ECONOMY, ENERGY AND TOURISM COMMITTEE

Wednesday 25 November 2009

Session 3

£5.00

Printed and published in Scotland on behalf of the Scottish Parliamentary Corporate Body by RR Donnelley.

CONTENTS

Wednesday 25 November 2009

ECONOMY, ENERGY AND TOURISM COMMITTEE
31st Meeting 2009, Session 3

CONVENER

*Iain Smith (North East Fife) (LD)

DEPUTY CONVENER

*Rob Gibson (Highlands and Islands) (SNP)

COMMITTEE MEMBERS

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

COMMITTEE SUBSTITUTES

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

*attended

THE FOLLOWING GAVE EVIDENCE:

Stephen Hester (Royal Bank of Scotland)
Andrew McLaughlin (Royal Bank of Scotland)
Gillian Tett (Financial Times)

CLERK TO THE COMMITTEE

Stephen Imrie

SENIOR ASSISTANT CLERK

Katy Orr

ASSISTANT CLERK

Gail Grant

LOCATION

Committee Room 2

Scottish Parliament

Economy, Energy and Tourism Committee

Wednesday 25 November 2009

[THE CONVENER *opened the meeting at 09:33*]

Financial Services Inquiry

The Convener (Iain Smith): I welcome everyone to the 31st meeting in 2009 of the Economy, Energy and Tourism Committee. Our only agenda item this morning is our inquiry into the way forward for Scotland's banking, building society and financial services sector. I am pleased to welcome the first of our two panels of witnesses, who are Stephen Hester, the new group chief executive of the Royal Bank of Scotland, and Andrew McLaughlin, RBS group chief economist.

I invite Mr Hester to make some brief opening remarks, after which we will move to questions.

Stephen Hester (Royal Bank of Scotland): Good morning. Thank you for inviting us to attend and for the invitation to make opening remarks to complement the written submission that we have been pleased to make.

I am pleased to have volunteered to come before the committee. RBS in general has a special responsibility to be open, transparent and available to discuss all the issues in which we have played a central role, and which have resulted in our taking state aid. Moreover, Scotland is our home and headquarters. In my year in this role, I have been struck by a real sense of being part of the fabric of the community; by the sense almost of loss that has been felt in Scotland at the weaknesses that have been uncovered in its two major banks; and by the great sense that Scotland wants the banks to recover and be successful again and to be institutions that support customers and make the country proud. As a result, in addition to the hard business angles with which I have to deal every day, there is a specific community angle that I want to be faithful to and which is certainly relevant to today's meeting.

Over the past year of difficulty, we have been the recipient of a very large amount of support, both financially from the state of the United Kingdom and from our customers. We are very grateful for that support and are clear that it comes with a series of responsibilities, the first of which is that we should continue to serve our 40 million customers around the world well—including, of course, those in the UK and Scotland. Secondly, while doing that, we must return as swiftly as we can to stand-alone financial strengths in order to ensure that we do not need state support any more or, indeed, ever again. Thirdly, we must rebuild the institution's value to ensure that the taxpayers who, via the Government, have put their money at risk are, in the future, able to sell those shares at a profit and thereby complete the circle of our recovery. Those three responsibilities—to our customers, to return to stand-alone financial strengths and to rebuild the company's commercial strength in the interests of taxpayers and all our other shareholders—are our absolute focus.

However, we recognise that along with discharging those primary responsibilities we should also participate in the surrounding debates. Unfortunately, we have now been politicised, and some of the political kicking that comes with that can damage not us but the taxpayers' interest by delaying our return to health. Equally, we need to understand the rationale behind, and reasons for, all that and to embrace and to lead, for the banking industry, a way forward that involves more humility and less hubris, that ensures that we connect with our customers in an ever-improving manner and that contributes to the debate about regulation in the country.

What is clear is that, in the end, banks are a mirror of the societies that they serve. Given that for every loan, there is a borrower and that for every deposit, there is a saver or pensioner, fixing the banking industry's ills will inevitably involve our looking at the way in which society is constructed and the amount of borrowing that goes on. After all, the safety of the banking system relies on the safety of society and vice versa, and we want to engage in those important matters in a responsible way.

For all those reasons, I thank the committee for the opportunity to give evidence and welcome the chance to answer members' questions.

The Convener: Thank you very much. Perhaps I should start by asking whether, in the light of yesterday's interesting revelations, you have anything to share with us.

Stephen Hester: I am so sorry, convener—I did not catch the question.

The Convener: Do you have any secrets that you wish to share with us?

Stephen Hester: I will be as open and transparent as possible about all matters about which it is within my legal powers to be open and transparent.

The Convener: It might be useful if you could outline for the record the state aid that the bank has received to date and how that is playing out.

Stephen Hester: Sure. In effect, two forms of state aid have been made available. Pretty much every bank in the world, including RBS, was in receipt of state aid in the form of liquidity support from central banks and access to wholesale funding through Government guarantees. I am pleased to report that the success of those measures around the world for the banking system as a whole, coupled with self-help efforts by the banks, including RBS, has led to that aspect of the crisis receding considerably and to the vast majority of state support, in the form of central bank support, being repaid and released. The banking system is not completely out of the woods in that regard, but it is well down the path, as is RBS.

The second form of state support that was made available to many banks around the world, but to a smaller number, was direct capital support. In our case, we had direct capital support through a rights issue around this time last year and through the asset protection scheme and associated arrangements, which are being completed, although they were announced last February.

The Convener: It is interesting that you did not mention any figures. What were the actual amounts involved?

Stephen Hester: The equity or capital support was £15 billion, plus £5 billion of preference shares, which is £20 billion; then there was another £25 billion, which makes a total of £45 billion.

The Convener: Have all the liquidity loans been repaid?

Stephen Hester: No. The liquidity arrangements that were the subject of yesterday's Bank of England announcements were all repaid last year. Other accesses to liquidity are made available to all banks, including RBS, by different central banks around the world. We have reduced our usage of those amounts by about 70 per cent over the past six or eight months. I am afraid that, because a number of different banks with different rules are involved, I am not permitted to give you the figures. However, I have given you a sense of the reduction in our usage of the liquidity, the other side of which is a recovery in the bank's liquidity health.

The Convener: Thank you.

Ms Wendy Alexander (Paisley North) (Lab): I will to follow up on that narrow point. You said that direct support to RBS was of the order of £45 billion. There was also a loan of £36.6 billion, which was repaid at the start of this year. You mentioned that indirect support for the bank took place through the credit guarantee scheme, the special liquidity scheme and the asset protection scheme. Can you give us an estimate of the figures for those three elements of support over the past year? When did those three elements peak and what sums were involved, in so far as you can share them with us?

Stephen Hester: The asset protection scheme is not yet in place, so I will leave that one off, if I may. From memory, our usage of the other major liquidity schemes peaked around February, and it has been coming down quite sharply since Easter. The schemes were a good example of the world co-operating well, because central banks everywhere in the world made liquidity available to the banking system. We took liquidity from central banks in the US, Australia, Japan and Europe, foreign banks took liquidity from the Bank of England, and so on. It was therefore a genuine global issue that impacted on all banks.

Ms Alexander: It would be helpful if you were to write to us with a figure for the three elements to which I referred, which were in addition to the direct support of £45 billion and the short-term loan of £36 billion.

The Convener: Stuart McMillan has to go to another committee meeting to move amendments, so I will take him next.

Stuart McMillan (West of Scotland) (SNP): I have a couple of questions regarding your initial written submission, Mr Hester. You state in paragraph 3:

> "Our ambition is to become a new and very different bank rather than returning to the bank we were before the crisis."

Can you tell me what that actually means?

What implications does the divestment announcement have for RBS? Do you think that RBS can achieve its potential with fewer business opportunities?

09:45

Stephen Hester: That could be a very long and big question.

There are multiple facets to how we would like to improve and change, and on which we are embarked on change. The restructuring programme that is well under way at RBS is, I believe, the largest and most far-reaching restructuring programme in a bank, or in any company in the world on its scale. Obviously, many risks and stresses are associated with it, but it is necessary.

A major aspect of the change relates to making RBS safe again, which has multiple sub-parts to it, and making sure that what happened to RBS cannot happen again. In addition to that, as I illustrated earlier, the heart of any company in any industry is its relationship with its customers and how well they are served. Of course, that has to move on over time—we can all make improvements in our businesses. There have also been changes in the environment that lead us to need to change the way in which we serve our customers.

The third aspect that I hinted at in my earlier remarks is that one of the by-products of the shock of the past year is that the world has realised that it needs banks and banks have realised that they need the community—they need customers, so they need the world. With the fallout from that rather harsh realisation should come a reconnection with the broader community, an element of loss of hubris, and a willingness to engage in debates of the sort that we are having today and of a broader societal nature.

We are making many changes to the internal workings of RBS, including in management style, management effectiveness and so on, so that shareholders and customers can see the effective results and safety of RBS.

On the second part of the question, it is clear that we are, as a result of having got into trouble, having to pay some penalties which, in the short term, make our job more difficult. On the other hand, I completely understand why those penalties exist and why those pressures are there. I am not in any way whingeing or rebelling against them; they are part and parcel of the difficult situation that everyone is trying to deal with. It is my belief—I would even say that I am confident—that we have a good chance to execute our plan, return RBS to health, serve customers well, and allow taxpayers to get their money out at a profit despite those penalties. It is not straightforward. It is not that there are no risks, but I believe that the preponderance of likelihood is in favour of us succeeding.

Stuart McMillan: Has the European Commission intervention changed your vision?

Stephen Hester: The European Commission intervention is not yet finalised, but I hope that it will be in the next few weeks. It has a number of different aspects to it, and it addresses different aspects of the European Commission's mandate in relation to state aid. One part of it was to consider the viability of our plans and to ask whether they will, if they are executed, return RBS to stand-alone health. I do not believe that there is any dispute between us on that matter, although you would have to ask the EC for an authoritative view.

The second part was that RBS should make a contribution to the competitive environment of the market in which we have the biggest share, which is primarily business banking in the United Kingdom. We have agreed a disposal in that regard. You might say that anything that weakens our market shares is not good for RBS, but I completely understand and accept the public policy issues associated with that and we have no fear of competition. I am sure that we will talk about different aspects of that subject this morning.

The third aspect is other disposals and restraints that are placed on us that do not address competition per se, or viability, but nevertheless address what you might call setting an example—that companies should not get themselves in a position in which they need state aid. I do not contest the public policy argument in favour of that, but those disposals are extra tasks and stresses that we have to undertake and extra profits that we will not have in the future. However, we have the opportunity to undertake those actions in a manner and with timing that should not unduly jeopardise our task.

Stuart McMillan: I will return to that point. A moment ago you referred to safety. Will you please explain the difference between Sir Fred Goodwin's approach to risk management and yours?

Stephen Hester: I would like to avoid personalising my response and—because I was not there in the past—my observations will be necessarily somewhat limited. The real issue around risk management, not just at RBS but in relation to the financial crisis around the world generally, was that what was missed was obvious to all. That is the tragedy. The failure of risk management was in macro risk management, as opposed to things that were hidden in drawers and not visible. That is not to say that things that are hidden in drawers and not visible should not be risk managed: it is an incredibly important part of any bank's approach and one that is being overhauled at RBS, as it is elsewhere where there are multiple aspects of improvement of systems, people and policies—what I call the more detailed risks. It was not the detailed risks that made RBS and the banking system weak; it was the big macro imbalances.

In RBS's case, the weakness was in having a balance sheet that was too big, was vulnerable to funding and was not supported by adequate capital, and a management stretch that went alongside that. There were other contributing sub-factors, but that was the biggest one. Much of the problem arose from an acquisition that was approved by all shareholders. Everything was reported every year in the annual report so the vulnerabilities were on full view to everyone. Similarly, the vulnerabilities that brought about the global crisis—the imbalance, the balance of payments deficits, the borrowing binges, the house-price bubbles—were on full view to us all and none of us took adequate action. Of course, some people and institutions were more culpable than others; some countries and some banks were more vulnerable than others and they bear a special culpability. RBS is up there on the list of those with special culpability, which is why there is a need for so much change at RBS to fix those issues.

Stuart McMillan: On that point, you have been reported in the media this week as saying that banks need more regulation. That was in *The Scotsman* yesterday, if memory serves me correctly. If there had been more regulation in recent years, would banks such as RBS have got into the crisis they are in? Further, what specific aspects of regulation would you like to see being introduced in the future?

Stephen Hester: I wish that I had said more accurately that there needs to be regulatory change. Whether that means more or less regulation is not so much the point, because there are aspects of regulation that need to be improved. We are entirely supportive of that continuing process.

The banking system is quite special because of the role that money plays in enabling the world economy to function. That is why it is appropriate that it is not unregulated. Equally, it is clear that that no Government anywhere in the world—or, at least, no Government in the Organisation for Economic Co-operation and Development—wants to own the banking system's capital allocation function. There is widespread political consensus that that function is best conducted in the private sector, which is why regulation of private sector activities is the model that everyone has sought and chosen.

Multiple areas of regulation clearly need to be re-examined. For example, one of the big areas of weakness concerned liquidity. Much global regulatory change over the past 20 years focused on how much capital banks had, but very little regulation focused on liquidity. However, it is a truism that companies—whether banks or other companies—almost never go bust because they do not have enough capital; they almost always go bust because they run out of money. That, in turn, leads to not having enough capital, but the starting point for any company going bust is almost always that it runs out of money. To put it in a bank context, it is a liquidity issue. That was a glaring area in which regulation had not moved on adequately, which will now be addressed in multiple different ways, which is very important.

In addition, there is a lot of re-examining of capital to determine whether the financial industry has moved on in ways that have not been captured well, which might have led to risks that were not captured well in the capital regime. That is a second area of overhaul.

