ECONOMY, ENERGY AND TOURISM COMMITTEE

Wednesday 9 December 2009

Session 3

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ECONOMY, ENERGY AND TOURISM COMMITTEE
33rd 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:

Jon Pain (Financial Services Authority)
John Rendall (HSBC)

CLERK TO THE COMMITTEE

Stephen Imrie

SENIOR ASSISTANT CLERK

Katy Orr

ASSISTANT CLERK

Gail Grant

LOCATION

Committee Room 6

Scottish Parliament

Economy, Energy and Tourism Committee

Wednesday 9 December 2009

[THE CONVENER *opened the meeting at 10:32*]

Financial Services Inquiry

The Convener (Iain Smith): I welcome everyone to the 33rd meeting in 2009 of the Economy, Energy and Tourism Committee. We have one item on today's agenda, which is to continue with our banking and financial services inquiry. There are two panels today. Later on, we will hear from the Financial Services Authority. First, though, we have the pleasure of hearing from John Rendall, HSBC's chief executive officer in Scotland. I am pleased to welcome John to the meeting.

John Rendall (HSBC): On behalf of HSBC, I appreciate the chance to contribute to the committee's inquiry.

It might be helpful if I start by giving you a bit of background about HSBC in Scotland. The diversity of our business, operating as we do in 86 countries, with about 330,000 colleagues around the world, is of huge value to us. However, what is not universally known is that HSBC has strong Scottish roots. The bank that forms the foundation of what is today the Hong Kong and Shanghai Banking Corporation group was founded by an enterprising and internationally minded Aberdonian, one Thomas Sutherland, in 1865.

Likewise, the scale of HSBC's operations in Scotland is often underestimated. I have around 3,000 HSBC colleagues in Scotland. Aside from those based in our branches in Edinburgh, Glasgow, Perth, Inverness and Aberdeen, the corporate banking teams and the commercial banking teams, about 2,000 colleagues work in two of our major United Kingdom contact centres, which are based in Hamilton and Edinburgh Park. We also have a newer business at Edinburgh Park, our securities services operations. In 10 years, that has grown from what was basically a start-up business to one that employs 300 people. The Scottish operation has very much become the European hub for a globalised and highly successful business. In addition to customers of the HSBC brand, we also have many thousands of customers of our First Direct brand and—one of the most rapidly growing parts of our business here in Scotland—customers of our M&S Money business.

We are growing all parts of our business in Scotland and we are investing for continued growth in our business in Scotland. In the first half of this year alone, we increased our lending to businesses in Scotland by 32 per cent. We are just completing a £5 million investment in upgrading our Edinburgh Park contact centre and we are in the process of increasing the size of the team at that centre by around 10 per cent—about an additional 70 people.

We feel strongly that an important distinction needs to be drawn between the health of the market for financial services in Scotland and the health of the financial services institutions that operate in Scotland. As we head towards recovery, it is clear that a healthy and vibrantly competitive market for the supply of lending and other services to all parts of the Scottish economy is a vital enabler. Our contention is that the provenance of the market participants is less relevant than the maintenance of sufficient diversity on the supply side to ensure that healthy competition is maintained. My attention was first drawn to that issue by the committee's terms of reference, question 10 of which asks:

> "How can we ensure that the Scottish financial sector continues to retain a global perspective and does not retreat into a purely localised lending regime?"

We are very much focused on localised lending and on thereby enabling and supporting growth in the gross domestic product of the rest of Scotland.

We are competing vigorously for customers in Scotland. I am happy to report that, to date, we have not experienced any significant or recurring problems from a competition perspective from doing so. Perhaps our greatest challenge in seeking to continue the growth of our business here is simply communicating what makes us unique and different. Every time that a business commentator, journalist or politician slips into easy comments on the banks as a collective, the challenge of communicating what makes us different becomes slightly tougher. Likewise, the same happens every time that the health of the market becomes confused with the health of participants in the market.

I hope that those comments are helpful and I look forward to the committee's questions.

The Convener: Thank you for those interesting opening remarks. I am sure that members will explore a number of those issues.

Although the main focus of our inquiry is to look forward to the future of the financial services sector in Scotland, it might be useful to have your views on why HSBC seems to have emerged from the global banking crisis relatively unscathed or—this might be a better way of putting it—in better health than some other banks. Do you have any views on what went wrong with the major banks that are based here in Scotland?

John Rendall: I have only ever worked for HSBC—I joined Midland Bank, of which HSBC is the successor company, some 22 years ago—so it is impossible for me to comment on practices in other organisations.

In answer to the question why HSBC has shown resilience through what has been a very turbulent period, in a recent speech to a Merrill Lynch investors conference our group chief executive identified three factors: diversity, financial strength and management structure. First, we are deliberately highly diversified, both by customer group—we cover everything from retail banking and credit cards through to global banking and markets—and by geography. We view that diversity as a very valuable characteristic of our business in periods of turbulence.

Secondly, we have long held policies of commitment to capital strength and to maintaining high levels of liquidity. In April this year, we bolstered our equity capital to the sum of £12.5 billion. That was not from any Government investment but from our own shareholders, 97 per cent of whom subscribed to that process. At the end of the first half of the year, our tier 1 capital stood at 10.1 per cent, which is slightly above the end of the target range. We have always been committed to maintaining high levels of liquidity. Put simply, we do not lend money that customers have not deposited with us. That has allowed us to be far less constrained than many competitors by problems that have been experienced in the wholesale money markets. At the end of the first half of this year, the relationship between our advances to our customers and our deposits from our customers stood at just under 80 per cent.

Finally, how we are organised is important. The HSBC group consists of a holding company and, typically, separately incorporated local entities, and we have a very skilled and experienced management team. Members of the group management board, which is the executive team that is responsible for the day-to-day running of the group, have, on average, 28 years of experience in HSBC. That experience straddles different parts of the business and different geographies. That takes us back to the point about the diversity of our business.

The Convener: Will you expand on that? Are the risk-management structures well placed to meet the likely changes in regulatory regimes and the other corporate governance recommendations that are expected?

John Rendall: Our senior management is actively engaged in the discussions. We broadly support the direction of most of the major reviews that are under way, which we do not see as a threat to the way in which we manage risk in the business. We manage risk in a very structured way that has not changed during my career in the bank. The risk function exists independently of the business function, and, typically, the risk function and the business function join up only at the chief executive level. We have structured risk policies, processes and procedures.

There is consensus that the future of regulation must look different from its past. We are focused on two issues that relate to how the changes will proceed. First, all the regulatory changes should be considered in their totality and someone must take a view on the impact of each single change. We are concerned that, if things are introduced one after another independently, separately and too quickly, a risk will remain of choking off the credit supply that is necessary for the recovery of not just the Scottish and the United Kingdom economies, but the world economy. Secondly, there should be as much global co-ordination of the proposed changes as possible.

Lewis Macdonald (Aberdeen Central) (Lab): I am, of course, bound to be impressed by a bank that recognises the importance of Aberdeen in its origins and its future strategy. I welcome you on that ground alone.

I am particularly interested in exploring HSBC's wider perspectives on where we are now on the issues that we are addressing. In a speech in September, Stephen Green made interesting comments about the social usefulness or otherwise of banks in the wider society in which they operate and about how to return to proper or effective value in banking. Will you expand on his comments? They seem to chime more with commentary from outwith than within the sector.

John Rendall: I will do my best. In that and other speeches by the group chairman, there have been a number of consistent themes, one of which is a re-evaluation of the usefulness of relying entirely on market mechanisms. That was a key theme in the speech to which you refer. It is important to balance two points. First, we are clear that market mechanisms have so far proven to be the least worst alternative in innovating and providing services to marketplaces. Secondly, although some recent financial innovations look possibly harmful, many others have been advantageous and valuable to wider society.

The second theme that comes through is about a need to shift away from a short-term view of value and value creation—in the speech in September, the chairman highlighted the pressure that boards and managements have come under from investors, among others—and to refocus on the creation of longer-term value.

10:45

Lewis Macdonald: I have a couple of specific questions in that context. We have heard in evidence from several witnesses the proposition that there is or ought to be a distinction between the type of banking that is engaged in retail and working directly with customers and, on the other hand, what has been described as casino banking. What has your engagement been in those types of banking, and how do you see the situation in future?

John Rendall: We believe strongly that issues of values, culture, business model and risk management are more important than questions of size and structure, or at least as important as those questions. Looking at the banks that have encountered serious difficulties in the recent past, not just in the UK but throughout the world, it is not at all clear that some kind of separation between retail and investment banking would have served to prevent the problems that were encountered. In our business, we do both those things and there are important connections between the two. Arguably, it would be difficult for us to offer fixed-rate mortgages, for instance, to our personal customers without being able to access the hedging skills in our investment banking business.

Lewis Macdonald: So you think that making that distinction is either false or dangerous.

John Rendall: We believe that there are other aspects that are more important, and we question the practicality of the solutions that are proposed in that direction.

