, that the most fundamental reforms were on remuneration and bonuses. Is it fair to say that that was what you said?

Michael Kirkwood: Yes.

Gavin Brown: You gave an indication of the clawback for the chief executive, but can a specific percentage be clawed back from other investment bankers and so on? Is it 50 per cent or 100 per cent? Apart from the chief executive, is a timescale applied more widely to others?

Sam Woods: It varies by seniority. I do not want to go beyond what we have agreed with the banks about what we will disclose. Leaving aside the most junior staff, the clawback is at least 50 per cent—considerably more in some cases.

Gavin Brown: There have been suggestions in the financial press that some banks are working round restrictions on remuneration and bonuses by having what they call golden parachutes to attract employees. Have you seen much evidence of that? Would that practice concern you, as a major shareholder?

Sam Woods: I think that there is an issue in that if a bank wants to attract someone who works at another bank and has remuneration there that ties them in in some form, it is often the case that the bank will have to offer some sort of quid pro quo if it wants that person. We have been clear that we are not in favour of multi-year guarantees. That is also an important part of the FSA's agenda. If a single-year guarantee can be described as a golden parachute, I do believe that banks are doing that, but I think that it is a function of the phenomenon that I just described.

Michael Kirkwood: There has been some comment about this issue, including from competitors of RBS. You will appreciate that we have an interest in RBS being commercially successful. Banking is a highly competitive business and it is fundamentally a talent-based business. It is therefore important that RBS can retain and, where it has gaps, attract the highest-calibre people.

It will not surprise you to learn that RBS is not exactly flavour of the month as an employer for someone who may be at an institution that has not been through the same difficulties. The natural outcome of that is that RBS probably has to be quite aggressive to fill the important slots that it needs to fill in certain key areas.

Christopher Harvie: At last week's meeting, Jeremy Peat was sitting in the chair that you are in now. I am afraid that he was extremely pessimistic about RBS ever being a major actor in the Scottish economy again. That was the view of the bank's former chief economist.

I am old enough to remember interviewing people such as Charles Winter back in the late 1980s, when he stressed that it was the Royal Bank's locality, its communicability and its accessibility to local industries—particularly those that were derived from the oil fields—that had anchored it in Scotland and isolated it from the sins of the City of London, which had just been spectacularly on show in the Guinness takeover.

Just after that time, I was interviewed at some length—I cannot say that I was paid adequately for giving the interview—by Will Hutton. I talked about the systems of banking in the German state that I served for nearly 30 years, Baden-Württemberg, where banking is harnessed to the Rhenish notion of sophisticated, ecological manufacturing and where the quotient of gross domestic product in manufacturing went up by 5 per cent between the 1990s and the noughties. To all intents and purposes, the Royal Bank is, as far as control is concerned, a Landesbank—a state-owned regional bank. If RBS comes back to Scotland, why do we not go further in that direction? After all, Baden-Württemberg is a conservative state; it is not a socialist paradise by any means. As well as a strong state bank, it has a strong mutual savings sector and, underneath that, an industrial sector.

Scotland's priorities are infrastructural. They are to do with low-energy industries and the provision of housing of a far higher standard than the immense amount of housing that was put up during the boom, which is of grade C quality in European terms, if it makes it into that category. What is there against us adopting such a mutual model, going back to the building society or the Trustee Savings Bank, as it was, and forgetting about the notion of having a world role? Traditionally, the role of the Scottish banks has been to develop our economy, and the demands for such development will be on quite an extraordinary scale.

I have one final point, as this is turning into a statement rather than a question. About six weeks ago, "Panorama" put a concealed camera in an office of Lloyds in Jersey, I think, where the local banker offered a £4 million investment in his bank. No questions would be asked and no tax would be paid, even though the state was, in effect, the owner of the bank. Comparing the situation in a prosperous, technologically advanced German state with the Anglo-Saxon model, I have no doubt at all where my loyalties lie. Should I reconsider that view?

Michael Kirkwood: I enjoyed that tremendously. I am not quite sure whether I should be recounting

> "Wee, sleekit, cow'rin, tim'rous beastie,"

or saying,

> "Die Sonne scheint, und es ist warm,
> Der rote Vögel sitzt auf dem grünem Baum."

Christopher Harvie: That is good enough for a start.

Michael Kirkwood: That was my way of saying that I am not quite sure what you were asking me to answer.