The third area is what we might call systemic. I refer to the debate around living wills, as it is perhaps called. The world must try to move to a position in which it is unnecessary for state intervention in banking crises to be on the scale that we have just witnessed. Banks must be able to function through crises and, if there are losses to be taken, they must be able to take them without such a level of public support. It is complicated, but it is an important systemic issue with which to grapple and on which to make progress.

Stuart McMillan: Have the European Commission's proposals on investment banking, compensation and insurance caused you to change your vision for the RBS?

Stephen Hester: To be clear, do you mean the specific European Union aspects of that?

Stuart McMillan: Yes.

Stephen Hester: As the proposals relate to pay, the EU has simply confirmed what we had already done, which was to say that we would comply—indeed, we would be at the leading edge of compliance—with the new standards that were articulated first by the G20 and, on an on-going basis and in much more detail, by the Financial Services Authority. We will shortly get the Walker report on that. We are in compliance, intend to be in compliance and have been leading the way on some aspects, so that aspect of the EU proposals was simply a confirmation of the extant position.

Was your second question about the sale of the insurance business?

Stuart McMillan: Yes. The question was about investment banking, compensation and insurance.

Stephen Hester: There were no proposals on compensation and insurance—just the sale of the insurance business. We have agreed that we will sell our insurance business within the next four years. That is the largest of the disposals that we have to make.

Stuart McMillan: You talked about setting an example. Does that mean that you believe that RBS is being made an example of and do you still want the job?

10:00

Stephen Hester: In some senses, RBS perhaps made itself an example by being the largest—if not the largest, then perhaps the joint largest or second or third largest—near casualty of the banking crisis. We were certainly the largest such casualty in the UK. With that unenviable starting point, it is sad but inevitable that we became a special focus of political and regulatory debate. The simple point that I must keep making is that, although it is entirely legitimate and appropriate that political and regulatory debate should happen after such crises, and that we should be involved in that debate, it is also important for all of us that we look forward. Part of looking forward is that the United Kingdom taxpayer has £45 billion-worth of reasons why RBS's recovery should be made possible, so some of the contradictions and things that make recovery more difficult just need to be leavened with that knowledge.

On the question whether I want the job, I have been very clear that this is an extremely difficult and stressful job—of course there are moments when one feels that. On the other hand, my colleagues and I are trying to do a very important thing in serving our 40 million customers well. Our impact on the economy is very important. If we can bring off a recovery, we will feel a strong sense of accomplishment. That is part of the reason why all of us work, and I believe that we can do it.

Rob Gibson (Highlands and Islands) (SNP): Good morning. How important is Scotland to the Royal Bank of Scotland?

Stephen Hester: I think that we should look at that on multiple dimensions. The short answer is "very", but let me give a longer answer.

Clearly, as Scotland is our headquarters, where our board meets most often and where we are incorporated, to the extent that companies have cultural hearts—we can have a philosophical debate about that—we feel grounded in this community. We feel a sense of identity in this community that would not be replicated to the same extent in other places around the world where we are present. All of that is important. Secondly, Scotland is a major area of employment for us where people with expertise that the bank needs are located. That is important for us. Thirdly, we have a valuable client base across Scotland, which is also important for us. Importance lies across each of those dimensions.

Obviously, like any large company, we have other communities around the world about which I could also say some of those things. Of course that does, and must, balance the issue.

Rob Gibson: It has been said that you believe that the bank is anchored in Scotland. What do you mean by "anchored"?

Stephen Hester: When I said that, I was referring primarily to what I have just said, in terms of the bank's headquarters, history and identity, and culturally feeling part of the community. I was referring to those sorts of things.

Rob Gibson: I am trying to get a feel for how the bank is run. For example, I am interested in where the senior personnel live. Where do the bank's board members and senior officers live? Do any of them live in Scotland?

Stephen Hester: The model that is found in all multinational companies in every industry all over the world is that, to be successful as a company, the company must serve its customers well. In service industries in particular, that means having people where the company's customers are. It also means having expert people, which means having people where expertise is found.

In common with the staff of all multinational companies, our people are spread around the world, mostly in proportion to where our customers are. We have 1.7 million customers in Scotland, compared with 40 million globally. We could no more serve a customer in America from Edinburgh than we could serve a customer in Glasgow from Hong Kong. Our people are out with their customers all over the world. In that sense, although the headquarters represents a concentration of people and certain group functions, there are limitations on what you can or should do from there. Different people have different jobs, which dictate where they should be located. Most people at a senior level end up travelling a lot—that is true of me, for example.

Rob Gibson: Where do your board meetings take place? You said that they most often take place in Scotland. How often is often?

Stephen Hester: Over the past year, our scheduled board meetings have been roughly once a month, although we have actually had more meetings than that, as you would expect in a crisis period. All but one of those scheduled board meetings took place at our headquarters in Edinburgh; one took place in the United States; and there have been a number of conference calls and so on.

Rob Gibson: Indeed, but since, as you said, your people are based in various places, the degree to which the operation is Scottish will depend on the way in which you protect and develop the expertise that is based here. We need to know how the management sees the way in which that expertise can be used. Does it value it to the point at which, even though you have business all over the world, you will keep the amount of expertise that you have here rather than moving to get expertise elsewhere?

Stephen Hester: Artificial engineering seldom works and is dangerous. In the end, all economies and locations have to develop their own merits and strengths and play to those. If the strength is not there, it is hard to create it artificially. Our primary duty as a big multinational company is to have really good people located where it makes most sense to have them located, from the point of view of our customer base. I do not think that we are trying to engineer a position artificially.

That said, Scotland is an attractive place for us to operate in. There is a good skills base in Scotland. It is a place where we enjoy staff loyalty and stability and where the costs of doing business, the lifestyle factors and so on are positive. That is the reason why the financial industry—not just RBS—remains a strong presence in Scotland. However, Scotland is not the only place of which that could be said.

Rob Gibson: Where is your office?

Stephen Hester: My principal office is here. I have a secondary office in London and tertiary offices on aeroplanes all over the place.

Rob Gibson: I asked where key executives live. Do any of them live in Scotland?

Stephen Hester: Absolutely. It depends on their jobs and on the business and the headquarters. Andrew McLaughlin, for example, is based here, as is our head of human resources—I could go on.

To be frank with you, I am blind to where people live. My job is to ensure that the best people are working in the places that are most relevant in terms of the success of the company and serving our customers. If that is in Scotland, it is in Scotland; if it is in Bristol, it is in Bristol; and if it is in Manhattan, it is in Manhattan. We will not do anyone a favour if we try to engineer artificially where people live at the expense of our customers or of the talent that we have.

Rob Gibson: In that context, there has been a lot of talk about decision making and the whole structure of the bank moving towards London, particularly in areas such as investment banking. As a result, the question of your anchorage in Scotland is thrown into doubt. You are talking about a universal bank. In your model, investment banking provides a lot of the income—up to 2007, it accounted for about 40 per cent of the profit in RBS. How much control of that business is held in Scotland and how much of it is held by senior personnel who are working in London or elsewhere?

Stephen Hester: We could look at that issue in relation to every industry. For example, Nestlé—which, as you know, is the world's largest food company—is headquartered in Switzerland, which is a small country. However, probably 95 per cent of its business is located outside Switzerland. The company has a truly global management team, the largest part of which is located outside Switzerland. However, I do not think that the Swiss think of Nestlé as a foreign company; they think of it as a Swiss company, although 95 per cent of its business is not located in Switzerland. The same goes for the company's executives.

I do not easily accept the proposition that, for a company to have its headquarters in Scotland, a particular proportion of its business or its people must be based here. The nature of headquarters is different in the multinational world. Our investment bank is headquartered in London because London is one of the two global centres that have the deepest customer base and talent pool, if you like, for such operations. We are not in any way unique in that respect. Similarly, our US bank is headquartered in the United States, as one would expect of a US bank. That is how our businesses work—it is how any other multinational would work.

Rob Gibson: The damage to credibility following the way in which RBS and HBOS were lost, which we talked about earlier, has had a huge effect on Scotland. Do you think that that credibility is recoverable in the future structure of banking?

Stephen Hester: We will never forget what happened, nor should we. It is only through learning lessons from the past that we derive improvements for the future. I am sure that, in the future, the salutary lessons that have been learned from what happened will be built on. Both RBS and the now merged Lloyds HBOS will again be strong, vibrant and successful institutions of which one can be proud, which can be good employers and which can serve their customers and society well. I believe that that can and will happen.

Rob Gibson: Will they continue to retain a large number of their workforce in Scotland?

Stephen Hester: Provided that Scotland is a place where there are merits in employing people. As part of globalisation and industrial evolution, we have learned—painfully, in many instances—that protectionism does not work. The terrific thing about Scotland has been its ability to move on through the process of industrialisation and reinvent itself, adding skills and reasons for talented people to want to work here.

You talked about London and Scotland. Recently, I have had a number of conversations with my colleagues about whether we can move jobs from London to Scotland, not because I have a geographical bias towards Scotland but because I think that there would be merits in that from a commercial standpoint.

10:15

We have just agreed to make an investment in technology in Edinburgh of, I think, £75 million and will be moving jobs and spend from other parts of the world, such as Chicago, to Edinburgh. That will happen not because it is Edinburgh but because we believe that the decision is supported by a good business case, a good skills case and a good economics case. The key thing is for Scotland to ensure that it has the necessary skills and the economic position for jobs to come here, not somehow to protect jobs against logic. Scotland has hundreds of years of proud mercantilist history, during which skills and talent have been built up here. If that continues—as it should, judging by all the universities and so on that are contributing in that regard—that is the best way of keeping employment vibrant here.

Lewis Macdonald (Aberdeen Central) (Lab): The news that you have just given us about the jobs that might come to Edinburgh is welcome. However, you will of course be aware of the number of people who are affected by redundancies that you and others in the system have announced. Can you tell us a little bit about the process of that restructuring and, in particular, how many jobs you think will be lost in Scotland and how many jobs will be moved here as a result of the initiatives that you have described this morning?

Stephen Hester: In every industry in the world, companies must stay at the forefront of efficiency if they are to serve their customers well. The recession and the banking crisis have doubled that requirement. One of the least attractive aspects of the responsibilities that I and my senior colleagues carry involves making those human decisions, which are necessary but uncomfortable, as each one has a human cost. Of course, that is a process that never ends, as the world is changing all the time. To date, however, RBS in Scotland has lost just over 800 jobs, of which only one seventh were compulsory job losses. We have had a constructive relationship with Unite, in particular. It is a doughty and fierce fighter for its members' interests, but the fact that only one in seven of those job losses has been compulsory suggests that we have worked well with the union, as well as with aspects of government across Scotland, particularly in Glasgow.

The job-loss figures for Scotland are lower, in proportion to our workforce, than they are globally. Again, however, they are not lower because of some geographic concern but because the merits of the case dictated that they should be lower.

I cannot give you an answer with regard to what will happen in the future—the future unfolds as it will, and we make decisions accordingly. Another reason is that we talk to our staff first about such matters, not to anyone else. However, I can say that we believe that the largest announcements that we have to make on jobs have already been made. Any further announcements are likely to be significantly smaller in scale.

Lewis Macdonald: That is encouraging. You talk of a constructive relationship with Unite, from which we will hear in due course. It would be interesting to know whether you continue to have conversations with Unite around those possible future changes and what your views are on where there might be potential for jobs growth in the future.

Stephen Hester: I mentioned an example of jobs growth that we have just decided on in the technology area in Edinburgh. We are constantly reviewing such issues and trying to find opportunities. Generally, part of our efficiency drive is to operate in fewer centres around the world, but to make those operations bigger. Another example is our mortgage operation in Greenock, outside Glasgow, to which we have been moving jobs. These things will ebb and flow in both directions as we move jobs around the world in response to customer moves and to developments that dictate where we can operate most effectively and efficiently.

Lewis Macdonald: Are you able to tell us how many jobs that £75 million of investment in technology in Edinburgh might generate?

Andrew McLaughlin (Royal Bank of Scotland): That particular investment is more about preserving and developing high-value-added jobs than it is about bringing more jobs to the city. An important overall point to make in the debate is that we need to retain and create high-value-added jobs in cities such as Edinburgh, not least because those are what we need to sustain the cost base of living and working in such cities. We must not try to preserve or create jobs that are not high value added or which do not bring a comparative advantage. If we do that, we will simply build vulnerability into the system.

The £75 million investment in payments in Edinburgh will create a small number of new jobs, but it will preserve existing jobs and bring added value to the city. That is as important as what is being done in, for example, the mortgage centre in Greenock, where we are adding jobs as a result of our rationalisations around the country.

Stephen Hester: Andrew McLaughlin will tell me if I get the numbers slightly wrong, but it is interesting to note that our average salary in Scotland is second only to that in London—in fact that applies to its position in relation to our United Kingdom operations and probably our global operations. That indicates that we are talking about not only the number of jobs but the value-added element, which salary captures, to an extent. Our average salary in Scotland is about £28,000, I think. In the rest of the United Kingdom, outside London, it is £23,000. In London, it is about £30,000 or £32,000. The economy in Scotland is in the process of moving from lowvalue-added and low-paid jobs to higher-value-added jobs, which I would have thought would be a positive development, from your perspective.

Lewis Macdonald: Absolutely, but I take it that irrespective of whether restructuring has negative or positive consequences, you discuss those matters with the staff and their trade unions before you make a public announcement.

Stephen Hester: Indeed. I will not tell you that we always agree, but we have discussions.

Lewis Macdonald: If it is true that, before the crisis, RBS was the

"worst-managed bank this country has ever seen",

and your ambition is to go back to a very different way of working, you will want to make some pretty radical changes in the corporate governance of the group. Can you tell us a bit about that in terms of the turnover of senior staff and the roles of the board and of senior staff in ensuring that some of those fundamental issues are addressed?