Lewis Macdonald: I guess that we are bound to ask you, in the context of wider discussions, how the different approach to values that Stephen Green has outlined and that you have described relates to remuneration, particularly in investment banking, in which bonuses across the sector tend to be very large. Is your practice different from that of other banks in that respect? What is your view of remuneration? Do you pay bonuses in cash or shares? Have bonuses been affected by the recent crisis?

John Rendall: Again, it is difficult for me to comment on other organisations' practice. We fully support the G20 principles. The fact that they are G20 principles for application throughout the world is helpful. We are ready to comply with the FSA code from 1 January in respect of 2009 processes. We have an important and powerful independent remuneration committee as part of our board structure and management process. We fully support proposals that enhance transparency. In some jurisdictions in the world, we are already ahead of the proposals in the UK. We are not in the practice of rewarding failure. We should find out what the near-term future might hold during the course of today, so we should wait for that.

Lewis Macdonald: That is helpful.

Rob Gibson (Highlands and Islands) (SNP): You gave us an idea of your vision for HSBC in Scotland and the business priorities. You mentioned personal banking. What markets will you target in the Scots economy as it recovers?

John Rendall: I am delighted to say that we are growing our business by winning customers in almost every part of the marketplace.

I will take business banking as an example. We are 100 per cent open to all types of Scottish businesses. We are sometimes perceived as being heavily or almost exclusively focused on businesses that have an international requirement, which I think is because we have been particularly successful in that area and can offer some different and unique services to businesses. However, we are interested in hearing from any business in Scotland that has a viable business plan and is interested in a banking relationship rather than a banking transaction, where we believe that we can generate a fair rate of return for ourselves.

We have a particular focus on certain areas . As Scotland moves into a recovery phase, its ability to support export-oriented business will be very important to the economy, and we can offer unique services in that area.

Rob Gibson: One of those export business areas is energy. Are you investing in Scottish energy companies?

John Rendall: We are doing two things right now in relation to energy. We have been able to provide a lot of support and help to the oil and gas sector, by virtue of the degree to which that industry is globalising, particularly—but not exclusively—out of the north-east of Scotland.

Since I returned to Scotland, less than six months ago, it has been clear to me that the level of interest in and prospects for the renewables sector are an important issue and I have commissioned some work specifically on that sector. We currently do not have a sufficiently clear policy or set of processes for the size and the nature of that opportunity, but we are working on it.

Rob Gibson: I will read you a quote from an article from the energy section of Monday's edition of *The Press and Journal*, written by the section editor, Jeremy Cresswell. He said:

> "I have been accosted time and again by oil&gas supply-chain bosses, plus a scattering of North Sea minnows, about the lack of liquidity. Two bank brands have popped up monotonously in such conversations—RBS and Bank of Scotland—and the manner in which they have clammed up

on lending, even to apparently solid companies with a reputation for financial probity."

How do you respond to that?

John Rendall: It illustrates a point that I made in my opening statement: we still have a lot of work to do to communicate our enthusiasm, commitment, interest and capabilities in the marketplace. Frankly, I am surprised to hear those comments—we have been involved in the majority of the major transactions in the oil and gas sector in the Aberdeen marketplace this year.

Rob Gibson: Are you saying that that charge does not apply to HSBC?

John Rendall: It definitely does not.

Rob Gibson: It appears from that quote that people in well-established businesses are finding difficulty in getting liquidity. How soon will you be able to help the recovery of the Scottish economy if, as you said in your remarks about renewables, you are doing only scoping work at present?

John Rendall: We are helping that recovery day in, day out, right now. The piece of work that I mentioned is very specific—the renewables opportunity is complex and important and it is important that we take steps to address it. That does not mean that we are not engaging with businesses in that sector right now.

With regard to the broader question of support for Scottish businesses, I go back to one of the points that I made in my opening statement. In the first half of this year alone, we increased our lending to businesses in Scotland by 32 per cent, in a very tough climate. That is powerful evidence of our support, and of our commitment to that support.

Rob Gibson: Is energy viewed as a high-risk investment in Scotland? Is it the type of thing that a normal commercial bank gets involved in?

John Rendall: Yes, for us.

Rob Gibson: Would you get involved to a greater degree than you have been at present? It has been suggested that risk averseness at this time is one of the things that is holding back the economic recovery.

John Rendall: In the past 12 months, the fastest-growing part of our business banking in Scotland has been the work that is done through our Aberdeen-based teams. That work is substantially around the oil and gas services sector, and involves supporting businesses in Aberdeen and the north east, and the ambitions of those businesses to take their business models all over the world.

Ms Wendy Alexander (Paisley North) (Lab): Obviously the competitive landscape in Scotland has changed significantly in the past year, and you have touched on the opportunities for HSBC. When it was waving through the HBOS merger, the Competition Commission pointed to an absence of competition in the personal account, mortgage and small business lending markets in Scotland. Are there any structural impediments in any of those markets to HSBC growing its business here? Do you have competitive concerns that should be on our agenda?

John Rendall: I have not come across any such concerns. I refer to my earlier comments. The challenge is partly ours, and it is simply to communicate day in, day out our ambitions for growth in Scotland, the fact that we are in a different place from some other organisations and that we offer some different and unique services. That is made tough when all banks are aggregated and statements are made that apply to all banks. For example, the statement is made that all banks have stopped lending, but all banks have not; we are continuing to lend and, if anything, the growth in our lending is accelerating.

Ms Alexander: You talked about the desire to build business relationships, which raises the issue of how easy or difficult it is for small business customers to switch suppliers, particularly in periods of difficulty. Can I press you to say whether there are any impediments to easily switching supplier and whether we should be looking at any issues? Certainly, a number of small businesses feel that there are issues around access to credit, but that switching supplier is particularly difficult.

John Rendall: There is a set of industry-wide procedures, tools, mechanisms and processes in place that are designed to ease the switching process. It is inevitable that the more complex a business is—if it has performance guarantees issued in various countries, or if it has entered into forward exchange contracts to hedge its currency risks—the more complex the process of switching becomes. However, we are not sitting in meetings expressing our frustration about our experience of working with other banks to achieve the switches that customers have identified that they want to make. Customers might well perceive that there is an issue, and if customers perceive switching to be difficult that is in many ways far more important than the reality.

Ms Alexander: Can I press you to be a little more concrete about the nature of the banking opportunity for HSBC in Scotland? What size and shape do you envisage for HSBC in Scotland in five years' time?

John Rendall: In five years' time, I believe—I am trying to decide whether I should say "hope" or "believe"—

Ms Alexander: You will have a market share target. Share it with us.

John Rendall: I genuinely do not have a market share target.

Ms Alexander: Aw.

John Rendall: I believe that, in five years' time, our business will be at least two to three times larger than it is today. Our business will continue to have a strong bias towards business and personal customers who have international dimensions to their requirements.

Ms Alexander: What percentage share of the business market in Scotland does HSBC have at the moment?

John Rendall: It is modest and it depends on how that market is defined. Some of the research evidence on small businesses shows that our market share could be as small as 2 per cent. Our share in mid-corporate businesses is fundamentally harder to determine, but it is somewhere between 5 and 10 per cent. In all cases, the share is growing and the rate of growth is accelerating.

Ms Alexander: Do you envisage that HSBC's growth by two or three times will be organic or by acquisition? Do you envisage HSBC being a prospective buyer of any of the assets that the Royal Bank of Scotland and Lloyds Banking Group are likely to have to dispose of as a result of the state aid ruling? Setting aside whether you would have the right to bid, would you be interested in acquiring any of those assets, were it possible to do so?

11:00

John Rendall: I am afraid that we have a long-standing worldwide policy of not commenting on hypothetical scenarios of that type. I apologise, but I will decline the opportunity to comment. We are extremely focused on growing the size of our business strongly and sustainably and doing so organically. I am clear that we can accelerate our growth rates and look forward to doing so.

Ms Alexander: Forgive me for pressing you slightly, but you have not said no. For example, Tesco Personal Finance has said that it is uninterested in acquiring any assets on the high street in Scotland. I understand that you do not want to comment, but you will appreciate that we read from that that you might be interested in acquiring some of the RBS and Lloyds Banking Group assets. Tesco has ruled it out, but I do not hear you ruling it out, so I give you the opportunity to do so.

John Rendall: You will appreciate that, given the size of our operation, if we started to comment on each structural possibility in every country, we would probably do little else.

The Convener: I will ask the question a different way round: will you comment not on whether you would bid, but on whether you are aware of any impediments in the European Union ruling that would prevent you from bidding for any of the assets?

John Rendall: We are fully respectful of the role and objectives of all the various regulatory authorities. It appears that the current intention is to restrict the ability of existing participants to compete for those assets in some cases. However, it is an emerging situation and the discussion is highly hypothetical.

The Convener: I appreciate that. The reason that I pressed you on the question is that we have had some evidence that suggests that there may be some difficulty in divesting the Lloyds TSB branch network in Scotland because of its size and nature. We are trying to find out where any interest in that network might come from.