13:30

Christopher Harvie: Back in the 1990s, we discussed the notion of a stakeholder economy, which Hutton was identified with. Would it not have been better to go in that direction? And, having got to the Titanic-and-iceberg stage that we have now reached, would it not be better for the Scottish banking and industrial finance sector to go back in that direction in the future? After all, as I read my *Financial Times*, I am told that the priority is now the manufacturing sector.

Michael Kirkwood: One could make the case that 75 per cent of the Scottish economy is service sector based and that the financial services sector constitutes a pretty big chunk of that. An economist might, therefore, debate with you whether there would be an imbalance in looking at one aspect of the economy in isolation. If Scotland has a GDP of just under £100 billion, can it realistically sustain £3.5 trillion, £4 trillion or £5 trillion in financial services assets? That is a broader question and it is clearly not within our remit, although it would be interesting to discuss the matter over a glass of whisky sometime.

Sam Woods: If the events were as they were portrayed by "Panorama", that would be unacceptable. We understand that that employee has been suspended.

John Crompton: Frankly, it would be unacceptable for any UK-regulated bank to do that. It is not simply our investment that makes the difference.

On the economic model point that you made, I have a couple of points to make in return. First, the strategy that RBS has implemented, if successful, will enable it to be an effective major player in all the regional and product-line markets that it serves. Therefore, we expect and hope to make a meaningful contribution to the continued development of the Scottish economy. Secondly, how we get from the current model to a completely different model is a matter of speculation—we have no sense of what the path would be from the current ownership structure of RBS to a notional regionalised, mutual structure. Thirdly, the German banking system is seen to be one of the more challenged banking systems in Europe not least because of its large, state-owned banks without strong commercial incentives around them. Although it may have regional successes, it is also highly challenged in some regions.

Christopher Harvie: I would not regard the Baden-Württemberg region as one of those. I would not compare it with the Bavarian or the WestLB system—it is a different system altogether. I teach economics students when I am in Tübingen, and they are totally disillusioned with what they have been taught in conventional economics, with its Black-Scholes theorems and that sort of thing, which are supposed to govern the structures of derivatives.

The Convener: One of the sub-points under the heading "Overarching objective" in your framework document is:

> "promoting competition in a way that is consistent with a UK financial services industry that operates to the benefit of consumers and respects the commercial decisions of the financial institutions."

We have received evidence that suggests that one of the problems that have adversely affected competition and the benefit of consumers is the demutualisation of the building society sector in particular and the Trustee Savings Bank in Scotland. That has removed competition and consumer choice by reducing the number of different types of ownership of institutions.

The other part of your overarching objective is to

> "execute an investment strategy for disposing of the investments in an orderly and active way through sale, redemption, buy-back or other means … within the context of an overarching objective of protecting and creating value for the taxpayer and shareholder".

Would anything in that prevent you from considering remutualising assets such as Bradford & Bingley and Northern Rock—which has been mentioned to us specifically as an institution that could be remutualised—and the assets that Lloyds Banking Group must dispose of, such as Cheltenham & Gloucester and the TSB network here in Scotland?

Michael Kirkwood: Remutualisation is not excluded.

Sam Woods: Under the remutualisation model, it would probably take longer to pay back the taxpayer's funding to Northern Rock and Bradford & Bingley. As Michael Kirkwood said, remutualisation has in no sense been excluded from our thinking, but that is the tension that would naturally arise if we took that route.

John Crompton: The question is really relevant only to Northern Rock, which has an operating lending and deposit-taking business. In the case of Bradford & Bingley, the branch system has been sold to Santander. Our ownership relates to the pool of mortgages that it has lent, not to an operating business that could be remutualised.

The Convener: I have one more question. What would be UKFI's attitude to a bid to take over RBS?

Michael Kirkwood: You could say that it would depend on from whom the bid came.

John Crompton: We have a clear remit on the point. No restrictions are placed on the way in which we could sell the assets. If someone were to approach us with a bid for our stake in RBS, we would think seriously about that as an economic proposition. We do not have a mission to sell our stake in any particular way.

The Convener: That is a clear answer. I thank Sam Woods, Michael Kirkwood and John Crompton for the evidence that they have given us this afternoon. It has been of extreme interest to the committee and given us additional food for thought for our later evidence-taking sessions, especially next week's session with RBS and our later session with Lloyds Banking Group.

The committee's next meeting will be next week, when we will take evidence from Stephen Hester of the Royal Bank of Scotland and Gillian Tett of the *Financial Times*.

Meeting closed at 13:37.

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