Stephen Hester: That quotation did not come from me or anyone at RBS. I am not signing up to it or otherwise; I will just let it lie, if I may. Nevertheless, it is clear that, as I said earlier, substantial change was needed and is under way. I will talk about the two top levels at the bank. The board of directors has been substantially changed. It has shrunk in size, because it was too big to be effective, in my judgment, and there has been an almost complete change of membership, including the chairman and the senior independent director.

The top level of management at the bank is my executive committee, which is made up of nine people. Every member of that executive committee was new to their job in the past year. Roughly half have come from the outside and half have been promoted in various ways from the inside. There are further levels of change in the bank globally.

As I have said, however else you characterise the issues at RBS, you should remember that the vast majority of its businesses are very strong and good and, throughout all this, the vast majority of its people were doing their jobs at least adequately and often better than that. RBS's failings were overwhelmingly at the top—and I mean that in a broader sense; I do not mean to personalise the issue vis-à-vis my predecessor.

The good news is that that makes things easier to change, because we do not have to change 170,000 people to get RBS right. I believe that we have already carried out the vast majority of the executive changes that are required to bring us back. It was necessary to do that at the beginning of the process, and I moved very quickly on that when I took the job.

Lewis Macdonald: Your comment that the weakness was at the top of the company certainly reflects other evidence that we have heard. Last week, for example, witnesses from UK Financial Investments Ltd told us about an institutional bias towards growth in acquisitions instead of growth in value and an inadequate risk management culture. Particularly striking has been the evidence that we have received from a number of directions that, although RBS's board members were eminent people in the world in which they moved, they simply did not deliver their challenge function. What have you been able to do at board and executive levels to widen the gene pool and bring in more people who are independent or are able to ask questions and make challenges? Do the changes that you have described adequately address the previous inadequate risk management and go-for-growth culture, and will they ensure that such things do not happen again?

Stephen Hester: This might disappoint you—if I can put it like that—but there is no getting around the fact that there will always be human error. You can create as many governance rules and regulations as you like, but those will never prevent companies from having problems. After all, the limitations on companies are the very limitations that humans have individually and collectively. I am afraid to say that I am not a big proponent of hugely elaborate governance rules as a source of great safety. However, although we cannot prevent banks from getting into trouble in future, we need to prevent the damage that is caused when such things happen.

Notwithstanding those comments, in thinking through the human and skill dynamics, we have tried to the best of our ability to address cultural weaknesses or weaknesses in the process and, as a result, we have tried to increase the proportion of our non-executives with financial services skills. Although I do not believe that bank boards should be made up entirely of people from one industry, I think that the financial services industry has special aspects that require a certain understanding. We have also tried to ensure that the board's human dynamics are conducive to openness, challenge and strength. One of the major themes that I have introduced in the bank's executive management is that power should be devolved, people should be substantially more empowered, accountability should be increased and challenge should be seen as not just okay but expected. As a result, many of these things end up being soft values—of course, they are no less meaningful for that—rather than being part of a policy that you can wave at someone.

Lewis Macdonald: I am sure that you are right about the importance of having on the board financial services skills, but it is also important to have a perspective that is not from that sector. Are you satisfied that the board contains the diversity necessary to shine a light on things that might be less visible to people who have spent their whole career in the sector?

10:30

Stephen Hester: It is a bit like painting the Forth bridge, because that needs to be done constantly. All good management teams and all good boards of directors evolve over time. Inevitably, what we have done so far is what we have been able to do quickly. I am sure that, in the coming years, we will keep working on that and make improvements.

The Convener: Before Gavin Brown asks his question, I want to press you a little further on UKFI's role in the bank's corporate governance. When UKFI gave evidence to the committee last week, it was not entirely clear what UKFI does on a day-to-day basis in carrying out its responsibilities as the majority shareholder.

Stephen Hester: I would say that, overwhelmingly, UKFI sets itself out to behave as a very engaged ordinary institutional shareholder. By that, I mean that, for example, I typically meet UKFI once a month whereas I would meet most of my other institutional shareholders between two and four times a year. UKFI is more frequently engaged, but the vast majority of that engagement is similar to the engagement that I would have if I was meeting Standard Life, which is a big shareholder of ours, Fidelity or any other major institution. It is a discussion on how the bank can succeed in its key roles, in its restructuring plans and in creating value and, in that regard, protecting the position of the taxpayer. That accounts for the vast majority of the nature of the discussion.

The exception is that a smaller part of our interaction with UKFI involves its acting as what one might think of as a political buffer. For the strong eddies of politics that inevitably swirl around the banking industry, and particularly around the banks that have taken state support, UKFI provides a valuable interpretation and buffer mechanism to help understanding in both directions and to avoid unforeseen damaging outcomes. I would say that that is a minority duty, but it is important nonetheless.

The Convener: What part does UKFI play in developing the bank's long-term strategy and considering the impact of that?

Stephen Hester: UKFI played no part in developing the strategy. We believe that we do everything that we do as a shareholder-owned company. Indeed, it is our legal duty to treat all shareholders equally in that regard. After we developed the strategy, we went over it extensively and in detail with UKFI. We also went over it extensively and in detail with other shareholders but less extensively and in less detail. Clearly, we respect all our shareholders, and we particularly respect the biggest of our shareholders. If questions or issues were brought forward that we regarded as meritorious, of course they would lead us to go and think again, but our duty to all shareholders would be at the forefront of that thought process.

I would describe UKFI's engagement as having been a positive interaction and an interaction that was as it was designed, with us behaving as a normal company and UKFI behaving as a strongly engaged shareholder—but nevertheless a shareholder as opposed to a manager.

Gavin Brown (Lothians) (Con): I want to explore the EU's pronouncements—I accept that they are not decisions yet—on which I am sure that negotiations are still on-going. Your reaction to the EU's insurance pronouncement is well documented and well noted, but were you surprised by that decision?

Stephen Hester: Yes.

Gavin Brown: If I have read this correctly, you have made the point that the decision will not change competition very much.

Last week, when a representative from the European Commission gave evidence to us, she gave three reasons for its decisions, not only relating to RBS but more generally. The first was that it wanted to get rid of what she called risky areas of banking. The second related to competition, which I suspect gets most of the focus. The third reason that she mentioned related to what she called the credibility of paying back the state aid. That was the first time that I had heard of that third aspect of the EU's reasoning. Had you heard of that prior to that evidence?

Stephen Hester: Forgive me if I cannot respond directly to that, but I have not read the *Official Report* of the EU's evidence to the committee. As I said earlier, my understanding is that there were three angles to what the EU did. First, there was a competition angle. Secondly, there was a viability angle, which might be my way of describing what you have just mentioned. The EU wanted to understand whether our restructuring plan gave us the best chance of becoming safe and viable and not requiring any more state aid. Thirdly, my perception—rather late in the day, which may be my fault but we can discuss that—was that there was also an example-setting component.

Gavin Brown: I think that it was the personal view of last week's witness that it is not credible to say that the state aid money can be repaid unless the insurance division is sold. Do you take a different view from that?

Stephen Hester: I have no desire to stir up political controversy vis-à-vis the EU. It has a job to do, which will not always be completely in alignment with us. We set forth what we believed was the most effective restructuring plan for RBS that would give the highest probability of success, a key aspect of which would be the state's ability to sell its shares at a profit in the future. I still believe that the plan that we set out was the best one, and the drop in our share price after the EU's announcement suggested that the markets did not disagree with our perspective. Notwithstanding that, we completely respect the EU's jurisdiction and have tried to work with it in as constructive a way as possible. Over the next few years, we will try to turn that extra burden into something that is at least neutral.

Gavin Brown: Looking wider than the insurance point, comments were made in relation to where you can be in a league table on various parts of investment banking. Taken as a totality—although, again, there has been no final decision—how do the announcements of 3 November change your longer-term vision of RBS?

Stephen Hester: They do not change it irreparably. My three priorities are an enduring customer priority—we will always have customer priority; a priority to make the bank safe again, which is today's priority to get the balance sheet, the capital and the risk management right; and, later in the piece, the priority to get the taxpayer's money back.

The taxpayer will get his or her money back through the Government selling its shares in RBS. In order for that to be possible, the share price must be healthy and investors other than the Government must want to own the shares, and in order for that to happen we need to make profits. Anything that reduces our profits will make that harder to achieve and, in that sense, selling the more profitable of our businesses will make the job harder. However, because we have four years in which to do that, we will have the opportunity to get at least a fair price for those businesses and turn what is clearly a disadvantage, in terms of our future profitability, into a neutral. I hope that we can do that.

Gavin Brown: The Government set RBS a number of large targets not only for lending to businesses but for mortgages. I have read conflicting reports about what is going on: some say that we are on track and all is going well, while others suggest that it will be impossible to reach the lending targets for a number of reasons, one of which is lack of demand. What is the reality?

Stephen Hester: This is another big subject. The discussion about lending commitments, which took place at the beginning of last year, centred on the observation that, although it was necessary from an economic point of view for our economy to change to one that borrowed less and saved more, it was desirable for the change to be eased. In the UK, as in other countries, there were great concerns about a huge withdrawal of foreign banks from our markets and the fact that that could leave a big gap of lending support in the UK that, if left unfilled by the domestic banks, could lead to a more abrupt transition to a lower borrowing economy than was desirable. The concept was always to incentivise domestic banks through the leverage of state support, which was to be available in the event of an abrupt withdrawal of credit that was something other than a natural adjustment in the UK economy. The measure related specifically to the withdrawal of foreign banks but, of course, could be applied to any other source.

As a result, the sizing of the lending commitments involved a series of calculations about how much of the market the foreign banks took up, what the gap might be if they all withdrew, and so on. The commitments were always to make lending available, but only to credit-worthy borrowers to whom one should lend anyway at market prices.

That is the background. Fast-forwarding to today, we see a picture that is different in the different segments that emerged from the initial thought process. For example, we are well ahead of the extra lending commitment that was implied in mortgages, because a lot of lenders who were big in the market—Northern Rock, to cite an easy example—have either disappeared or very much pulled in their horns. Although the mortgage market itself has not expanded—after all, people are trying to pay off their mortgage instead of increasing their indebtedness—the departure of certain people has allowed us to step into the gap, grow our market share and make the market more stable. I believe that that illustrates the rationale behind the process.

I should also point out that that is true not only of the aggregate statistics in the mortgage market but of first-time buyers. For example, this year, 17 per cent of our mortgage lending in Scotland is to first-time buyers, and we are also making available 90 per cent loan-to-value mortgages to assist the process. Moreover, we have something like a 90 per cent success rate—in other words, 90 per cent of people who ask us for a mortgage get one.

With regard to the business banking sector, which is the other element, the dynamics are the same but there is a different outcome. The market as a whole is not borrowing more, which is as it should be given that Britain is too indebted and needs to borrow less. That overall picture is not unusual and, indeed, can be seen in every country in the world—or perhaps I should say every economically mature country, because it is not the case in, for example, China or India. The economy that has seen the biggest repayment of borrowings is the United States which, as we know, has come out of recession faster than the UK.

10:45

The phenomenon of people not wanting to make their borrowing worse is not in any way surprising. It is natural, obvious and not inconsistent with economic recovery, and it is happening in business banking as well as in mortgage banking. However, unlike mortgages, there has not been a material withdrawal of foreign lenders in business banking, and the capital markets' rights issues and bond issues, which provide an alternative source of money to bank lending, have been phenomenally buoyant. The consequence of that is that there has been no gap for us to step into to increase our market share in business banking, which means that our lending picture in business banking, unlike in mortgages, is quite similar to the market as a whole, which is to say that it is roughly flat.

Clearly, that is an area around which there is some debate and controversy. I think that that is because, in stressed periods such as a recession, people worry more about money than they would in good times, so one hears more about that worry than normal. It is also true that there are more financially precarious companies in a recession than there are in good times; they get closer to the point at which it would not be right to lend to them, as lenders would only be repeating the sins of the past, in that they would be lending to people who could not pay them back. The stress that arises as a result of those issues is responsible for the noise that one hears.

Therefore, we work as hard as possible to find ways to give our customers the support that they need, short of deliberately lending to someone whom we think will not pay us back.

In aggregate, we are lending to exactly the same proportion of people who ask us for money as we were before. Eighty-five per cent of all businesses that ask us for money get it, and 90 per cent of mortgage applications are granted. Those percentages are the same as before, but some of the people who are asking us for money are in a worse condition than before, so we must work harder to find a way to get them money while protecting our position—by arranging covenants or extra security, for example. That is simply a function of a recession weakening companies and us having a duty not to lend to people who will not pay us back. You can understand the stress around that.

Of course, any individual will always consider themselves to be a better credit risk than we will. All that I can say to you is that not only are we lending to the same proportion as we did before, in a market that generally has fallen, but we have £27 billion of undrawn overdrafts that are available and committed to businesses in the UK. Taking the aggregate numbers, although there are exceptions, British businesses have not been drawing down their overdrafts. If there were a widespread desire to borrow that was not being met by the banks, people would be drawing down their overdrafts, but they are not.

I do not want to say in any way that there are not individual items of stress, some resulting from a company being in difficulties and some resulting from banks making mistakes. In the aggregate, however, the economy is behaving in the way in which we would expect it to. The fulfilment of the banking commitments is happening in the way that it was designed to, which is to say that where there is a gap it is being filled, and where there is not a gap we are trying to reassure people that money is available.

We have lent £45 billion of new money to businesses in the UK this year, but they—or other businesses—have paid us back about the same amount, which is why the net figure does not show a significant increase.

I am sorry to have given such a long answer, but I thought that it was important to answer you in full.

Gavin Brown: I take it from that that you are likely to hit the targets that were set in relation to mortgages but unlikely to hit them in relation to business lending.