Gavin Brown (Lothians) (Con): I will focus on lending to businesses, particularly small and medium-sized enterprises, because the committee gets a lot of correspondence on that, particularly from smaller businesses. You said a couple of minutes ago that you had increased lending to business in Scotland by 32 per cent in the first half of the year—I think that I have got that right. Do you have a breakdown of how much you increased lending to SMEs against the increase for what you described as mid-corporates?

John Rendall: I do not. I cannot give you a precise figure for that. Partly because of the success of our business in the north-east, the rate of growth among our mid-market customers for the past 12 months and for the past six months has been faster than that among our small-business customers. I will be interested to see how that looks when we produce the results for the second half of the year.

Gavin Brown: So that figure is split between the two. You think on balance that it would be weighted towards the mid-corporates, but you do not have specific figures just now.

John Rendall: That is correct.

Gavin Brown: My next question is slightly hypothetical. We are still in the second half of the year and there is still the best part of a month to go, but do you hope to see a similar percentage increase in the second half of the year, or is it impossible for you to say at the moment?

John Rendall: There are issues of arithmetic with that. To be honest, I have not sat down and looked in detail at the figures. At the moment, I find the level of our work in progress on new customer acquisition most encouraging day to day. That work does not always relate to lending, but I can confidently say that the number of new customer cases with which our commercial banking side is dealing has never been higher. If anything, the level of interest and referrals that we receive is increasing such that we are increasing the resources in that part of the business to try to ensure that we are capable of delivering and coping with that growth.

Gavin Brown: You said very clearly on the record that you are 100 per cent open for business. I get the impression that you are saying that, although people might have a certain perception of the type of businesses that you have worked with in the past, you are open for any kind of business.

John Rendall: Yes.

Gavin Brown: Is HSBC doing specific things to target, educate and advise SMEs?

John Rendall: A couple of things are going on at the moment. The first involves simply trying to talk to anybody who is willing to listen. We want to be as visible as possible and as engaged as possible with the professions that advise businesses and with the representative organisations that speak for businesses.

The second relates to what the convener said a moment ago. In the past month, we have been focused on making a contribution to the conversation around the kind of financial support that is going to be required in order to sustain recovery. In most recessions, there tend to be more problems with business insolvencies and bankruptcies during the recovery phase than during the recession itself because businesses start to receive orders and suddenly find themselves under fairly severe working-capital constraints.

The findings in our recent report on the matter—which I took the liberty of circulating to the committee—give us cause for concern. Although 32 per cent of the growth businesses in the sample that the report used said that they believed that accessing finance was going to be an important element in their ability to achieve their growth plans, only 15 per cent were actually able to access finance. We are concerned that there is a slowness about the shift from the defensive, recessionary mindset to a more opportunity-minded, recovery mindset. We are trying to encourage a debate around that. As you might have seen, we have placed advertisements in various Scottish newspapers to encourage people to access the report, consider its findings and contact us if they believe that we can assist them.

Gavin Brown: You have given us an indication of percentage increases. The other question that small businesses always ask this committee concerns the terms of credit and finance. Some banks might be saying yes as often as before, but the terms might be significantly different from those that were offered two or three years ago. That might be justified, in some cases.

I know that this is quite a broad question but, in general, how have your terms of finance and credit to businesses changed from, say, three years ago?

John Rendall: There has been no fundamental change in our processes or models. There has clearly been a change in the price of risk over the past two years. In the past, markets were awash with liquidity, which meant that the price of risk was low. That has changed fundamentally. Now, when we sit down with customers to renew facilities that were agreed two or three years ago, the models that we use to determine prices will often indicate a higher price than would have been the case previously. We find that the majority of businesses understand that. The biggest difference for us is simply the way in which we deal with that and communicate with the customers.

In December last year, when we saw the full scale of the economic crisis, we put in place a $5 billion fund—I think that that figure is correct—to support SMEs across the world. In the UK, that took the form of a £1 billion fund to provide new facilities to new SME customers. After half a year, we had got through half that £1 billion—we had lent £493 million to customers by the end of June. However, a different set of customers had repaid us more or less the same amount.

One of the interesting indicators on access to finance is the level of utilisation of facilities that are in place. Someone might have an overdraft limit, but how much of it is being used? At the half year, we had seen only a very slight increase, from 48 per cent typically being used to 50 per cent typically being used. At the moment, there is a balance between the demand for finance and the supply of finance.

The Convener: You say that you are open for business to everyone, but, from a banking risk point of view, are there any sectors that you are less likely to support than others, or which you are less likely to support than you might have been a year or two ago?

John Rendall: We decline to support some sectors for wider policy reasons. We have a long-standing policy—it has been in place for more than 10 years—of not supporting defence-related activities. Likewise, for a number of years, we have been careful about providing support for businesses where we perceive there to be important environmental impacts or risks. None of those policies has changed as a consequence of the events of the past couple of years. There are sectors that we would be extremely careful about supporting today, such as the property sector. A proposal for a speculative property development would be fairly unlikely to attract support, for obvious reasons.

The Convener: Would it be fair to suggest that construction, commercial property and tourism are some of the sectors in which you would be reluctant to invest at the moment?

John Rendall: I am not aware of any specific policy that we should be cautious about tourism. I said earlier that we manage risk in a structured fashion. Typically, we are updated once a quarter on sectors where we see opportunity, and one sector in which we have been successful and in which we see further opportunities for growth is food and drink. On the other hand, we are also updated on sectors where we perceive reasons to be cautious. However, we will almost always have good customers with whom we have long-standing relationships even in sectors that we perceive to be risky.

Marilyn Livingstone (Kirkcaldy) (Lab): I want to ask about the extent of your restructuring. You said that, in the second phase of its plans, HSBC announced a further 1,700 job losses out of 50,000 jobs in operations in the UK. How many of those job losses will affect Scotland?

John Rendall: At the end of October or early in November, we announced further changes in our organisational structure specifically around taking layers out of parts of our personal banking business and concentrating some of our service support operations in a number of centres. The impact on Scotland has been almost zero. I believe that only one or two people are affected. On the contrary, we are growing the number of people in our business in Scotland. Right now, we are looking to recruit an extra 70 people in our contact centre at Edinburgh Park.

Marilyn Livingstone: You are saying that there was very little impact on Scotland in phase 2. What about in phase 1? Obviously, if there was a phase 2, there must have been a phase 1. What was the number of redundancies in phase 1? What was the impact?

John Rendall: To be honest, I will have to check that. I am not aware of any significant impact at all. The phase 1 changes took place before I returned to Scotland to take up my role, but I am happy to check that for you.

Marilyn Livingstone: It would be good if you could let us know.

What were your working relationships with the trade unions during the process?

John Rendall: We have a healthy and open dialogue with unions and internal representative organisations.

Marilyn Livingstone: You said that there will be perhaps 70 call centre jobs in Scotland. Do you envisage any other areas of growth in HSBC in Scotland?

11:15

John Rendall: On the contact centre roles, our contact centre at Edinburgh Park does our highest-value contact centre work in the UK. It looks after our highest-value customers, offering them a remote relationship management service. We find that customers are increasingly happy to talk to us on the phone or via e-mail, instead of coming into branches.

We are growing elsewhere, but it is an organic process. We are looking for a number of people in our commercial banking business at the moment, and we made an appointment in our corporate banking business last week. Month in, month out, there is incremental growth across the whole of the business.

Marilyn Livingstone: I would be grateful if you could let us know in writing what happened in phase 1.

John Rendall: I will do that.

Christopher Harvie (Mid Scotland and Fife) (SNP): Stalin famously asked how many divisions the Pope had. It is rather reassuring to find a major bank that is run by a clergyman.

A couple of things have popped up in relation to the background to the moral principle. You have had considerable growth in Scotland. How much of that has been due not just to the Scottish banks' problems but to the withdrawal of foreign banks from lending in Britain? If it is more to do with the latter, where are the banks in question based?

John Rendall: I would need to double-check this to be absolutely confident, but the vast majority of, if not all, the customers that we have acquired during the time that I have been here have come from UK banks—predominantly, but not always, Scottish banks.

Christopher Harvie: I note the opposition of your bank to investment in the defence industries. I found that heartening, although it might pose problems. What would be your attitude to any approaches from BAE, which is now our only major shipbuilder?

John Rendall: We would be happy to explore discussions about such relationships. The policy is a global one, with a clear process. I have personal experience of establishing very early on in a conversation whether we believe that a particular proposal for a particular customer is on one side or the other of the lines that are drawn in the policy.

Christopher Harvie: It is easy to see where BAE's priorities lie: it does not have a single civil shipbuilding contract in Scotland. There are problems there.

John Kay, adviser to the First Minister in the Council of Economic Advisers, has spoken about the utility of narrow banks. One major area of Scottish finance will involve loans and financial arrangements for householders to make their houses as carbon neutral as possible, and money will have to be made available for very large-scale schemes for the generation of power from renewable resources. Would that be better done by two types of banking organisation: a sophisticated mortgage provider, possibly a mutual, handling housing; and an international finance bank that, like your bank, can have links with the Chinese, for example, and the technology and expertise that are available there? Alternatively, would it be better to use the universal banking model, bearing in mind what we have been through with that model?