Andrew McLaughlin: In mortgages, we had a commitment of £9 billion and said that £1.7 billion of that would be allocated through our regional funds to Scotland. As of the end of September, we had lent £1.5 billion of that £1.7 billion, so we are very much on track on mortgages in Scotland, and the situation is the same at a UK level.

In the case of business lending, our lending year to date in Scotland is up about £120 million, which is a couple of per cent—as Stephen Hester says, that is, broadly, flat. That is because people are repaying loans as quickly as others are drawing down new money.

Stephen Hester: The response to your question is that we believe that we will be completely in compliance with our lending commitments, but the pattern is likely to be that our new lending will exceed the target in mortgages and will significantly undershoot in business banking.

Ms Alexander: I have a question about the Scottish character of the bank, although I essentially want to ask about strategy.

The line of questioning that you have been subjected to this morning is the result of the fact that concerns have been expressed that there will be a real and measurable shift in the location of senior personnel and where operations are led and managed from. There might be respectable commercial reasons for that, but is it true to say that such a drift is under way?

Stephen Hester: If you were simply to ask how many members of our board are Scottish, the answer would be that there are fewer now than before. I do not really look at it like that, however. I am trying to be blind to geography, and I want the best people in the best place for those jobs, whether that is in Scotland or not. There is no policy in that regard. There is a clear policy that our headquarters is in Scotland, that the community in which we are most rooted is here—witness my appearance before this committee—and that this is where our board meets the preponderance of the time.

Ms Alexander: Obviously, there is a public policy dilemma in the knock-on effects for business services and other activity, given that you are 84 per cent or 70 per cent owned by the taxpayer. That is a matter of interest, but we should not pursue that point today.

Those of your senior colleagues who have been through the regime change say that one of the refreshing aspects of your leadership is that it has been very strategic in its thinking about where the bank is going. Can you share with us a little of the detail of the sort of bank that RBS is going to be in five or 10 years' time? Will it be global? Will it be international? What will be the international spread of its activities? Will it be narrow or broad in scale? How significantly will investment banking feature?

Stephen Hester: I will try to answer your question, but one of my many weaknesses is that I am not necessarily big on the vision thing.

I see myself as very much a business pragmatist. I think that the first law of business should be that, whatever you do, you had better be good at it and that you should do things not because you would like to do them but because you are going to be good at them. Too many companies fall into the trap of what I rudely call pie-chart management. They say, "Wouldn't it be nice if our business divided up in a way that looked pretty in a pie chart?" whether by geography, nature or whatever, and they then try to reverse-engineer their business to produce such a pie chart. That leads them to make mistakes.

The starting point of our strategy, rightly or wrongly, was to audit what it is that we are good at. That does not mean that we cannot be better at things—in fact, we must be better at things—but it is much easier to get better at something that you are naturally good at than it is to try to be good at something that you are not naturally good at. By the way, that is true of humans as well as businesses. I do not start with any philosophical attachment to a particular size, shape or geographic spread. My attachment is to success. I want to make RBS successful, and the size, shape and spread of RBS will be the result, not the driver, of that aim.

In the case of RBS, it was my observation before I joined—and it is still my observation—that most of our businesses are strong and successful in their markets. They might not be today, due to mismanagement, but that is what they naturally are. Although we have a massive restructuring plan, which involves a reduction of assets and businesses worth something like £500 billion, that reduction is overwhelmingly focused on areas in which we are not naturally good. Sometimes, that is a geographic-spread issue and sometimes it is a business-line issue. Sometimes, it involves something that we are good at but took to excess.

Having gone through that analysis, it seems likely to us that the RBS of the future will be what I would call a universal bank, which means that it will have activities that can be successful and customers who can benefit from a range of banking services from the most basic current account through to more sophisticated foreign exchange and bond issues and so on. It seems to us that we can be successful on a global scale, but that is totally different from saying that we can be successful in every country or in every business line.

It seems to us that something like 60 to 65 per cent of our business is likely to be in the UK and that a similar amount—roughly two thirds—will involve basic retail and commercial banking. However, we do not take that view because we have started with a pretty pie chart or some philosophy or other; we get there simply from a pragmatic analysis that asks what we are good at, where the big markets are that we can be successful in, and where the opportunities are for us to serve customers in the future.

Ms Alexander: Are you saying that, roughly, 60 per cent of your business will be in the UK and 40 per cent will be global, and two thirds of the UK market will involve retail and commercial banking?

Stephen Hester: No, two thirds of our global business will be retail and commercial.

Ms Alexander: So, by implication, a third would remain in investment banking.

Stephen Hester: Yes. However, the point of my philosophy is that, if those percentages turn out to be completely different, I do not care. We are not aiming at those percentages; we are aiming at being strong, safe and successful, at serving customers well and at paying back the taxpayer. If the markets change, if circumstances around us change or if our view of what we are going to be successful at changes, that is fine, because I never want to be caught in the trap of reverse-engineering a business to match a pie chart.

Ms Alexander: Can you be successful in the investment banking market, given the pay restrictions that you are subject to, which your competitors do not face, and the restrictions on bond trading? How do you engineer to be number 5 in the bond trading league? That is a restriction that your competitors do not face. Has that led you to rethink your position on investment banking?

11:00

Stephen Hester: There is a risk in all our businesses. We are under some political constraints, including on pay, that have an impact on all our businesses. If that politicisation were to get out of hand, it would threaten all sorts of businesses. To work for RBS today is to feel quite embattled, whether the employee is in the branch down the road, the business centre over in Glasgow or the investment bank in Hong Kong. I am not complaining about that and I understand the situation, but we must manage it. It has an impact on all our businesses and not just on the investment bank.

In common with our other core businesses, the bits of the investment bank that we have kept—something like half the investment bank of yesterday is gone or going, so that is the biggest restructuring—are pretty valuable. For example, we are among the world's three or four most active foreign exchange traders. Of our Scottish farming customers, 25 per cent have used our foreign exchange services this year to hedge their European Union support payments.

We are number 1 in the world at trading US Treasury bonds. The size of the US deficit makes that essential business for humanity, because the US must be able to finance itself. They are Government bonds, so they are not at the ritzier end of life. That is also true of sterling—we are the biggest trader in gilts, which enable the UK Government deficit to be financed.

We have skills in important activities that some choose to characterise as casino activities but which I see in a different light, just as we have skills in retail and commercial businesses. That is why we have tried to preserve those investment bank activities. Yes—politicisation is a threat, but it threatens all our businesses in different measures.

Ms Alexander: Are you convinced that you can manage risk effectively in the United States?

Stephen Hester: Yes.

Ms Alexander: You described yourself as a business pragmatist, so I encourage you to give the timescale in which you envisage a return to profit and privatisation.

Stephen Hester: Our core businesses are strongly profitable today. They are not nearly as strong as they need to be, but they are nevertheless profitable in the aggregate. However, the losses that we are making on the wind-down of what might be called the excesses of the past and what I more euphemistically call our non-core activities outweigh the profits in our continuing core businesses, so the company as a whole is in loss. None of us has a perfect view of the future, but we estimate that those losses will continue next year and that we have a good chance of being profitable as a whole as well as in our core businesses thereafter.

As for the second issue that you raise, you need to ask UKFI that question. The taxpayer's ability to realise money on the investment in RBS is partly in the taxpayer's gift through deciding to sell the shares—we have no control over that. Our part of the bargain is to make RBS sufficiently attractive to other investors that there is someone around to whom the shares can be sold at an attractive value. That is all to do with our recovery efforts.

The difficulty in predicting timing is that stock markets normally anticipate the future, so the stock market is likely to anticipate our success before our success is absolutely there. Therein lies the difficulty of assessment.

Let us take a simple example. The average cost to the taxpayer of a share in RBS was 50p. Our share price was above 50p for several months this year. I was surprised by that, but it was. That was not because we are profitable today—we are not; it was because people were looking to the future. Every quarter, six months or year that goes by in which we demonstrate positive steps on our road to recovery will help to build people's confidence in the future and bring forward the moment when the demand is adequate for privatisation.

Part of the reason why we have moved our financial transparency to a level that no other bank in the world yet provides is that we want to give people the tools to look at what we are doing and to understand its merits and demerits. That will help to build confidence in the future. I would be disappointed if there were not several opportunities for profitable share sales during the period of our strategic plan, which was initially for five years and now has four years left to run. However, the specifics on the timing of privatisation are for the Government and the stock market to decide, not us.

Ms Alexander: What would be your attitude to a possible future takeover bid?

Stephen Hester: I have always held the view, in all companies, that it is not our job to decide who our shareholders are; it is our job to run the company as well as we can. Any time that someone thinks that the company is more valuable to them than it is to our current shareholders or that we are doing a crappy job, a takeover is one option and firing the management is another.

Ms Alexander: My next question is on a completely different matter. We have dwelt on small business banking in Scotland, in particular. You have talked about the current complexities of the market. In your written submission, you say that RBS currently banks 35 to 40 per cent of small businesses and that that figure will diminish by 5 per cent or slightly more as a result of the EU state aid agreement. However, that still leaves somewhere between 30 and 35 per cent of small businesses in Scotland banking with RBS. If you were a small business in Scotland, would you have concerns about that level of market concentration in the banking services that were available to you?

Stephen Hester: You could argue that both ways, and I am sure that businesses do. I have spent a reasonable amount of time going round Scotland—as well as other places—speaking with our staff, our customers and the communities. Within Scotland, I have met an incredible level of customer support, loyalty and appreciation. By and large, our customers feel that we are there for them and provide the services that they want and value. In some communities, we have a van driving around because there are no branches there, and we have banked some businesses for decades. In competition, anything can be artificially engineered, but markets revert to those businesses that supply people with things that they want and need in ways in which they want and need them. That is the main feedback that I get. Nevertheless, I am sure that some customers would say that, in a perfect world, they would have more choice.

Ms Alexander: I have a final question. You have, understandably, dwelt on the rather politicised environment in which you, as the head of the bank, have been compelled to operate over the past year. In your time in post, have you sought or received any support from the Scottish Government?

Stephen Hester: We have not sought or received financial support, but we have extensive links with the Scottish Government and with local authorities in Scotland. We try to make the support work in both directions, wherever we can, which might mean adding our support for the year of homecoming, for example, or, when we are shedding jobs in Glasgow, figuring out how best we can make that work for the community and for our people. Andrew McLaughlin might want to add something on that.

Andrew McLaughlin: On the latter point, we have a compulsory redundancy rate in Scotland of one in seven, whereas the rate is about one in four in the rest of the UK. The level of our redeployment of people in Scotland is high. That is partly a testament to the fact that the Scottish Government, local authorities and Scottish Financial Enterprise have got together in the jobs task force, and because, when we have known that there were going to be redundancies or office closures, we have worked effectively to proactively redeploy people and put as much support as possible around people who have been at risk. I would not count the support as direct financial support to the company, but there has been a tremendous amount of engagement at the national and local levels to figure out how we can make a difficult process as bearable as possible for the people involved.

On the point that Mr Gibson made, we completely understand the need for a deep and enduring talent pool in Scotland. That is important. At the moment, we are shedding labour but, with a fair wind, we will be recruiting people again in aggregate in a number of years' time rather than shedding them, and we want to ensure that a talent pool exists when we reach that point. One way in which we can do that is by working hard to retain as much talent as possible in Scotland. We have done that successfully on a small scale in Glasgow, but it is noteworthy that perhaps more progress is being made on that in Scotland than in other parts of the United Kingdom.

Ms Alexander: Obviously, it is not possible to give a full answer to my question in such an evidence session, but you might want to write to us about the nature of any additional support that has been sought or received.

Have you had the opportunity recently to meet the First Minister or the Cabinet Secretary for Finance and Sustainable Growth to discuss the future of financial services in Scotland?

Stephen Hester: We meet them all the time at different levels.

Ms Alexander: Do you want to share anything with us about the wider future of the financial services sector in Scotland? Obviously, there has been a period of enormous turmoil and change.

Stephen Hester: Forgive me if I am not in possession of all the right statistics, but my impression is that employment levels have not gone down in the way that we might have feared as a result of reading the newspapers. Indeed, in some instances, such as our information technology investment and Tesco, the opposite is happening. It appears to me that it is far from accurate to talk about the demise of Scotland's financial services industry; the facts on the ground do not bear out its demise. I know that also from a different context because, when I go to see our shareholders, I always spend a day here seeing institutions in Scotland—mostly in Edinburgh and to some extent in Glasgow—that manage money on behalf of global customers. It is not clear to me that hand wringing is the order of the day. Like all industries, we should continue to focus on education, a co-operative quality of life, planning permission, Government engagement, costs and productivity.

Andrew McLaughlin: We must be careful that we do not suffer a complete crisis of self-confidence in Scotland when it comes to the economy and financial services. There has been a tremendous amount of inward investment in Scotland. One reason why redeployment levels have been high as we have gone through the process is that there are inward investors in areas such as Glasgow's financial district. We need to learn the lessons from what has been, to put it mildly, a chastening experience, but we also need to be a bit confident about the inherent attributes of the industry in Scotland, its longevity and the fact that it can be competitive. The industry might have a slightly different shape; I hope that it will have a different attitude and that we will have learned lessons. There is a lot of play for. We must not, in true Scottish fashion, talk ourselves down to the point where other people come along and eat our lunch for us. I hope that we go forward with that attitude.

Marilyn Livingstone (Kirkcaldy) (Lab): I want to follow up Wendy Alexander's question about Scotland as a global financial services centre. How should Scotland differentiate itself and promote itself as a financial services centre in the future?

Stephen Hester: Scotland starts with an advantage: language. The language of financial services is English and there are many centres around the world that have the disadvantage in human capital and skills of starting with a workforce that does not speak English. Secondly, Scotland has a strong relative global position in education, as we have discussed. The costs of doing business in Scotland are also on the favourable end of the global scale. That will always be important. It does not mean to say that there are not more favourable parts of the world, because it is always a trade-off. However, that has to be considered. Infrastructure is always important too.

Perhaps Andrew McLaughlin might add some items to that list.

11:15

Andrew McLaughlin: No. As I remarked earlier, we have to be confident about what we have. To be frank, our part of the bargain is that we need to heal ourselves. We need to learn some fairly major lessons from what has just happened, make the company strong again and restore it. If we fulfil our part of the deal, that will help.

If our senior independent director, Sandy Crombie, were here, he would have quite an argument with the committee about how successful financial services are because there are tremendous strengths on the fund management and asset management side. Parts of the sector are currently successful and have come through the crisis in reasonable fettle. Others, ourselves included, have some work to do. However, I am confident that, in five years, we will have a strong industry in this country. We must not be complacent or insular. That applies to headquarters and to discussions about talent, where people live and where they work. The industry is global, so we must have a global attitude and outlook if we are to compete effectively in it.

Marilyn Livingstone: I will ask about the decision that we await from the European college of commissioners. We heard from it that the case is still being assessed. To what extent have you been involved in discussions with it?

Stephen Hester: To a deep extent.

Marilyn Livingstone: Okay. To what extent will your discussions influence its decision? Is that why there is a delay?

Stephen Hester: I am not aware that there is a particular delay; I think that the process is on schedule.

We were given plenty of opportunity to state our case. Not all our views were accepted. I suppose that you would say that that is normal, but we have had the opportunity to state our case and engage with the Commission. It, in turn, has the ultimate decision-making ability.

It is worth saying that the process takes place technically via the UK Government—the Treasury. We might more accurately describe it as tripartite. The outcome will depend heavily on the level and effectiveness of the UK Treasury's support for our case. That should not be underestimated, as it is a key part of the process.

Marilyn Livingstone: We also heard that the timescale for changes within the Commission is the end of this month or the beginning of the next. Will there be an announcement before those changes take place?

Stephen Hester: My understanding is that the college of commissioners should meet in December to decide the case. I am afraid that I do not know where that sits in the Commission's change schedule.

Marilyn Livingstone: We certainly heard in evidence that commissioners would change at the end of this month or the beginning of the next. We asked whether that would cause a delay and were assured that it would not.

Does the requirement in relation to disposals and divestments represent value for money for the key shareholder—that is, the taxpayer?

Stephen Hester: Whenever you are forced to sell something, and everyone knows that you are a forced seller, there must be a threat to value. We have a period of time in which to execute the sales that we are forced to make, which—we hope—allows us to mitigate much of the impact but, inevitably, there is an impact.

The Convener: To follow up on that point, I am slightly confused as to where the proposal for divestment of the insurance businesses, rather than some of the other businesses that you are not happy about, comes from. You said that you were shocked, or surprised, by that proposal. Irmfried Schwimann from the European Commission, who gave evidence to the committee last week, said:

> "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."—[*Official Report*, *Economy, Energy and Tourism Committee*, 18 November 2009; c 2662.]

Who came to the Commission with the proposal that it should divest you of your insurance businesses?

Stephen Hester: If you will forgive me, I do not believe that getting into controversy on that issue would work in our interests.

The Convener: Okay—I was just trying to get some clarity on how the process works.

Stephen Hester: I understand, but I have to protect the interests of RBS, and I do not think that that would work in our interests. I apologise.

The Convener: Okay. I note your comments.

Christopher Harvie (Mid Scotland and Fife) (SNP): I am sorry to come in late—I got marooned in the Borders by a broken-down bus.

I am interested in the two other rubrics of this committee—energy and tourism—because they come at either end of the investment scale. Energy requires huge investments in the manufacturing industry, while tourism is very much microcapitalism, in that it involves very small businesses.

The area in which I used to work in Germany concentrates generally on manufacturing and tourism. Baden-Württemberg's manufacturing has risen from 30 to 35 per cent of gross domestic product—and we are talking about high-level, high-technology manufacturing. Does it seem to you in retrospect that the course that investment banking in Britain took over the past 20 years, which involved building up the notion of financial services as independent from a manufacturing and technology background, ought not to have been undertaken?

Stephen Hester: I suppose that I would view those things as two different issues. It is desirable for us as an economy to have as many successful engines of growth as we can come up with. It should, therefore, be a matter of public policy to figure out in which areas we can make ourselves advantaged, and to pursue those areas—the more, the merrier. However, it is also true that financial services are one of the areas in which we are highly advantaged on a global scale, and that they are an industry with long-term GDP and GDP-plus growth characteristics. It seems entirely sensible that we should want to be successful in financial services; I do not view the issue as an either/or question.

Christopher Harvie: I will elaborate slightly on the theme. In dealing with manufacturing investment, one deals with a fairly recognisable feedback loop: the thing can be developed, it can be marketed, it can earn adequate profit and that comes back. However, in financial services, it seems that, particularly bearing in mind the career of RBS, or HBOS for that matter, there are three areas in which one could say there are elements of secrecy and inadequacies of information coming into the spectrum.

In retrospect, do you share, for instance, the views of your chief economist, Stephen Boyle? We had him here as an interview partner on 1 October 2008, just before the ceiling fell in, and he said of the securitisation business of the bank that only two or three people in the bank knew how it worked. That is one aspect.

Another aspect arose in May this year, when I was at a Commonwealth Parliamentary Association conference in Guernsey on the slump.

We had an interesting talk from a man called Tom Burns, from the law school at the University of Aberdeen, who had been going to undertake research into the law of securitisation until he discovered that it did not exist—the whole thing was, in fact, carried out by computer.

Thirdly, what proportion of RBS's financial service activities take place in secure jurisdictions? You referred earlier to Switzerland and its success in banking. However, is that not due to a great extent to the notion of the numbered account and banking secrecy?

Those are three aspects of investment banking and financial services that I, as someone trying to look ahead to how the Scottish economy should develop, regard as dangerously opaque. Have you got the same degree of trepidation when you are confronted with those?

Stephen Hester: Taking securitisation, I guess it must be true that, in all industries, technology and techniques move on and are applied in different measures over time. It sometimes takes a while for regulation to understand and catch up with that. A different example is the way in which the internet is being transformed. Search engines such as Google are playing a fundamentally different role in, for example, their ability to decide what pops up when we search for something. All of us, including regulators, have to catch up with that. There are developments in every industry that happen faster than people's understanding of them, and we have to catch up with them. Securitisation is an example of that in banking.

As in other industries, I do not think that one should blame the technology; at most, one should blame the use to which it is put. We do not want nuclear bombs, but we are happy with nuclear power. Securitisation is a powerful, positive instrument in financial services, which, if harnessed correctly, does enormous good, not least in financing a huge number of schools and hospitals through private finance initiative programmes in the UK. We have identified areas in securitisation where understanding, regulation and risk adjustment must move forward, but we should not regard securitisation as somehow involving dark arts that are to be frowned on and disliked.

There is an appropriate, swift, global focus on what we might call inappropriate banking secrecy. The areas where that can be practised are quickly being attacked. I am very supportive of that process. However, only pretty small amounts of the financial services activity across the globe relate to those areas, and they are fast diminishing, which is appropriate. I would hope that we have zero inappropriate activities, and only a few that might be vulnerable because of the locations in which they take place. I am sorry, because there was a third point.

Andrew McLaughlin: We will have to check the transcript of what Stephen Boyle said. My suspicion is that he will have been making a point that I think many economists have made, which is that techniques and products that were ostensibly designed to reallocate risk around the system and disperse it and guard against systemic risk had the opposite effect from what was intended. In fact, the risks ended up being concentrated in some cases back on the balance sheets of banks. That process was not well understood by the market participants or the regulators. That is one of many lessons that our industry is having to learn and put right in the period ahead.

Christopher Harvie: Would you say that the corollary of that is my old schoolfellow John Kay's apophthegm that being too big to fail is equivalent to being too dumb to live?

11:30

Stephen Hester: This is a whole other big area, so I will go into it only if the committee wants me to do so.

As I hope I indicated earlier, it is important that, as a global economy, we figure out how to facilitate bank failures without the consequences that the world was worried about. It is preferable that we figure out how to avoid such failures, but we need to figure out both those things. That issue is not solely about size. When last I looked, Northern Rock would not have been considered in any too-big-to-fail list that would ever have been constructed, yet the Government judged that bank as being too big to fail. Therefore, I think that focusing on size alone is an error. Focusing on how we reduce the systemic risks, or make them more resolvable in a crisis, is very important. I am wholly supportive of that process.

The Convener: You said earlier that the failure in risk management was macro and no one spotted it. Who should have spotted it? Where does responsibility for spotting such things lie most? Does the responsibility lie with bank boards or auditors or with the regulators?

Stephen Hester: This is an issue that I find frustrating. Inevitably, when things go wrong, people search for scapegoats. That is in part fair and in part serves to deflect criticism that might more appropriately be more broadly held. The truth is—this is not in any way to seek to avoid the responsibility of RBS or of the banking industry as a whole—that the global imbalances that led to the current financial crisis were ones that we should all have seen and done something about. Anyone sensible should have known that the UK could not spend its entire time driven by consumer spending that was funded by withdrawal of equity from house prices spiralling ever upwards. Everyone should have seen that huge Government balance of payments deficits in the west financed by the east were not sustainable. Everyone should have seen that the explosion of commercial property development in Spain and in Ireland was not sustainable. Those were not hidden things.

The difficulty is what I would call the democratic dilemma, which is to say that none of us is good at voting for a poorer present in favour of a safer future. It is hard for politicians to make it into office by telling people to deny themselves today. That is a hard thing to do, because people are not good at denying themselves today. However, the things that went wrong were visible to everyone.

The Convener: The key issue is not to find scapegoats but to find ways of preventing the crisis from happening again.

Stephen Hester: The issue is that people need to understand that the banking industry is a mirror of the economy that it serves. For example, if the bit of the banking industry that serves the UK was overborrowed—which it was, as banks were overextended—that is because the UK was overextended. As a country, we were borrowing more than we saved. You cannot fix the banks without also fixing the economy itself. The two go hand in hand.

The Convener: We are running short of time, so supplementary questions must be kept very brief.

Christopher Harvie: Would that apply to having received that huge loan from the Government that we have heard about only today?

Stephen Hester: Sorry, would what apply?

Christopher Harvie: Do your remarks apply to the loan from the Government last October that bailed out the RBS, which we have heard about only today?

Stephen Hester: Is the implication that the loan was overborrowing?

Christopher Harvie: Yes.

Stephen Hester: The reason why the loan was needed was that RBS had overborrowed and was vulnerable to a crisis of confidence. The reason why sterling was particularly weak through the crisis was that the UK had overborrowed and was vulnerable to a crisis of confidence. Absolutely, RBS was the poster child of excess in the banking industry. That is why we are all having to pick up the pieces. I am not in any way trying to dodge that—I live with it every day—but I am simply trying to point out that you cannot have a safer banking system in a vacuum.

Ms Alexander: The governor of the Bank of England has advocated a return to narrow banking and a splitting of banking functions. Is that technically possible and desirable?

Stephen Hester: I do not want to comment specifically on Mervyn King's comments because the discussion is complex and detailed, and I am not entirely sure of his position in any event and he is a very intelligent man whom I respect. However, I will give my observations on the topic.

I do not believe that there is any evidence at all that the shape or size of banks caused banking weakness. In fact, the banks that have needed support or have gone bust in the crisis around the world have preponderantly been narrow banks. They have been narrow investment banks, such as Lehman Brothers and Bear Stearns; investment banks that had to be bought by others, such as Merrill Lynch; narrow mortgage banks such as Northern Rock, Bradford & Bingley and the Dunfermline Building Society; and consumer banks such as Wachovia, Wells Fargo and Washington Mutual in the United States. The banks that got into trouble tended not to be broad banks but were preponderantly, although not exclusively, narrow banks. If one wants to learn lessons from the crisis, it is not apparent to me that the Glass-Steagall argument is the lesson that one would learn. That is not to say that that argument is invalid, but one would have to construct it to address different issues.

Ms Alexander: Do you have any final thoughts on how we can address the too-big-to-fail issue without incurring the sort of costs to the taxpayer that there have been?

Stephen Hester: The issue is complicated, and it needs to be debated and discussed a lot. I do not have a fixed set of answers to your question, but it seems to me that part of the answer might lie in resolution regimes. In the United States, chapter 11 allows companies to continue their day-to-day functions while they reconstruct their balance sheets. If a chapter 11 for banks could be found that could work, which is phenomenally difficult, that would allow the things that frighten people about banks going bust—payrolls not being met every day and people not being able to take anything out of cash machines—to be addressed while losses could be allocated at the level of the accounts. The resolution regime needs a lot of discussion.

The discussion of the process of who bears losses, and how and in what order they should do so is also important. In the crisis, we have found that equity holders—including staff and management—have been the only people who have easily lost money. Layers of instruments were designed to be loss absorbing but, in practice, they were hard to attribute losses to. That is another important area for exploration in addition to all the things that will make losses more unlikely in the first place, which should be pursued anyway.

The Convener: Rob Gibson wants to ask about an issue that has arisen today that you may be aware of.

Rob Gibson: This morning, it was announced that the Supreme Court has ruled in favour of the banks on overdraft charges. Customers are therefore set to face huge charges. Is it right that a state-funded bank such as the Royal Bank of Scotland should be involved in such predatory activity?

Stephen Hester: You will forgive me: that announcement has been made while I have been in this meeting, so the details are not available to me. With that important caveat, I would say that the court case was about the past and whether what happened in the past was in some way illegal, wrong or whatever word one wants to use. I hope that the case indicates whether something in the past has to be dealt with or whether a line can be drawn under it; I will not know that until I have studied the case. Obviously, aside from the legal process—I hope that that process has provided clarity, but I do not know about that—we need to focus on the future. Earlier this year, we substantially changed and reduced our overdraft charging mechanisms, and we are well on the way to a charging system that is more in line with what our customers would like, although I will not characterise it as better or worse.