John Rendall: In a quiet and typically understated fashion, we would hold ourselves up as evidence that a universal banking model can be operated safely, profitably and successfully.

As I said, we feel strongly and passionately that the diversity of our activities, by sector and by geography, is an important contributor not just to the resilience that we have demonstrated during the past two years but to our being in a position in which we can take advantage of and contribute to growth opportunities as we move into recovery.

Christopher Harvie: Do you envisage a revitalised mutual sector, such as was found in the TSB and mutual building societies, being a component of the financial system?

John Rendall: We regard some of the mutual organisations as important participants in many of the markets in which we operate. We hold many of those organisations in some regard, given our experience of competing with them and our knowledge of them. However, it is not for us to seek to dictate the future shape of the system.

Christopher Harvie: But the balance that is provided by the presence of mutual sector organisations is part of your idea of diversity.

John Rendall: Perhaps, yes.

Stuart McMillan (West of Scotland) (SNP): In relation to personal finance and commercial banking, does HSBC have particular hot spots and locations for organic growth in Scotland?

John Rendall: In the context of commercial banking we have seen the fastest rate of growth in the north-east, where growth has principally been driven by the growth in our relationships with globalising businesses in the oil and gas sector. However, that is far from being a unique focus for us. We are interested in hearing from any business in any sector throughout Scotland. We are seeing business in all parts of the country.

Stuart McMillan: What about personal finance?

John Rendall: Likewise; we are seeing growth in the newer locations in which we operate. Our two newest branches are the branch in Perth, which we opened two and a half years ago, and the branch in Inverness, which we opened in July last year. They are growing strongly, and our branches in Aberdeen, Edinburgh and Glasgow continue to experience comparable growth rates.

Stuart McMillan: In October 2007, HSBC received £750 million from its far-east operations, to help with its liquidity situation. Did HSBC contact the Treasury or the Bank of England to seek capital at that time or subsequently? Nothing of that nature has been reported in the media.

John Rendall: I am not familiar with the October 2007 transaction, I am afraid, but I would be happy to clarify that for the committee.

I am very clear about the more recent history. We have not sought direct support from the Government of any country in which we operate. On the contrary, we took the view that the first quarter of this year was the appropriate time to request support from our shareholders, to bolster our capital base and position us well for the recovery. We are delighted that 97 per cent of shareholders chose to subscribe.

Rob Gibson: Your chairman made a speech in Frankfurt in which he talked about

"clearer codification of directors' responsibilities".

Should bankers be personally liable for debts that are run up and insolvencies that occur? Should such liability be extended to include criminal liability?

John Rendall: I am not sure that that would be practical or fundamentally helpful. We operate our business in a very structured fashion. Our board of directors is heavily biased towards non-executive roles. Our group board consists of an executive chairman, five executive directors and 15 non-executive directors. The two most important committees of that board are the one that deals with audit issues, including risk management issues, and the one that deals with remuneration. We have a diverse board of directors from a wide range of backgrounds, and they are encouraged to seek information from whichever area in the business they want to take an active interest in.

We subject our board processes to external scrutiny to ensure the health of those processes and that they are up to date and up to the mark.

We are moving into an economic situation in which perhaps the single most important objective for us is willingness to provide support to enable what looks like a tough economic recovery. I would be extremely concerned if I felt that the lending managers in my team in Scotland were, in every situation, wondering whether they were putting their personal wealth and wellbeing on the line. A measure of that type is more likely to hinder progress than to support it.

Rob Gibson: You are HSBC's man in Scotland. In the United States recently, HSBC bought HFC, which is involved in a lot of sub-prime, and 6,000 jobs were lost. We know that personal liability is a legal issue in the USA. Have any people in that sector been charged with anything as a result?

John Rendall: Not to my knowledge, although if that has happened, I might not necessarily be aware of it. However, I am happy to check.

Rob Gibson: Personal liability is a legal issue in the USA, but you are saying that it should not be. Is it a legal issue in any other part of the world outside Europe?

John Rendall: With respect, I would have to check the rules in all 86 countries in which we operate. In answering your initial question, I was seeking to put the issue into the context of willingness to provide support, and whether moves to broaden personal liability would be likely to support that or to hinder it.

Lewis Macdonald: In response to an earlier question, you said that throughout the world, HSBC was, in many respects, ahead of the regulatory reform curve, so to speak. How true is that in relation to the UK and in Scotland? In other words, should we be aware of any changes that you are in the process of making, or which you envisage making, other than those in the remuneration area, which we touched on earlier?

John Rendall: The key focus at the moment and in the recent past has been on taking all the steps that we need to take to ensure that we are compliant with the new FSA requirements that come into force on 1 January. I am not aware of anything UK-specific beyond that.

The Convener: I will finish this session by pressing you a little more on the bonus issue, which is especially topical today. If you do not know the answer, you can perhaps provide it in writing. What percentage of profits from HSBC's investment activities is made available to the bankers as bonuses?

John Rendall: You are right—I do not know the answer to that question but I am happy to try to clarify the situation.

The Convener: Are the bonuses predominantly cash bonuses, share bonuses or a combination of both?

John Rendall: Bonuses involving either shares directly or share options have always been an important part of the remuneration structure for as long as I have been with HSBC. Over time, the balance between those has changed—I apologise that, again, I probably need to seek specific clarification of that—but, in my experience, that approach has always been an important part of the remuneration model.

The Convener: Chris Harvie has a final, brief question.

Christopher Harvie: I seek clarification on just one point. We have been terribly influenced by Alan Greenspan's phrase "irrational exuberance", but is the pursuit of very big bonuses—and then clearing off to an island in the Caribbean with a yacht and that sort of thing—irrational at all? Such behaviour seems to me to be utterly logical if things are based on volume rather than on net worth. By and large, has HSBC been free of that particular charge?

John Rendall: It is difficult to be confident and absolute about that. Such things sit less comfortably within the culture of our organisation than within others.

Looking forward—and at the risk of paraphrasing our group chairman—I think that the matter requires a number of components, including encouraging a longer-term view of value creation not just on the part of management teams and boards of directors but among investors and analysts. In addition, yes, we need to align remuneration models with that longer-term view.

The Convener: That concludes our questions, so I thank John Rendall not only for taking the time to attend today but for being so open where possible and for being willing to provide us with further written information on the questions to which he did not know the answers. We look forward to receiving that information.

I suspend the meeting for five minutes while the witnesses change over.

11:31

Meeting suspended.

11:36

On resuming—

The Convener: For our second panel, I am pleased to welcome Jon Pain, managing director of supervision at the Financial Services Authority, which is the independent body that co-regulates the financial services industry in the United Kingdom. I ask Mr Pain whether he wishes to make any brief opening remarks.

Jon Pain (Financial Services Authority): As you said, the FSA is an independent non-governmental body that was given statutory powers by the Financial Services and Markets Act 2000. We are accountable to UK Treasury ministers and, through them, to the Westminster Parliament. We operate independently of Government and we are funded entirely by the firms that we regulate. We do not have an objective to promote the financial services sector either generally or specifically in one region or country. As you pointed out, we act as a national regulator for the UK as a whole and we do not regulate specifically in any particular country or region.

About 1,300 firms in Scotland are under our supervision. We recognise Scotland's importance to the financial services sector and note the recent report from Scottish Financial Enterprise stating that the Scottish financial services industry counts for more than 7 per cent of Scottish gross domestic product and employs 100,000 people directly and more than 100,000 indirectly in support services that are related to the industry. As members are probably aware, we have an office in Scotland, with some 60 people working there. That provides visibility for the FSA in Scotland. The staff in Edinburgh work primarily on supervising small retail firms throughout the country, including Scotland. Mostly, those are in the home finance broker markets and the general insurance broker markets. The staff also supervise independent financial advisers.

It might be helpful if I mention briefly the FSA's current focus. Obviously, we are still managing the consequences of the financial crisis. We are modernising our supervisory practice and laying out proposals for changes in the global regulatory architecture, as we set out in the Turner report earlier this year. We have been embedding our intensive supervision model in our day-to-day work, changing the style and impact of our supervision and the overall philosophy of supervision. We have commenced and completed a substantial hiring of additional resources into the FSA. We have also put in place new liquidity rules to ensure that banks can raise funds more quickly in tough economic conditions with low market confidence.

We have published our remuneration code, which was referred to in the committee's previous meeting, which requires large banks and others in the UK to establish, implement and maintain remuneration policies that are consistent with effective risk management. We have also recently issued plans to interview significant individuals in firms and their holding companies.

In a wider context, we have published our mortgage market review, which is an in-depth analysis of the mortgage market and what lessons we can learn for it from the crisis. That is currently out for consultation, with the process finishing in January next year.