We should understand that we are not talking about a free lunch. There are certain costs for banks in doing business. If those costs are not paid in one way, they must be paid in another way. It was certainly clear to us that our customers thought that how our charges were organised was not the best way for us to charge for our services. That is why we made changes. We will continue to try to get the best alignment that we can between what our customers want and our ability to be in business.

Rob Gibson: Thank you for that explanation.

The Convener: I thank Stephen Hester and Andrew McLaughlin for participating in a lengthy session.

I suspend the meeting for five minutes.

11:41

Meeting suspended.

11:49

On resuming—

The Convener: Our final witness this morning is Gillian Tett, who is assistant editor of the *Financial Times* in charge of global markets, and the published author of a highly relevant book that provides a useful insight into derivatives trading and JP Morgan in particular.

I thank Ms Tett for coming along—we are sorry to have kept you waiting for so long, but as you can imagine, our session with RBS was of particular interest and went on for longer than we had originally planned. You may make some opening remarks if you wish, and we will then open up to questions.

Gillian Tett (Financial Times): Thank you for inviting me along this morning; it is a great honour. It is somewhat peculiar, because as a journalist I am trained to ask questions rather than to have people ask me questions, but I am pleased to be here. I rather hope that being on the other side of the lens will make me a better journalist.

I welcome what the committee is doing today. I started covering complex finance back in early 2005 and became concerned fairly swiftly about what was happening. As I moved around the City of London and New York, looking at what was going on, I found it incredibly hard to get politicians at all interested in what was happening inside the core of our banking system. In fact, I got so frustrated that, in the spring of 2007, I wrote a column entitled, “Politicians are from Mars, bankers are from Pluto” to illustrate the sheer gulf in understanding between the two sides. That gulf is particularly stark in a place such as London: Westminster is only a couple of miles away from the City of London but, frankly, the bankers and the politicians could have been on different planets.

It is obvious these days just what terrible costs that lack of inquiry and oversight has brought for all of us. I am pleased to say that in Westminster there is now a committee called the Mars and Pluto group that is apparently trying to get politicians to talk to bankers and vice versa. The thought was very much on both sides: bankers for the most part did not regard politicians as people with whom they needed to engage, and politicians were not asking hard questions.

What the committee is doing today and for the next few months in trying to peer inside the banking system is extremely welcome and I wish that more politicians had been doing it earlier. If they had, we might not be in quite such a mess today. I urge you to keep going and to keep asking questions well beyond next March, and well beyond when—or if—the crisis starts to recede.

The Convener: I note that you have a PhD in social anthropology. I wonder whether, given that experience, you have any thoughts on the culture of the City of London and the bankers, and on whether attitudinal factors helped to set up the problems that we face in the banking sector.

Gillian Tett: Behavioural aspects were absolutely key. When I went around the City of London four or five years ago and said that I had a PhD in anthropology, the bankers would often react with a great deal of surprise, and many were pretty patronising. I remember someone saying to me, “Anthropology? Isn’t that all a bit hippy?” The feeling—certainly four or five years ago—was that the only academic backgrounds that really counted in finance were maths, hard science or economics.

In many ways, that points to the very core of the problem that we face today. Bankers spent far too much time thinking that banking was all about numbers and that people were irrelevant. Finance had become cyberfinance—conducted on computers in a place where real human beings did not exist. In reality, the social aspect of what happened was critical. Being an anthropologist gives a person training in at least three things that bankers tend not to do. First, it teaches you to look at how all the bits of a system join up together; you are trained to take a holistic vision of finance. The bankers, for the most part, were not doing that at all. They were operating very much in silos—in little departments, both structural and mental. They tended to scurry around in their own little patches being fiendishly busy and frantically trying to make money. There were very few people who were able to look outside that tunnel vision and see the big picture: to ask, “Does this make sense?” or “How does this create risks that added together could destabilise the system?” Banking had become a silo that was semi-detached from the rest of society.

The other thing that bankers are not trained to do is to ask hard questions about power structures and to take a very cynical attitude towards ideologies and rhetorics, with which an elite tend to cloak their activity. I was trained in a particular field of anthropology that was very heavily influenced by the work of a man called Pierre Bourdieu, a French anthropologist, who argued back in the 1970s that the way that any elite stays in power is not merely by controlling the means of production—the money—but by shaping the way that a society thinks: the intellectual discourse.

What really matters in that respect is not simply what is discussed in public but what is not discussed. In recent years, it was incredibly important that the financial industry and the political elite signed up to the view that deregulation was good and that we should let bankers get on with banking without asking too many difficult questions, because free markets would fix everything. It was equally important that, as bankers got on with their banking, very few people were looking closely at what they were doing—there were a lot of social silences. My key point is that neither bankers nor most people outside banking were aware of those social silences. Partly as a result of that, large parts of banking carried on unchecked for years, without people asking questions.

As Stephen Hester said, much of what happened—the terrible risks that were run and the crazy imbalances that existed—was not hidden by a deep plot that had been created by bankers but was, essentially, hidden in plain sight. The problem was that people did not ask the really obvious questions.

The Convener: Have the attitudes that you describe changed? Are bankers exhibiting, despite what has happened, the same behaviour patterns that they exhibited in the past?

Gillian Tett: Some aspects are changing. One welcome consequence of the crisis is that politicians such as you are now asking hard questions about bankers. As I said earlier, if there had been more questioning five years ago, we would not be in the mess we are in today. At the same time, some bankers recognise that they need to start engaging with society more broadly. It was striking that Stephen Hester commented that there needs to be less hubris and more engagement with society, and that banking is a mirror of society. Not many bankers would have used that kind of language five years ago, and that change is welcome. On the other hand, many people in the financial industry still think that they can go back to business as usual, or some element of it. If we have some sustainable recovery in the coming years, there will be a tremendous temptation for wider society to avert its gaze and to stop asking questions.

Rob Gibson: You were quoted by Will Hutton on the issue of bankers in the dock. There were quite a number in the dock in the 1980s and 1990s, but there has been no indication yet of people taking blame or being apportioned blame. Would you like to comment on that?

Gillian Tett: In a column a few weeks ago, I made the point that, in the aftermath of the savings and loans crisis in America in the late 1980s and early 1990s, not just hundreds but thousands of financiers were put in jail because they were found to have broken laws. It is striking that in the current crisis almost no one has suffered any kind of criminal penalty as a result of what has happened. On one level, that reflects the fact that much of the wrongdoing and many of the mistakes that occurred over the past decade or so were the result of bankers going to the edge of the law. Essentially, they were doing what is called regulatory or legal arbitrage—dancing around the rules, often by creating clever products. Often they were not breaking laws per se, but dancing around them.

It can be argued that they were breaking with the spirit of what constitutes safe and wise banking—I would argue that strongly—but I suspect that it will be tough to construct criminal cases against many financiers. There are probably some cases in which people can be shown to have broken the law. There are a number of areas in which bankers were knowingly negligent and took stupid risks in ways that may have involved breaking rules, committing fraud and being in dereliction of duty, but I imagine that such cases were in the minority.

That raises a broader question about the potential for growing political anger in the coming years. If no one is seen to have paid the price for what has happened, it will be hard to convince the public that justice has been done and that they should back a further rescue plan if, God forbid, another bank was to run into problems. There is a real political problem at the moment because of the lack of meaningful retribution.

12:00

Rob Gibson: Could the fact that the European Commission intends to create a regulatory framework for the single market in Europe begin to make up for the lack of a framework in Britain in the past and create a different climate that will enable us to avoid bankers "going to the edge", as you put it?

Gillian Tett: What the EU is doing to create a more unified approach to banking across Europe is in many ways to be welcomed. The crisis has exposed clearly the terrible paradox of having global capital markets at a time when we have national regulators, national Governments and, it could be argued, national politicians. There is a fundamental contradiction at the moment.

You asked whether the EU's actions will create a climate in which bankers are no longer allowed to do whatever they want without anyone else looking at what they are doing. In London, there is already a tremendous drive on the part of the British regulating authorities to rein things in. Whereas three or four years ago the dominant mantra was light-touch regulation, now groups such as the FSA are trying to micromanage and are getting involved. The pendulum has already swung in the other direction.

Rob Gibson: Do you think that the FSA in its current role is beginning to redress the balance enough to ensure that something like it can be retained as part of a tripartite arrangement in regulation?

Gillian Tett: The FSA is doing that, because it recognises that it has no choice. However, there is considerable uncertainty about the future of the wider regulatory structures in London. You asked whether there will be a sea change as a result of the EU's actions. What has happened in the past couple of years marks something of an intellectual break point. The type of extreme free-market ideology that pervaded so much of the Anglo-Saxon financial community and political world during the past couple of decades has been significantly discredited. We do not yet have a clear alternative vision for the future, but I do not think that anyone will return any time soon to extreme free-market orthodoxies as the way of running a banking system.

Rob Gibson: If that is the case and we are aiming to have a regulatory system that creates socially useful banking, will there be an acceptance that bankers must be taxed—for example, through a transaction or Tobin tax—to maintain Government's ability to pick up the pieces, if need be?

Gillian Tett: Earlier I made the point that there is a political economy problem, as most ordinary non-bankers think that there is a lack of justice. Fixing that problem will not be easy. I understand why people argue in favour of a Tobin tax or a tax on bankers. The problem that confronts a country such as the UK is that we live in integrated global capital markets. The level of meaningful change in the US does not appear to be significant; my judgment as a journalist is that, in many ways, the US appears to be losing its appetite for reform.

I do not think that the final scorecard on reform is complete yet. What has happened thus far is more akin to the starting whistle of a match being blown than the final scorecard. Much will depend on what happens in the wider economy in the next couple of years. If we have a recovery, pressure for meaningful reform will ebb; if we have a W-shaped recovery and things go pear shaped again, I suspect that there will be more clamour for a clampdown on Wall Street.

Consider where Congress is right now. Much of the reform initiative is getting bogged down in health care debates, for example. The key point is that if the US does not significantly reform—if it does not try to tax banks, break them up or take other similar measures—it will be jolly tough for the UK to press forward with radical change by itself because, if it does that, it will lose global share in the financial services industry because activity will go to the US. That is a nasty dilemma for the Government.

Rob Gibson: We are examining the matter from a Scottish perspective. We have a highly skilled workforce here, so should we be worried that the Government could be swayed against proper regulation in favour of activity that is not socially useful in order to let the industry flourish? Is that sustainable in the long run? We want socially useful banking, insurance and asset management;

we have the skills, abilities and personnel here. Should we be worried about a Government in London that gives in to the pressure of people being attracted to work elsewhere?

Gillian Tett: There is a challenge, which Stephen Hester articulated well. If you want banks such as RBS to pay back the taxpayer's money as quickly as possible, they have to get themselves into a vibrant business situation. The easiest way for them to do that in the short term is to go back to doing what they did previously, or something like it. That would allow us to get the taxpayer's money back. On one level, that is pretty attractive for the Government—a profitable banking system is desirable—but if there is a bigger case to be made for reshaping finance more generally for the long term, we would not want to go down that path. It is a difficult decision that needs to be made—more public debate about it is necessary. I guess that we want to try to steer a middle line—although that is my guess as a journalist, not as a politician. It is for people such as the committee to articulate how we will steer a course between those two different and somewhat contradictory goals.

Lewis Macdonald: It is useful to have the perspective of your knowledge and experience of the City of London and of New York. It would also be useful to have your perspective on particular features of the Scottish financial services sector. Is it significant that the banks that failed in Britain were based here or in Newcastle, not in the City of London? Did certain aspects of HBOS and the Royal Bank of Scotland make them particularly vulnerable to what happened? Do you have a view on the recovery process and how it might impact on banks that are based outwith the City of London?

Gillian Tett: Back in January 2007, I attended an awards dinner in the City of London. People were handing out gongs to the best investment banker of the year, the best equity derivatives house and so on. A big bunch of white-toothed American bankers picked up big awards and, in the middle of all this, suddenly someone from Northern Rock got up on stage to collect an award for being the most innovative corporate borrower. [*Laughter.*] Exactly—you could not make it up. He looked incredibly out of place, partly because he did not have white teeth and a permatan.

Seeing that, I had a really uncanny sense of déjà vu. Back in the late 1990s, I worked in Japan and covered the Japanese banking crisis. I saw regional banks from the sticks in Japan that were suddenly being vaunted and celebrated as masters of the universe with a little swarm of white-toothed American salesmen all around them stuffing them with products. For a period, they thought they were geniuses because—guess what—their balance sheets looked great. They thought they were riding high, but it ended up in disaster.

Back in January 2007, I remember being very alarmed, which prompted me to start looking very closely at Northern Rock. I wrote a big article of 2,000 words at the end of January 2007, using Northern Rock's story as a way of illustrating the dangers of securitisation. I had no idea that the article was going to be quite so prescient, but—hey!—you get lucky sometimes.

My key point is this. Among the factors that drove the Japanese banks to do what they did were naivety, insecurity and a desperate desire to catch up quickly on the global stage and to take short cuts. Similar factors were driving what happened at Northern Rock.

You can tell from my accent that I am not Scottish: I do not know the ins and outs of the Scottish financial sector. However, I argue that among the things that drove the Scottish banks to do what they did were—again—a sense of insecurity, a desire to catch up quickly and be big on the global stage, naivety, and the thrill of the glory of suddenly being Mr Big and of thinking that their balance sheets were going to be as big as the entire UK economy, when they were nobody a few years ago. That is a heady and toxic combination that is, as we now know, lethal.

Scotland has some long-standing areas of strength; it can, for example, be very proud of its asset management business. However, that business was built not in three or four years but by a lot of hard graft over many years. If there is one big message to take from the crisis, it is that there are not many short cuts: that people should value and take pride in prudent, slow and steady building.