As I mentioned, our Turner review has set out a comprehensive analysis of what went wrong in the crisis and made a number of recommendations that we think need to be addressed to strengthen the regulatory regime and the capital and liquidity regime in an international dimension.

The Convener: Thank you for those opening remarks. We particularly welcome the willingness of the Financial Services Authority to come and give evidence to this Scottish Parliament committee, which is in stark contrast to the Bank of England, which is another regulatory authority that we would like to come before the inquiry. Thank you for coming this morning.

Could you outline in a bit more detail the areas in which UK legislative reform and issues coming from Europe and international regulators will impact on how the FSA regulates the banks?

Jon Pain: As the Turner report sets out fairly comprehensively, work is being done on the capital and the capital structures of banks to look at the adequacy and definition of capital. That work is being undertaken on a global basis, and the Basel regime is likely to make recommendations later in 2010 about how the capital regime should be strengthened. We have also issued a policy on liquidity, and that liquidity regime is likely to be adopted across Europe. It will strengthen the quality and quantum of liquidity in the banking system.

Of course, we have also looked at strengthening the governance regime following the Walker report. The strengthening of influencing individuals in banks, the interviewing of individuals in banks, and the expectations of the qualifications of those individuals are all part of the regime that we have laid out.

Finally, changes in the European regulatory bodies were announced this week and will take effect by the end of next year. A European financial stability board will be formed, and three regulatory bodies will replace the three level III committees that exist in Europe at the moment.

The Convener: One of the comments that have been made about the FSA's role is that it perhaps spends too much time supervising and not enough time regulating. You mentioned that your Scottish operation has 60 staff who are largely involved in supervising relatively small financial service companies. What level of resource do you give to the regulatory function in Scotland, particularly in relation to some of the large financial institutions that are based here, to ensure that you provide adequate skilled staff and specialisms to provide adequate regulation of those bodies?

Jon Pain: We carry out regulation of firms on a UK-wide basis, so the office that we have in Scotland is a representative office and just a subset of our overall supervisory resource. I have in the region of 1,200 people in my team for supervision. The FSA's resources have grown 30-odd per cent since 2007 to just more than 3,000 staff in total. Our model is to use the direct supervision resources in my team, along with an array of dedicated risk specialists, actuaries and credit analysts in conjunction with those supervisory resources when we look at a firm. Post-Northern Rock, there has been a substantial increase in the amount of resources dedicated to individual firms of a particular size, particularly in the banking sector. We substantially increased the amount of resource that is dedicated to the larger banks in the UK during that period.

The Convener: Are any of those staff based in Scotland?

Jon Pain: No, because we regulate some of the firms that are based in Scotland on a national and global basis. The teams for that are based in the division in London. We regulate both the UK and global operations of those firms.

11:45

Lewis Macdonald: Like the convener, I am very pleased that you have agreed to give evidence to our inquiry.

I am struck by the fact that although many features of Lord Turner's analysis of the causes of the situation that we are in—for example, the underestimation of risk, global imbalances and so on—have been echoed by other witnesses, there has been no specific comment about failures in regulation or by regulators. Have you, with the benefit of hindsight, taken a view on the FSA's performance in relation to HBOS, RBS and the Dunfermline Building Society? Do you think that your supervision of those aspects of their work for which you had supervisory and regulatory responsibility was inadequate?

Jon Pain: We have on numerous occasions owned up to the FSA's regulatory failures, particularly post-Northern Rock, and our chairman has pointed out that the regulatory environment and the expectations of the regulator have changed substantially since what happened to Northern Rock in 2007. The regulatory philosophy pre-2007 was fundamentally different from what it is today; indeed, in my opening remarks, I mentioned that we have used our increased resources to increase the intensity and intrusiveness of our supervision. However, it is fair to say—and we have said it ourselves—that regulation was much more light touch before the crisis. The approaches that we took were dictated by the market and the regulatory authorities at the time but, with hindsight and as things have changed, we recognise that some of them are no longer appropriate.

Lewis Macdonald: Again with the benefit of hindsight, witnesses have told us that some of the fundamental weaknesses in the institutions in the marketplace went back a number of years. For example, RBS's acquisition strategy and HBOS's approach to risk in lending predate 2007 by some way. I presume therefore that, in looking at how to move forward, you have taken a view on whether you or other regulators missed any earlier opportunities to pick up some of these issues.

Jon Pain: We have made it perfectly clear that there were failures in the broader regulatory regime. As I think Lord Turner has pointed out, there were failures by the regulators, central banks and Governments in not recognising some of the imbalances that you referred to in the macro-prudential economy, which clearly had a lot of bearing on the crisis. We recognise that and our part in it; to be honest, I think that, in recognising the FSA's failures, we have probably been more candid than most.

Lewis Macdonald: I imagine that, as you move forward, you will want to be equipped with the necessary skills to deal with, for example, hedge funds and other banking practices that were underestimated, inadequately understood or inadequately supervised. Are you confident that the additional recruitment and the change in approach that you have referred to will equip you with those skills?

Jon Pain: They are part of the solution. As I have said, we have been investing these additional resources in the situation for a couple of years now. Of course, they go hand in glove with the changes to the regulatory regime that I have also talked about. I believe that, at a European and global level, there will be a higher level of capital required; redefinitions of the type of capital that banks need to provide; and different approaches to resolving problems with banks that get into difficulties, including the introduction of so-called living wills. Such new measures, which we are in the throes of implementing, will make the regulatory regime tighter and more capable of dealing with the outcomes of a crisis like the one that we have had to deal with over the past 18 months.

Lewis Macdonald: As a board member of one of the legs of the tripartite system, do you have a view about any further reforms to its operation that might be required? Has the general approach to reforming the relationship been the right one?

Jon Pain: I believe so. The Financial Services Bill, which is currently before the Westminster Parliament, proposes the creation of the council for financial stability, which is basically the tripartite system that you talked about. It will give the FSA particular financial stability responsibilities alongside the Bank of England, and it will define how the three authorities should work together to deal with financial crises.

Lewis Macdonald: We are all at risk of analysing what to do about the next crisis simply in terms of the previous crisis. Can you collectively or corporately step back from the response to the previous crisis and say that what has been put in place through the changes gives us a regulatory structure that will be fit for purpose for any foreseeable developments in the global financial industry?

Jon Pain: I suppose that there is always a risk in saying that what has been put in place will cope with any crisis, because we can never be sure about the shape or form of a future crisis. However, the reforms that we have made internally to the capabilities of the FSA, the wider national and global changes in the regulatory environment that I have talked about, and the way in which we have reformed the tripartite process in the UK are all positive indicators of how we have reflected on and learned from the lessons of the crisis.

Stuart McMillan: Good morning. I want to follow up Lewis Macdonald's question. In his final Mansion house speech as Chancellor of the Exchequer in June 2007, Gordon Brown talked about a new world order being created and

"the beginning of a new golden age for the City of London."

He highlighted Britain's flexibility and its vigilance against complacency. However, within a few weeks of that speech, HSBC received £750 million from its far east operations. Last week's National Audit Office report highlights the fact that the authorities were aware of HBOS's potential weakness. With that in mind, how could the Prime Minister have been so wrong? Did he fail the banks and the public in the UK?

Jon Pain: That is probably a question for him rather than for me. The context for the crisis and how it occurred is global. Your colleague referred to that. Obviously, we have drawn painful lessons about capital and liquidity in the banking system and what that means in a crisis. That was painfully exposed during the recent crisis. However, the steps that we are taking and those that we have yet to take with respect to the overall capital regime will substantially strengthen the financial system.

The Convener: I have one more question about FSA's fitness for purpose to regulate the banks. A key issue that has emerged from all the reports is that too few people understood the nature of some of the derivatives that were traded. That includes people in the FSA to some extent, and it certainly includes some members of the boards of the banks that you were meant to be regulating. Are you satisfied that the new staff and procedures that you have in place will enable you to ensure that there are people on the boards of banks who understand the nature of the derivatives and other things in which those banks trade? Does the FSA have people on its books who understand how such things operate to ensure that the excessive risks that were taken in the system will not be taken again?

Jon Pain: I will answer that in two parts. When I referred to the substantial growth in the FSA's resources, perhaps I did not make it clear that the increase has largely been in specialists drawn from the marketplace. They are not necessarily just supervisors; they are technical specialists on the whole spectrum of the firms that we regulate. That equips us with the specialists whom we need to look at firms and the risks that they pose both to our objectives and in respect of their own activities.

It is evident from the financial crisis that the level of capital to support investment banking activities was not adequate. We have referred several times to the fact that there will be a substantive increase in capital to support investment banking activities. That in itself will drive a different appetite for such activities, because capital comes at a cost. Firms will be far more wary about the risks to their balance sheet that are posed by the activities that they take on.

A third issue is the governance and effectiveness of the boards of institutions. Post-Walker review, we expect a strengthening of capabilities around the board table. As part of our significant influence function regime, we have made it clear that we will interview—and sanction—members of boards of major financial institutions, particularly people who are in key posts, such as the chairman, senior independent non-executive director, chair of the audit committee and chair of the risk committee. Those interviews are not cosy chats around a coffee table but substantive reviews of the capability and competence of individuals to undertake their roles.

Rob Gibson: On the regulatory approach that we might prefer in future, does the FSA agree with Professor Kay that its immediate emphasis should be on regulation in the public interest and not on shadowing the business decisions of banks through a supervisory role?

Jon Pain: I do not remember that comment, but I will respond as best I can. Our view is that it is important that we understand the inherent business model and strategy of a particular financial institution, because such a level of analysis enables us to understand the risks that are posed to the firm and to the marketplace as a whole. It is entirely appropriate that we should focus on those areas, together with some of the regulatory issues to do with capital and liquidity that we talked about.

A challenge that arises in that regard is that rather than looking back to events that have happened—we talked about that in the context of our regulatory approach in the past—we are trying to assess judgments for the future. That creates a considerably more challenging environment for a supervisor, but only if we do that effectively can we anticipate some of the risks that are posed by particular institutions' strategies or business models. That is at the heart of our understanding and our new level of intensive supervision of firms.

Rob Gibson: Do you give no consideration to the socially useful aspects of banking, which we require if the real economy is to recover? Is that not a specific part of your duties?

Jon Pain: The Financial Services Bill, which is currently going through the Westminster Parliament, confers on us a wider statutory responsibility in relation to stability. In addition, our focus is on ensuring that banks function effectively in the marketplace and, in turn, for the real economy. It is not necessarily about the size and scale of institutions, unless an institution's size and scale pose a particular risk to market stability.

Rob Gibson: The market in Britain is dominated by the financial services sector and not the real economy. Surely an attempt by the FSA to ensure that banks are the servants of the people and not masters of the universe is central to our ability to have a real economy again.

Jon Pain: I agree. We are focusing on ensuring that banks are properly run and have a sound business model and strategy and sound capital and liquidity management, so that they can work effectively in their role in supporting the wider economy. During the crisis of the past 18 months the banking sector's importance to and connection with the real economy have been only too plain. When the sector does not function properly, the consequences are plain.

Rob Gibson: Professor Kay criticised the make-up of the board of the FSA. Are you satisfied that the changes that are being made will mean that you can avoid regulatory capture in future?

Jon Pain: We have made changes to the FSA board and changes are still under way. Three new members joined the board during the past few months. I think that our chairman regards the strengthening of the board as an on-going issue.

Rob Gibson: A comparison has been drawn between the FSA's board and that of the Water Services Regulation Authority—Ofwat—in England. Ofwat has a lot of people who are not directly involved in the water industry but are there to ensure that the industry works. Should the FSA adopt such a model? Should the majority of its board members be people who are not from the banking world?

12:00

Jon Pain: The majority of the people on the board come from a cross-section of industry; they are not all from the banking sector by any stretch of the imagination.

Rob Gibson: Do you have a breakdown of the board's members? It seems to us that there is a revolving-door principle whereby people from failed institutions are taken on by a regulator before going off to a job in another part of the banking industry. That does not seem to be a way of letting in the fresh air that is needed because of the size of the crisis.

Jon Pain: The most recent three additions to the board have not come from the banking industry. In fact, other than me—I came from the banking industry around 18 months ago—and the chief executive officer, who was in investment banking some years ago, the other, non-executive board members are not from the banking industry. I can send the committee a breakdown of our board, which will demonstrate that in some detail.

Rob Gibson: That would be interesting, thanks.

Ms Alexander: To what extent are we in the process of avoiding the too-big-to-fail scenario that proved so damaging in the past 18 months?

Jon Pain: That is a key question, which was posed by the Turner review. We come at the issue from a number of directions. The increased capital regime that we have been talking about is one; the changing of the capital regime for investment banking activity, which involves a substantial hike in the capital that is required, is another. Plans are also under way in respect of what are known as living wills but are more properly called resolution plans. On a global basis, we operate and encourage the operation of a series of supervisory colleges in which regulators share their insights into the operation of global institutions so that they can understand the impact that they have across those territories.

Ms Alexander: However, there is concern that, if we have extremely large-scale institutions, there might still be a risk—despite the capital requirements—of banks continuing to trade with depositors' moneys at their own hand. Are you confident that we have in place—or could you hazard a guess about when we might have in place—a regime that will allow part of a bank to fail without damaging those parts of the utility banking function that we would wish to continue? What is the timeframe for the new capital requirements regime and the resolution plans to be put in place? Obviously, at the moment, we find ourselves in a precarious situation in which we have not yet been able to put in place that new regime.

Jon Pain: You are right that that is still work in progress, but you should not underestimate the work that we have already done. The capital in those large institutions has already been strengthened, as you can see from recent market activity, and we have carried out extensive stress testing of those institutions to ensure that they have adequate capital, against our existing regime.

It is fair to say that, through our new regulatory approach, we expect to reduce the instance of failure. The resolution plans are designed to reduce the impact of any failure on the wider economy and on depositors. Over the past 18 months, we have also strengthened the depositor protection scheme. There is still on-going policy work in Europe about how that might be strengthened still further. Through the financial services compensation scheme, we have sought to put in place faster pay-out mechanisms for depositors as a further protection for depositors in those institutions.

Ms Alexander: When do you think that the resolution regime might be in place? That is very important with regard to doing away with the moral hazard that we currently have.

Jon Pain: It is obviously a very complex area. We are issuing a consultation paper on it early in the new year, and we are already undertaking work with some pilot banks. That work is a global exercise, given the global nature of some of the banks and the crisis management issues that have arisen. I expect that substantive progress will be made in 2010 to put those regimes in place. That is another part of the Financial Services Bill that is before the Westminster Parliament.

Ms Alexander: It is hoped that, towards the end of 2010, there will be clarity around the resolution regime that will apply to any bank that operates in the UK.

Jon Pain: Yes, those measures are aimed predominantly at the global banks—the biggest banks. We will consider some of the things that we learn from that process and think about how they might apply to other institutions, but the primary focus is on the global banks, given the complexity and the interconnectivity around the globe.

Ms Alexander: I have two brief unrelated questions. You helpfully make clear in your paper that the FSA is not responsible for

"the availability or cost of credit",

and that that is properly a function for the Office of Fair Trading. The OFT appeared before the committee to talk about the level of competition in small business banking in particular. Are you surprised that the OFT has no work under way on that subject?

Jon Pain: That is really a matter for the OFT rather than for us. As you mention, it is not our remit—we are not a competition regulator in that context.

Ms Alexander: I have a question on something that you might want to check and write to us about. Have you had any representations of any kind from the Scottish Government during the past 15 months on areas that fall within your remit? If so, what did those representations concern?

Jon Pain: Your question is quite wide; I will have to write to the committee on that.

Ms Alexander: That would be helpful.

Marilyn Livingstone: The regulation of bonuses has been a controversial issue. What are your views on the likely bonuses that may be paid to state-run and controlled banks, such as RBS and Lloyds Banking Group? What is the FSA's role—now and in the future—in the regulation of bonuses?

Jon Pain: You are right: that is a very topical question. You are probably aware that we have issued a remuneration code that comes into effect at the beginning of next year. We have already made it clear to all banks in the UK that, despite the fact that the code takes effect from the beginning of next year, we expect bonuses that are awarded in respect of 2009 but paid in 2010 to be subject to our code.

We have asked institutions to produce for us a remuneration policy statement that sets out clearly how they are complying with our code and how the code will be put into effect in each institution. We have made it clear that we do not expect firms to commence their bonus arrangements or distributions until they have completed that process of confirming to us how they comply with the code.

Marilyn Livingstone: That is good for the future, but there is controversy just now. What is the FSA's role in what is happening this year?

Jon Pain: As I tried to make clear, the code captures the bonuses that will be awarded in respect of 2009. Bonuses are not normally paid in the same year—they are paid in January to March of the following year. The 2009 bonuses will therefore be subject to the code that I have just outlined.

The Convener: Does the code set limits on the percentage of profits that can be distributed as bonuses? Does it indicate what part of bonuses can be paid in cash, shares or deferred shares?

Jon Pain: It is worth taking a step back and asking what the focus of our remuneration code is. The aim is to ensure that the risk management within a firm, as reflected in its remuneration code, is acceptable and that the appropriate checks and balances are in place in that regard. Our code is not about setting an absolute maximum in respect of institutions, save for one important exception: as a regulator, we expect the institution to ensure that it has adequate capital on a forward-looking basis to meet our requirements following the impact of the distribution of dividends or bonuses. If an institution was to put its capital position at risk by overdistributing either bonuses or dividends, we would take a keen interest in correcting that. However, we are not a regulator of the quantum of bonuses.

The Convener: We have heard squeals from some banks that if restrictions are placed on bonuses, there will be a mass exodus of key staff, who will go all over the world to find jobs in what is presumably a contracting banking sector. There have also been claims that windfall taxes on bank bonuses will have a similar effect. Is that likely to happen? Is there anything that can be done by way of global or European regulation to capture those issues and reduce the risk?