Lewis Macdonald: That is very interesting. Last week, UKFI told us that an institutional bias for growth by acquisition rather than growth in value was the fundamental weakness—particularly of RBS—and what you have just said describes an anthropological or social version of that institutional bias.

Gillian Tett: I have one other anecdote that I find very funny that will put RBS's story into perspective.

After I worked in Japan, I wrote a book about a Japanese bank called Long-Term Credit Bank of Japan Ltd, which boomed dramatically in Japan's boom years, and then collapsed. LTCB bought a group called Greenwich Capital Markets Inc over in the States, and I interviewed Greenwich Capital in the early years of this decade, and asked what it was like being owned by the Japanese. They said that it was fantastic because the Japanese came with pots of cheap capital and, although they did not know much about what Greenwich Capital was doing, they said, "Here's all this cheap money; go and build a business," so they did. That business made a number of the Greenwich Capital traders pretty rich. Of course, things went horribly wrong because the Greenwich Capital traders made bets on really dumb things and LTCB went bust. Along the road, LTCB sold the bank to RBS. When I was talking to Greenwich Capital, I never thought to ask whether the whole game was being played all over again. Essentially, what went wrong with RBS was that it had a pot of cheap capital and all that money from domestic deposits that was being used to fund riskier business. As I say, the story is similar to what happened in Japan.

Lewis Macdonald: In terms of the way forward and the recovery of banks such as RBS and Lloyds, which has acquired HBOS and all its liabilities, what is your view of the prescription advanced by the EC of divesting certain businesses? What is your view of the Mervin King proposition of narrow banking? Is it about going back to something like the banks were before the mad rush for growth, or is it about, as Stephen Hester said this morning, a more rationally managed global business?

Gillian Tett: It is important to call a spade a spade. The global financial system badly needs a way to cope with big banks when they are going bust, and to let them go bust without potentially dragging down the entire financial system. We do not have that today—witness what happened with Lehman Brothers. The most intelligent way to deal with that is to create a kind of holding place for banks that are going bust: to put them in a box, aside from the system, and to wind them down or sell them off in a calm and rational way—a resolution mechanism. The US, for example, has that in the Federal Deposit Insurance Corporation. Over 100 small and medium-sized US banks have gone bust this year without pulling down the financial system or causing great convulsion. When they go bust, they get put into an FDIC mechanism—it is very well established and everyone knows roughly what is going to happen—and the creditors are dealt with calmly and it does not create chaos.

12:15

It is therefore blindingly obvious to me that we desperately need an international version of the FDIC—a mechanism whereby a big bank that is going to go bust can be dealt with, even across borders, and be closed, broken up or sold down without destabilising the whole system. However, the reality is that regulators are finding it completely impossible to agree on how to create that kind of international FDIC.

The problem right now is that we have lots of big banks but no way to deal with them if they go bust. Almost every possible solution to deal with that problem is a kind of second-best option. For example, we can try to build up capital buffers, as the regulators are trying to do right now, but that will not be fail-safe. We can try to break up the banks, which there is a strong case for doing, but if we try to do that in some countries but not others, we will lose national advantages. If America does not break up its banks, which it currently appears to be not minded to do, how can the UK then break up its banks dramatically? How can Switzerland and others do that? They could say, "Well, we don't really care if we end up not having the most effective banks on the world stage." However, that is a tough call for politicians to make.

Narrow banks can be created, which John Kay is calling for—I think some of you know him—and the view can be, "Well, okay, we'll create some super-safe banks which are basically just taking deposits and putting their money in gilts." That is one way to create fairly rock-solid banks—although I am not so sure how safe gilts are these days—but it raises lots of questions. Who is going to fund small businesses and mortgages? Are we going to push small business lending, which is often risky, into a kind of hinterland whereby only the casino banks fund small businesses? Is that what we want? A lot of questions are raised for which there are no easy answers.

As I said before, what is needed is an international FDIC. However, in the absence of that, we basically face an ugly contest rather than a beauty contest by trying to work out the least bad option from a number of pretty bad options.

Lewis Macdonald: It is a global problem, so a global solution is needed.

Gillian Tett: Unfortunately, it is.

Gavin Brown: I think that you came pretty close to touching on this, but I would like to see it on the record. In Scotland, we are obviously very upset about the things that have happened to Scottish banks, but there is a danger of looking internally too much and doing ourselves down. You can be more objective from the outside. Do you think that the reputation of the Scottish financial services industry has suffered more than that of the financial services industry across Europe and the rest of the world?

Gillian Tett: This is purely a journalistic answer. The great thing right now, if you like, is that everybody has suffered. Almost nobody has emerged with their reputation intact from the past few years, although perhaps the Australians and Canadians have done a bit better than most. However, as I said, nobody right now would put

Scotland in the same category as Iceland. It has certainly not done Scotland's reputation a lot of good, but if there was ever a good time to have your reputation go bad, it has probably been the past couple of years, if you see what I mean.

Gavin Brown: I take it that that is a personal view, but overall you do not think that we have suffered disproportionately.

Gillian Tett: I do not think so. To be really cynical about it, the Royal Bank of Scotland was really regarded as much as anything as a sort of British bank rather than just a Scottish bank per se. I would not have thought that Scotland should beat itself up indefinitely about it.

Gavin Brown: There are a couple of groups that seem to have got off lightly on reform and the level of scrutiny to which they are subject. The first is credit rating agencies, which rated stuff as triple A that in retrospect was clearly junk. The second is accountants and auditors, who pored through the books of the 50 banks or so across Europe that have gone bust—and you mentioned that 100 have gone bust in America just this year. Do you think that the spotlight should be put on both auditors and credit rating agencies, to identify the reforms that they need to make?

Gillian Tett: I do. If you draw up a list of the institutions that have been shown by the crisis to have failed in some way in the past decade or so, it would definitely include auditors, regulators, politicians and rating agencies, alongside bankers. There were shortcomings in many parts of the system. People tend to focus on the bankers because, of the many groups on that long list, they were the only ones to walk away with gazillion-dollar cheques. By and large, people who work for rating agencies are not paid huge sums of money, while auditors do well but not that well. Fundamentally, there was a structural and systemic problem, and I agree completely with Stephen Hester when he says that, on one level, banking is a mirror to the rest of society.

Gavin Brown: You have already been asked whether the same attitudinal factors that existed in the past exist today. Do you think that they will exist in the future? In your book "Fool's Gold", you talk about groups going to all sorts of locations purely to come up with new ideas, such as credit default swaps, collateralised debt obligations squared and special purpose vehicles. In large part, such ideas were intended to circumvent the Basel I rules and enable things to be taken off balance sheet. If Basel III comes into force, is there not a danger that, fairly soon afterwards, similar groups will emerge to spend all of their time trying to come up with mechanisms similar to CDS and CDO squared in order to circumvent it? If the attitudinal factors remain the same, will we not always be trying to catch up with such bright sparks?

Gillian Tett: That is absolutely true. Over the past century or so, almost every time that regulators or politicians have slapped a set of rules on the industry, a few years later bankers have tried to run rings around them. As they have done so, they have usually created distortions in the system that have in some way paved the way for the next crisis—almost every crisis has been created as a result of a reaction to a previous crisis.

We can do two things about that. First, we can sit and pray that collectively, as a society, all of us—even the bankers—will have a great moral conversion to doing good. That is pretty unlikely. The second option, which I mentioned earlier, is to do something about oversight.

The reality is that we live in a world of tremendous technological innovation. All around us—not just in finance—there is pressure for innovation to create profits. We also live in a world of tremendous complexity, in which change is speeding up in some ways. Not just in banking, but in many areas of life around us, we are creating little silos of activity and knowledge that only a few geeks understand—in medicine, engineering, the energy sector and finance. When those silos of technical knowledge—those empires of the geeks—develop, there is a tremendous tendency over and over again to say, "Gee whiz, it is all so complicated—just leave it to the geeks and technocrats."

In the case of finance, which I wrote about in "Fool's Gold", people said, "Just leave it to the weirdos who understand what CDO of ABS is—why should the rest of us care?" As far as the media is concerned, it often seems that the stuff is pretty boring and complicated, and it is assumed that readers will not buy newspapers if they write about it. We have learnt in banking that that is incredibly dangerous. If we leave silos in the hands of the silo geeks—the silo experts—they have a nasty habit of blowing us all up.

What is desperately needed these days is the ability to have a specific expert view to understand the silos and a general vision of how all the bits add up and create risks. That means that, in an ideal world, you need a lot of cultural translators—people who can look at what the geeks are doing in their energy, engineering, medical or banking silo and translate it for everyone else.

In reality, many of the bodies of civil society that are cultural translators are under huge threat right now. We do not have many people who are able to translate what is going on in their silo and explain it to everyone else, but we have to keep doing that work because innovation almost always has two sides to it. It is Manichean—I am just being a bit geeky—as it has a dark side and a good side. Look at nuclear energy, to which

Stephen Hester referred earlier. Basically, nuclear energy can be used to build civil power plants and deal with our energy problems or it can be used to blow us all up. Believe it or not, derivatives have beneficial uses—Scottish farmers can use them to hedge their currency exposure—but they can also blow us all up.

To my mind, the only way to cope with that silo problem is to have cultural translators. That is also why, at the risk of sounding sycophantic, I applaud what you are doing here today, because in a way you are trying to help that cultural translation, which is necessary.

Gavin Brown: One source of the crisis was global imbalance. Countries such as China and the oil-producing nations had lots of excess funds, while western countries were running deficits and were desperate for those funds. Is there not a danger that that global imbalance is exactly the same today, given that China is talking about 8 or 9 per cent growth, the price of oil is creeping up and western countries have deficits that are probably larger than ever before? Is there not a danger that we will end up in the same position?

Gillian Tett: There is certainly a danger that we have not seen the end of the financial shocks. For what it is worth, I do not think that we are going to have another crisis triggered by mortgage bonds. Lightning does not usually strike twice in exactly the same place.

As I said earlier, what tends to happen is that regulators, bankers, politicians and journalists end up fighting the last war. They are so busy worrying about trying to prevent yesterday’s problem that they miss the next one. There are huge imbalances in the world today, and it would be naive to imagine that they will work themselves out smoothly.

Ms Alexander: Tell us a bit more about the FDIC as the optimal solution. You said that the United States had an embryonic one that had operated for small banks. Why did that not prove helpful in the case of Lehman Brothers, Bear Stearns or AIG?

Gillian Tett: First, I am a journalist, not a US regulator, so you should take what I say with a pinch of salt. The FDIC is basically set up to cope with small to medium-sized banks—domestic banks. There is not really a resolution mechanism in place in the US right now to cope with the really big or cross-border banks. The Americans are creating that at the moment, and there is discussion in other countries, too, about trying to create it. One problem is that many banks these days are cross-border in nature. If you do not have an effective cross-border mechanism, what are you going to do in a crisis?

One problem that we discovered with Lehman Brothers, for example, was that it had a big operation in London. As many of you will know, at the last minute it transferred billions of dollars to the US. It was not really clear who owned that money, and that issue has been a complete nightmare in trying to wind down Lehman Brothers. That is not the only example. In the case of the European bank Fortis, several different Governments grabbed its assets at the same time and pledged them as collateral, partly because when it ran into problems it was not clear who owned it or how it would be wound down.

12:30

In an ideal world, if a big bank is running into problems, an attempt should be made to put it into a holding pen to ensure that its contracts are honoured so that the people on the other side of them do not need to panic; to ensure that there is clarity about how it will be dealt with so that everyone is not in a complete state of panic about what is going to happen next; to ensure that there is enough money to protect deposits or whatever; and to preserve as much value as possible and either wind the bank down or sell it off calmly and rationally.

Of course, that approach requires an up-front fund. The FDIC collects money up front, although it is ultimately backstopped by the US Treasury. However, that is another bone of contention, because it would be necessary to ask the banks to put money into an up-front fund.

Ms Alexander: You said that the public want justice, but one of our problems is that we lack a burning platform for change precisely because we have averted depression. If we consider the US experience in the previous century, the crash happened in 1929 and by 1933 the US had the Glass-Steagall Act. There was a period of mounting anger during which the consequences were seen to be so severe, so systemic and so real that there was a powerful head of steam for change, which resulted in the 1933 act.

We cannot say to people, “You don’t understand: you’ve just avoided depression because we took global action on a global basis.” Scotland is a prime example of that. The scale of the job losses is nothing compared with what it would have been without the global and domestic intervention that took place. How do we build a burning platform for change among the public?

Gillian Tett: It is going to be tough. The next couple of years will be truly fascinating in terms of political economy. It is genuinely not clear to me which way things will go.

I would guess that we will hear a lot more about bonuses in the next six months, because the banks will pay their staff big bonuses and that will hit the headlines in January or February, probably at a time when the unemployment rate is still increasing, fiscal stimulus measures are coming off and it is clear that the real economy is not going through a V-shaped recovery.

Another key point is that, although people say that taxpayers are footing the bill for what happened, they have not done that yet. The bill is yet to land on our collective doormat, in the sense that there has not been any fiscal tightening this year—on the contrary, there has been fiscal expansion. We will not see the bill for another few years, so there is a fair chance that voters will get angrier.

Ms Alexander: In "Fool's Gold", you talk presciently about the difficulties of self-regulation and techy solutions. The problem is the same as the problem with bankers getting together in New York in the early 1990s to figure out whether derivatives should remain shadow, be regulated or be subject to self-regulation. I had a sense of déjà vu about that today when we asked Stephen Hester, "What is the solution?" and he said, "It's nothing to do with size or area of activity; it's all about who bears the losses and in what order. The loss-absorbing instruments should be made to work." How do we coerce the tribe to co-operate in devising solutions that are not about self-regulation? Can we do that in isolation, or do we just have to hope that others will do the same?