Jon Pain: We believe that the impact of bonuses might have formed a part of the financial crisis, but they were not the driving part or the cause of the crisis. Nevertheless, our code is designed to ensure an appropriate balance between risk and bonuses.

For that to be effective, global co-ordination is likely to have the best effect, as the institutions themselves are global. It has been noted that the G20 has adopted many of the outline principles, as has the Financial Stability Board, which has adopted the principles of our code on a European basis. We expect there to be co-ordination across the globe, particularly across Europe, on a standardisation of remuneration policies. The timing of that might be at odds in different territories, but the sense of direction is very much the same.

Ms Alexander: It became public knowledge in June that the board of RBS had agreed a total remuneration package for Stephen Hester that was potentially £9.4 million for 2009. Was the FSA consulted in advance on that remuneration package?

Jon Pain: That particular bonus arrangement will be subject to our code. We have considered it in relation to our code and, when we complete our review with that firm at the end of this year, it will form part of our approach—it is very much caught by the code.

Ms Alexander: My next question was going to be about that—whether you have reviewed that high-profile remuneration package since it was made public in June, after publication of the code, and whether you have sought to alter the package in any way. If it is under review, perhaps you could indicate when the conclusions of your review are likely to be made public. I reiterate that the terms of that package have now been in the public domain for some six months.

Jon Pain: Indeed. As I have already made clear, that bonus arrangement will be caught by our code. We have made that clear to the firm, and it has made clear to us its intention to ensure that the arrangement is fully compliant with our code. The process completes at the end of this year for the individual firms that I have mentioned. I fully expect that package to be compliant with the code, as I have outlined.

Ms Alexander: So we will know in a few weeks whether or not that package is compliant.

Jon Pain: I expect it to be—you can take that assurance now.

Ms Alexander: It emerged in the *Financial Times* this week—yesterday I think—that there are provisions to review bonuses under the Government asset protection scheme. They apply only to institutions that are making use of GAPS. I am trying to understand the relation between provisions on bonus pools or individual bonuses in the GAPS regulations and what is in the FSA's code. Certainly, the *Financial Times* yesterday expressed surprise that the GAPS regulations were being used as a way to monitor total bonus pools and individual bonuses. Can you explain the relation between the FSA's code and the GAPS regulations on bonuses?

12:15

Jon Pain: Indeed. Obviously, there are terms and conditions with respect to the GAPS facility that you talked about. That is a matter between Her Majesty's Treasury and the particular firm involved. Any bonus arrangements in institutions are effectively captured by our code on remuneration—there are no exclusions in that sense. Any incentive or bonus arrangements will be captured in the particular firm's overall framework and in our code.

Ms Alexander: So in what way do the GAPS regulations tighten up the code?

Jon Pain: I am not sure that they do that. They certainly do not take the particular individuals concerned out of our code in relation to maintaining and monitoring the assets within the GAPS scheme. Those individuals will therefore be captured within our framework in the same way as any other individual employed by that institution.

Ms Alexander: So how do the GAPS regulations add to the code? If they do not take anything away from the code, how do they add to it?

Jon Pain: Forgive me, but I am not sure of the details. Of course, any particular arrangements that are part of the arrangements between HMT and that particular firm are in addition to our code. They certainly do not subtract from our code in the sense of taking those individuals outside the scope of our code.

Ms Alexander: Does that mean that there will be a bilateral negotiation on bonuses for companies participating in the GAPS, or will the FSA be involved, too?

Jon Pain: As I said, the terms and conditions in respect of the GAPS are a matter between the Treasury and the institution—only one institution is utilising the GAPS, as you will know. The point that I am trying to make clear is that we expect any individual employed by that firm to be captured by our scheme. If additional requirements are set by the conditions of the facility that HMT offers, that will be a matter between HMT and the firm. However, it will certainly not take people outside our scheme's scope.

Ms Alexander: I am just trying to establish what the regulations are. The nature of the conditions that are being applied is a matter of wide public interest.

Jon Pain: I have not looked at the conditions in particular, Ms Alexander, so I cannot comment on the specifics. We are still in the midst of our bonus reviews with all the large institutions, which do not complete until the end of December. However, the assurance that I am giving you is that there are no exceptions to our code.

Gavin Brown: From where I am sitting, credit rating agencies appear to have got off fairly lightly. Many products were classed as triple A, when, with the benefit of hindsight, they were clearly junk. To what extent did the FSA rely on credit rating agencies as part of its work? To what extent will you rely on them in future?

Jon Pain: The role of credit rating agencies in the functioning of the marketplace is part of a current review of the European dimension, in terms of whether they are brought into the scope, as intended, of European regulation. That is therefore a live review and work in progress, and I fully expect to see developments in that sphere over the next few months into next year.

The marketplace obviously relies on credit assessments and counterparty risks, and the rating agencies have a part to play in that. One aspect of and lesson from the crisis is that a blind reliance on credit reference agencies' ratings without any appropriate analysis or due diligence on behalf of the counterparties is open to risk. That has been made clear. The process will probably be tightened and strengthened in the on-going regulation of the CRAs on a European basis.

Gavin Brown: You said that you expect to see something on that in the near future. Do you hope for anything specific?

Jon Pain: No. In the context of how the regulation regime will affect and trap the operations of CRAs within the European market—it is still under debate whether that will be part of the process—we would want a standard approach across the market irrespective of where the CRAs are located, because they operate globally.

Gavin Brown: Does the financial services compensation scheme fall within your remit?

Jon Pain: The financial services compensation body is independent. It reports to the FSA on its budget and operational performance. Clearly, we are involved in the development of the scheme.

Gavin Brown: If organisations wanted to effect change in that scheme, would they go to the independent body, the FSA or both?

Jon Pain: There has been quite a bit of focus on the scheme's impact, including on the member firms that operate within it. We have already made it clear that, next year, we will open a review into how the scheme operates, how it is funded and what funding mechanism and structure will be best for it in future.

Gavin Brown: I have recently read a number of press reports of credit unions complaining about the way in which the scheme operates. They feel that the percentage of money that they have to pay in relation to their turnover and the risks that they take penalises them for their fairly safe business models—they argue anyway that their models are fairly safe—rather than penalising organisations that take enormous risks. The costs are biting pretty badly. There are well over 100 credit unions in Scotland and the issue therefore has a particularly Scottish focus. Is that on your radar?

Jon Pain: It will form part of the review of how the scheme is funded. The question is whether we want a prefunded scheme, and that, too, will form part of the review. We will also consider the individual firms' and sectors' contributions to the scheme's overall scope.

I point out a trade-off: one of the scheme's benefits is that it is a universal market scheme, so various sectors underpin consumer confidence across the marketplace as a whole. Therefore, carving out distinct parts of the scheme to individual sectors or small sub-sectors of the marketplace could undermine the overall subsidy of the sector across the marketplace as a whole.

Those matters will all form part of the review.

Gavin Brown: I have a simple question in case any credit unions are watching the meeting. Has a precise date been set for the review and how do credit unions contribute? Has that been bottomed out yet or is it still to be decided?

Jon Pain: As with all our reviews, we will issue a consultation paper and then for a time—normally, it is three to six months—invite all interested parties to contribute to the consultation. Credit unions, like other keen stakeholders, will have ample opportunity to contribute.

Gavin Brown: Do you have a rough idea of the month in which that consultation paper is likely to go out or is it a case of it being sometime next year?

Jon Pain: The date escapes me, Mr Brown, but it is next year.

Gavin Brown: If the date has not been set, that is fine; if it has, will you let the committee know?

Jon Pain: Sure. I will do.

Marilyn Livingstone: What role did the FSA play in the 3 November announcement on the divestment plans of RBS and Lloyds Banking Group? What is your take on those plans and their impact on the Scottish financial sector?

Jon Pain: Obviously, we are not directly involved in those negotiations, which are between the firm, the Treasury and the European Commission under European competition rules. Our interest lies in understanding the impact on the individual firms and ensuring that the institution is still viable after its divestments. We were not directly involved in the negotiations, which were a matter for the three parties that I have mentioned.

Marilyn Livingstone: What is your view of the impact of the divestment plans?

Jon Pain: As the regulator, we think that the institutions will still be viable despite the divestments. As I said, we were not involved in sanctioning or negotiating the divestments or their extent.

The Convener: Are you satisfied that the businesses that are to be divested will be viable and that people will be interested in buying them, especially given the restrictions on competition that the EU has indicated?

Jon Pain: Part of the divestment strategy is to attract new players into the retail banking market. As a regulator, we will take an interest by approving the final owners of those businesses. As long as the institutions and anyone buying their businesses meet our requirements, we will encourage and support their plans.

The Convener: You are talking about new players but, because of the restrictions on UK companies who are not new players, the most likely buyers for those institutions are going to be overseas banks. Is that a fair assessment?

Jon Pain: The situation is unclear, because it is also true that the institutions have a four or five-year window in which to make the divestments and the market could change substantially during that time. We do not take any particular view on whether the buyers will be foreign banks, existing banks, new entrants to the market or other existing players. The competition elements of those divestments will be a matter for the competition authorities. We will be concerned with approving the appropriateness and capabilities of any institution that might acquire the businesses, particularly because some of them have retail customers and one of our primary objectives is to protect them.

The Convener: If a business is bought by an overseas bank, will it be required to have a UK-registered operation for your purposes?

Jon Pain: That will depend on where the buyer comes from. There are two routes for entry into the UK market. An existing institution within the EU can branch in if it is regulated in the EU. The normal route for an outside institution is for it to set up a UK subsidiary for its operations. It therefore depends on where the buyers emanate from.

Lewis Macdonald: I would like to widen the European question a bit to how the UK's tripartite system of regulation relates to European and G20 levels of supervision or regulation. Some concerns have been expressed about Michel Barnier's appointment and whether it might shift the focus of regulation for British financial institutions and thereby have a detrimental impact on Scotland or across the UK. Does the FSA have any view on the nature of European regulation and how it should best be related to what is done domestically?

Jon Pain: We invest a substantial amount of time and people in European matters because policy for the financial services marketplace is already largely determined on a European basis.

We have more than 100 people either on secondments or working on various aspects of European policy and changes.

We have, on that basis, been actively involved in shaping the three new regulatory authorities and we have provided input to that process. The processes as they have evolved—they are now subject to consideration by the European Parliament—provide a sensible framework to ensure the consistent application of regulatory rules throughout the European market, and establish some standardisation by creating one consistent rulebook for the European market. We endorse and will play a full role in the three regulatory bodies.

12:30

The Convener: Does that imply a move away from the light-touch approach that the FSA has traditionally taken?

Jon Pain: As I have said, we have moved away substantially from the light-touch regulation to which you refer. That is an historical aspect of the FSA.

Stuart McMillan: My question touches on that issue. The House of Lords Select Committee on Economic Affairs highlighted in a report a few critical issues, one of which was that the FSA paid too little attention to macro-level supervision of the financial system but focused excessively on individual business-by-business supervision. Will you provide two examples of planning that the FSA has done to ensure that that does not happen again? What safeguards are in place to ensure that the former system does not apply?

Jon Pain: We recognise that analysis of the crisis has shown that one failing was in the macro-prudential arena. We have said that and I have alluded to it this morning. One purpose of the Financial Services Bill that is before Westminster is to give the FSA an explicit financial stability responsibility, alongside the Bank of England. We expect the Bank of England to continue to take the lead on macro-prudential matters, but it is important that the micro-prudential supervisor has a firm upward perspective in the analysis. The macroeconomic analysis from the Bank of England will come from the other direction. The new council for financial stability is designed to co-ordinate that approach. That is the most concrete example that I can give on how the issue has been addressed.

Christopher Harvie: Fourteen months ago, Stephen Boyle—the Royal Bank of Scotland's head of group economics—sat just about where you are sitting and more or less volunteered the information that transparency in that bank was such that only two or three people knew the nature of the securitised instruments in which the bank was enthusiastically trading and on the basis of which it had bought heavily into ABN AMRO. The ceiling fell in a fortnight after he said that. A major aspect of that was the transparency—or lack of it—of particular instruments, and the non-transparency of what are called secrecy jurisdictions, such as the Isle of Man and numerous other tax havens over which Britain rules. The Cayman Islands were, of course, crucial in the development of hedge funds. What was the FSA's role in oversight of those tax havens? Will it be strengthened?

Jon Pain: If I understand the question, it is about the involvement of offshore elements in the formation of some securitisation vehicles, and about how their balance-sheet and off-balance-sheet arrangements were constructed. As I have said, a substantive change has taken place—it is recognised that many institutions did not understand the financial instruments in which they were trading. Part of the new regulatory regime will strengthen those aspects in relation to securitisation vehicles.

Of course, the marketplace has almost dried up in respect of that particular activity, but we are keenly focused on what emerges when the markets reopen or gain an additional appetite for wholesale funding operations such as those to which Christopher Harvie referred. There is an expectation in the capital requirements that firms will retain a vested interest in respect of such investments, so the nature of those operations will probably be that firms will not be able merely to securitise away all their engagement in such underlying assets and, therefore, their economic interest in those assets' performance. Those measures will bring substantive changes to how that marketplace operates.

Christopher Harvie: Will that supervision come in the first instance from British financial authorities or from the European Union, which has a much wider interest in transparency in an international sense? The EU seems to be taking more initiatives.

Jon Pain: On the level of analysis that we expect to carry out in respect of those banks and their assets, one of our current directions of travel is towards a very low appetite for any off-balance-sheet activities. There has been a move to bring all such activities on to the balance sheet, which adds to transparency. That is part of our capital regime with the institutions now—it is not something that is yet to happen. I envisage the frequency of off-balance-sheet activities being markedly reduced in the future.

Christopher Harvie: I have one historical question on which you might be able to enlighten us. Towards the end of 2005, the Centre for Policy

Studies—in particular its then director, Ruth Lea—attacked the FSA, saying that it ought to be more proactive in supporting City institutions and less regulatory. Did that contribute to any degree to the fetishisation of light-touch regulation that was evident in the then Chancellor of the Exchequer's speech at the Mansion House in 2006? Of course, it was just at that period that the tremendous acceleration of dealing in things such as commodities caused intense financial speculation throughout the world.

Jon Pain: I have already referred to the fact that the requirement on the regulator was for light-touch regulation, in support of the overall financial services marketplace. That was called for fairly substantially by all aspects of society, as well as by the industry and the Government, so it was the remit within which the FSA operated. However, as I hope I have outlined, that remit is substantially changed and light-touch regulation in that context is now historical. Our present approach to regulating firms is far more proactive and intrusive, as are our expectations of how firms will be structured and managed.

Christopher Harvie: What was the FSA's involvement in scrutinising HBOS's financial position when the merger deal that was factored by the Prime Minister was reached in October 2008? It appears that Lloyds TSB was not fully cognisant of HBOS's liabilities.

Jon Pain: The due diligence between two firms that are involved in a takeover is a matter for those two firms and their boards. The FSA's role was to ensure that the combined institution was adequately capitalised and could meet our capital frameworks. We do not undertake due diligence on behalf of firms in takeovers.

Christopher Harvie: The Prime Minister, when he was chancellor, was responsible for appointing as vice-chair of the FSA Sir James Crosby, who was for some time after that a director of HBOS, although not at the time of the merger. The Prime Minister also got a waiver from the Competition Commission that the merger would be allowed because of exceptional circumstances. Surely the issue entered very considerably into the political field.

Jon Pain: That is not within the scope of the FSA's responsibilities. You would have to address those questions to the Treasury or the competition authorities.

Christopher Harvie: That is one way in which you have considerably less power than, say, the US Securities and Exchange Commission, which could interdict actions by the Executive.

Jon Pain: Quite possibly.

Rob Gibson: I asked John Rendall about the remarks of his chairman, Stephen Green, who said that clearer codification of directors' responsibilities was "sadly necessary". Has the FSA discussed bankers' personal and, indeed, criminal liability for the actions that they take?

Jon Pain: It has not done so directly, to my knowledge. We expect directors to abide by the responsibilities that are laid out in the various codes on such matters, but individual liability is not part of our remit.

Rob Gibson: Personal liability is not one of your responsibilities. It is a feature of the law in the USA: should it be a feature of the law in Britain and Europe?

Jon Pain: As I said, we have not discussed the issue directly. The consequences of such an approach would need to be thought about and analysed carefully. We would need to consider how having personal liability might play out in respect of people's willingness to undertake to be directors of financial institutions.

Over the past 12 months, our ability to gain people's commitment to being non-executive directors of financial institutions has been severely tested. The pool of people who would want to take on those responsibilities or who are qualified to do so is not deep. Our putting more impediments in that area might have unintended consequences for the calibre and breadth of financial institutions' boards.

Rob Gibson: We were on the brink of the failure of capitalism, but you do not think that the people who are responsible for decisions should become liable for them in some way. We have been told in evidence that bankers danced around the law. We face a situation in which another crisis could happen—that is the "doom loop" of which the Bank of England has talked.

Jon Pain: That is not directly part of our remit. The Government would have to decide whether it wanted to introduce such an arrangement.

The Convener: Can the FSA impose sanctions on financial institutions' board members who it considers have failed in their responsibilities as board members?

Jon Pain: Yes, it can. We can take enforcement action against individuals or firms for any breaches of our rules or any activities that fail to meet our principles, and we have done so.

The Convener: Thank you.

That concludes the evidence sessions and our business for today. I thank Jon Pain from the FSA for his evidence, which has been extremely helpful to our inquiry. Next week, we will continue our inquiry into banking and financial services with evidence from Tesco Bank and Clydesdale Bank. I remind members that we will start at 9.30, when we will get an update from the Council of Economic Advisers. Sir George Mathewson, the chair, and other members of the council will be in attendance.

Meeting closed at 12:44.

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