Gillian Tett: Here is my intellectual conundrum. In an ideal world, it would probably be better to make the banks smaller and more diverse, simply because a more diverse ecosystem tends to be healthier. One problem is that, if all the banks are big and they all pursue the same strategy, they all tend to topple over if something goes wrong. It would be interesting for you guys to talk to Andy Haldane from the Bank of England, who—

The Convener: It certainly would. We are in a running battle with the Bank of England because we want it to come and talk to us.

Gillian Tett: Well, Andy Haldane wrote an interesting paper a little while ago that pointed out the similarities between the banking system and the Amazonian rainforest. If all the trees are highly evolved into one niche, the rainforest looks very pretty until something goes wrong and the trees all die—ditto with banking. A diversified, smaller system is good, but the big question right now is whether countries can create that if America does not play along. America is showing no sign of being willing to play along.

The cases in which there has been better risk management in the financial industry in the past few years have tended to occur in institutions in which there is some element of shared partnership rather than an extremely bureaucratic system. The problem with a bureaucratic system is that people assume that someone else is responsible, and there is not much communication between different parts of the system. This goes back to the silo problem that I was talking about earlier. Some of the banks that ran into big problems were set up as giant bureaucratic silos, and not only was there no communication between silos about problems, but there was a tremendous assumption that managing risk and being prudent was someone else's problem.

The banks that did better tended to have a much more collective attitude to and responsibility for risk. That was not always to do with size, but in reality it is often easier to have a shared partnership culture or collective attitude towards risk in smaller groups. I argue that, in some ways, regulators should encourage some of the riskier aspects of the financial system to move towards taking a more partnership-based, collective approach towards ownership, for example. At the very least, they should encourage the breaking down of silos and ensure that there is a culture of looking at risk holistically. People at the top should take collective responsibility and, above all else, recognise that their heads will be on the block if they screw up. That would incentivise people in the financial industry to act less stupidly.

I can see advantages to the arguments of people such as John Kay who advocate separating casino banking from utility banking. They say that casino banking should be run on a quasi hedge fund model whereby people share the risks and, if the hedge fund goes down, it dies and people move on. At least that would ensure that people had some incentive to watch carefully. However, if we want to create purely utility banks, what do we do about the risky parts such as commercial lending?

Ms Alexander: Is it possible to act on remuneration in isolation? Any domestic attempts to deal with it result in comments like, "You will make us uncompetitive—the business will go elsewhere and everyone will relocate."

Stephen Hester, impressive individual though he is, has been offered a remuneration package for this year of a potential £9.6 million. The salary element is only £1.2 million, and the rest is £2 million in non-cash bonuses and more than £6 million in deferred shares, but nevertheless that does not sound like suitable remuneration for the chief executive of a bank—84 per cent of which is state owned—that has made losses in the first three quarters of this year. It does not sound like a bank that has much partnership sharing of risk or that has shifted focus to the longer term.

That remuneration cannot be looked at because the new rules come in in January. Is that an appropriate contract? Will we continue to see more like it? Can we act on remuneration and performance in geographical isolation to induce some of the cultural changes that we want to see?

Gillian Tett: It is a huge, terrible dilemma. As a human being, I am appalled by the levels of remuneration in the financial sector in general. That is not purely because the situation offends any sense of social justice, but partly because it has allowed banking to suck up such a large proportion of resources in the economy as a whole, which has been bad for all concerned.

Again, it comes back to the fundamental challenge that the Government faces right now. Does it want to make banking profitable and vibrant in the short term to reclaim the taxpayer's money? If that is the case, there will have to be people in the banks who are good in their field, which requires their salaries to be internationally competitive. Do we want to reshape finance more generally in terms of its interaction with the rest of society for the long term? Do we want to get back our money quickly at the cost of simply reinforcing existing distortions? Do we want to take the more puritan route, if you like, and say that we have to try to reform for the long term and never mind if the taxpayer loses money?

Personally, I think that there is a middle ground to aim for, but it will be tough. There is a lot that can be done right now to tighten tax loopholes. There has been tremendous use of tax loopholes in the City of London in recent years. Something that makes my blood boil is that, when driving through Heathrow these days—or at least recently—we see big adverts that say that the Inland Revenue or the Government is looking out for benefit frauds, with a picture of some fairly poor person who looks like he is about to rush off to Spain and dare to claim his disability allowance when he should not. My feeling is, "Come on guys, get real." The Government should stop worrying about the small guys and start looking at the current scale of tax evasion or avoidance in the City of London. There is much that could be done there.

Purely from a pragmatic point of view, though, I suspect that we would probably get more tax out of the City of London and bankers from clarity and a simplified structure. From talking to bankers, I suspect that, if the tax rate was kept below 50 per cent but was fairly clear-cut, we might not get people rushing off to Switzerland. I suspect that there is something about the figure of 50 per cent that makes them all rush off to Switzerland. However, changing things will be very difficult.

Christopher Harvie: This is absolutely fascinating—it is a great seminar. I suppose that I am a retired cultural translator, because in my previous job in Germany I was the co-director of the international economics course in the University of Tübingen. I did the sort of humanistic bit, whereas the other people basically taught the students computerised dealing.

I examined a couple of students about a fortnight ago—I still go back, unpaid and at my own expense, to see my students through—and they were brilliant. However, one of them had spent a session as an intern in Frankfurt, while the other had gone out to India to work in new manufacturing. The cynicism of the person who had had the Frankfurt experience was dreadful—it was almost as if somebody had rutted them in a way; they were deeply ashamed at having been part of that system—whereas the one who had been in India was exhilarated by an experience that was also of capitalism but involved the setting-up of something new.

I asked both students whether they had read Adam Smith. They had not; their economics training had been so abstracted. However, Adam Smith is, in a sense, an economic anthropologist. If he is not, the other man from Kirkcaldy is: Adam Ferguson, who lived up the hill in Raith. Ferguson's view of society is very much an anthropological one.

The Convener: Chris, can you get to the point?

Christopher Harvie: Yes, my point is this. We have been talking about people exiting from the system with a lot of dough and heading for Switzerland or somewhere like that. Looking through the *Financial Times*, as I do every day, I find that that seems to be where people go. They do not remain part of the system, but make their pile and clear out. The classic case of that is Jon Hunt of Foxtons, who pocketed about £360 million for something that was possibly worth £20 million and zoomed off. The old Arnold Weinstocks would have hung around for 30 years, nurturing their firm.

Are we dealing with a type of behaviour that, in the rapidity of its financial transactions and the difficulty of regulation, approximates not to conventional economics but to the fourth sector, as Jeremy Rifkin calls it, which is organised crime? If we read Misha Glenny on McMafia, we get a narration from him about how all those marvellous liberation movements back in 1990 were led by poets, playwrights and cellists, but we realise that, second time round, they are led by gangsters, millionaires, oligarchs and former civil servants. In London, we have been deluged, directly or via places such as Dubai, with a vast amount of illegally acquired wealth. Can we have a system that obeys laws and submits to regulation when it has been invaded in that way?

12:45

Gillian Tett: There are two different issues in that. On the one hand, London has certainly been involved in dealing with a lot of money from the former Soviet Union that, in some cases, fulfils the definition of organised crime. That is what it is. That has been the case in recent years but, in fact, the number of Kazakh and Russian initial public offerings is probably rather lower these days.

I think that you are probably talking about whether western bankers have been engaged in organised crime per se. My definition of a criminal is someone who has broken the law, but much of the crazy behaviour in the financial world has not been a result of breaking laws; it has been about going to the edge of the law and dancing round it. The bankers had lawyers to advise them, and financial engineering was basically about dancing round the rules. We can say that the rules were dumb and we need to change them, but it was not organised crime as I define it.

Christopher Harvie: We could lob in a definition that comes from a Scottish-German book from 1975 by a lecturer in sociology in Glasgow called John Mack and a professor of criminology at Tübingen called Hans-Jürgen Kerner. The book is called "The Crime Industry", and it postulates that, with the growth of computers, tax havens and the general principles of globalisation, it will be impossible to distinguish between obedience—however dilatory—to the law, regulatory arbitrage and the sorts of things that Robert Maxwell got up to or the sorts of things that Russian oligarchs get up to. In other words, the whole area has become a grey zone in which it is almost impossible for the regulator to operate.

I will give one example of that. Graeme Pearson, who was the head of the Scottish Crime and Drug Enforcement Agency, said that, when we try to crack down on crime in Glasgow, it may take us six months to set up a conference of the heads of various forces to deal with it but the hoods can change their entire structure and command within a couple of hours. It seems to me that, in that rapidity of transaction, the two worlds seem dangerously close to each other—not in criminal intent but in methodology.

The Convener: That goes way outside the scope of the inquiry but if you want to comment, Gillian, you may.

Gillian Tett: I will say one thing about the career structure of bankers and the vision of them all going off at 35 or 40 to retire on the golf course for the rest of their lives. In an ideal world, it would be good to encourage the financial services sector to have more stability of employment. The fact that bankers have hopped between banks, particularly in the wholesale markets, has been a negative factor and has fuelled many aspects of the crazy behaviour in recent years. For many reasons, it would be desirable to create longer, more stable career trajectories.

If that is not possible—and it may not be possible or easy—one thing that we could do is to try to turn all the guys who retire wealthy at 40 or 50 into a new army of angel investors who could start financing and supporting new companies and entrepreneurial activity. I know a number of bankers who left the industry in their 30s, 40s or 50s. Usually they leave with pools of capital, the ability to take some risks and tremendous skills, which could usefully be employed back in society. Collectively, we should try to ensure that those skills are recycled and re-employed in a way that benefits people more broadly.

Stuart McMillan: Where do you expect the Scottish and UK banking sectors to be in five and 10 years' time, bearing in mind the European decision on Lloyds last week and the pending decision on RBS?

Gillian Tett: Banking will continue to be an important part of the British economy, but not such an important part as it has been in recent years. That is to be welcomed.

I hope that banking will steadily become more boring. At the end of the day, most banking business is utility business. People do not expect the water industry to make 25 per cent returns on equity each year and to grow at X per cent a year when the economy is growing at only 2 per cent. That does not make sense, and to a great extent it did not make sense in the financial sphere.

I hope that the UK can continue to play an important role on the international financial stage, as a good place to conduct foreign exchange trading and so on, because that is where some of its natural competitive strengths have been in recent years. It can continue to develop them.

Stuart McMillan: You spoke about banking becoming boring. If it does, surely there is a risk that regulators, politicians and others will take their eye off the ball once again.

Gillian Tett: Yes, there is. That is why cultural translators are so important and why I started by saying that, if five years ago more people in political circles had asked questions about what was happening, we would not be in the mess that we are in today. I hope that in five and 10 years' time you will still be conducting inquiries like this one.

The Convener: We may still be conducting this one. [*Laughter.*]

Stuart McMillan: Potentially.

My final question relates to yesterday's announcement that £62 billion was provided to Lloyds and RBS. What fallout will the release of that information into the public domain have in the rest of the banking sector and the financial industry?

Gillian Tett: Obviously, there will be more debate about Lloyds TSB's acquisition of HBOS. In retrospect, I think that it was pretty dumb to shove the two banks together in such a hurry, but it is easy to say that in retrospect, as those were panicky times. I imagine that there will also be much more debate about the need to create a more intelligent system for helping banks in times of crisis. Much of what has been done in the past two years has been ad hoc. There has not been a well-worked-out framework for how to deal with banks in crisis, either by creating a resolution mechanism or by providing liquidity support.

The Convener: That concludes questions.

I thank Gillian Tett for coming along today and providing a very interesting perspective on the crisis. Next week, oddly enough, we will hear from Archie Kane of Lloyds Banking Group, so we will be able to pass on to him Gillian's comments about the merger. We will also have a session with Lena Wilson and Crawford Gillies from Scottish Enterprise.

Meeting closed at 12:54.

Members who would like a printed copy of the *Official Report* to be forwarded to them should give notice at the Document Supply Centre.

Members who wish to suggest corrections for the archive edition should mark them clearly in the report and send it to the Official Report, Scottish Parliament, Edinburgh EH99 1SP.

The deadline for corrections to this edition is:

Monday 7 December 2009

PRICES AND SUBSCRIPTION RATES

OFFICIAL REPORT daily editions

Single copies: £5.00
Meetings of the Parliament annual subscriptions: £350.00

WRITTEN ANSWERS TO PARLIAMENTARY QUESTIONS weekly compilation

Single copies: £3.75
Annual subscriptions: £150.00

Published in Edinburgh by RR Donnelley and available from:

Blackwell's Bookshop

53 South Bridge
Edinburgh EH1 1YS
0131 622 8222

Blackwell's Bookshops:
243-244 High Holborn
London WC1 7DZ
Tel 020 7831 9501

All trade orders for Scottish Parliament documents should be placed through Blackwell's Edinburgh.

And through other good booksellers

Blackwell's Scottish Parliament Documentation Helpline may be able to assist with additional information on publications of or about the Scottish Parliament, their availability and cost:

Telephone orders and inquiries
0131 622 8283 or
0131 622 8258

Fax orders
0131 557 8149

E-mail orders, Subscriptions and standing orders
business.edinburgh@blackwell.co.uk

Scottish Parliament

All documents are available on the Scottish Parliament website at:

www.scottish.parliament.co.uk

For more information on the Parliament, or if you have an inquiry about information in languages other than English or in alternative formats (for example, Braille; large print or audio), please contact:

Public Information Service
The Scottish Parliament
Edinburgh EH99 1SP

Telephone: 0131 348 5000
Fòn: 0131 348 5395 (Gàidhlig)
Textphone users may contact us on **0800 092 7100**
We also welcome calls using the RNID Typetalk service.
Fax: 0131 348 5601
E-mail: sp.info@scottish.parliament.uk

We welcome written correspondence in any language.