

Statement on the Financial Conduct Authority's further investigative steps in relation to RBS GRG

July 2018

Executive Summary

The mistreatment of small and medium-sized (SME) customers within RBS's Global Restructuring Group (GRG) has rightly attracted considerable public attention.

In response to the allegations made about GRG, the FCA commissioned an independent review to be undertaken by a 'skilled person', Promontory Financial Group (UK) Limited, together with its sub-contractor Mazars.

The independent review found no evidence that RBS artificially distressed and transferred otherwise viable SME businesses to GRG to profit from their restructuring or insolvency. It did, however, identify that many aspects of GRG's culture, governance and practices were deficient and that in some areas the inappropriate treatment of customers was widespread and systematic. It concluded:

'[T]here was a failure on the part of GRG and RBS to fully recognise and manage the conflicts of interest inherent in GRG's twin commercial and turnaround objectives. There was also a failure to put in place appropriate governance, policies, procedures and processes ... to ensure that a reasonable balance was struck between the interests of the Bank and those of its SME customers.'

The independent review also observed that the decisions GRG made about its SME customers had the potential to exacerbate these customers' already difficult circumstances and to have a significant bearing on lives and livelihoods. In many cases, the future of SME businesses and the personal financial circumstances of the owner or manager were closely linked.

GRG did not appear to recognise the emotional stress suffered by SME customers in difficult personal circumstances, who were not only losing their

business and income but, in some cases where it was held as security by RBS, their family home as well.

RBS has acknowledged that it could have done better for SME customers in GRG in some areas and has apologised. It has conducted a review of complex fees and set up a complaints scheme for eligible SME customers. This scheme is overseen by an independent monitor, Sir William Blackburne.

Commercial lending is largely unregulated in the UK, and we do not generally carry out investigations into unregulated areas of an authorised firm's business. Due to the serious allegations made about GRG, however, we looked into the way they treated their SME customers in the relevant period between 2008 and 2013, including through investigations carried out by our Enforcement and Market Oversight Division.

The onset of the financial crisis fundamentally impacted the way GRG operated. After a significant increase in the number of firms referred to GRG, changes in systems and controls did not keep pace with what was needed in light of the growth in GRG's business (for example, while the reliance on central functions rather than a dedicated second line of defence for SME customers may have been reasonable initially, the level of control and oversight that was required increased as the business grew). Competing demands were put on senior management's time and SME customers, who were the minority of GRG's business (8% of GRG's total portfolio by value and 35% by volume), received less focus than larger customers. While GRG took steps to improve their systems and controls, it appears the changes were not sufficient to give senior management a complete picture of the way GRG was treating its customers.

The fact that GRG was largely outside the jurisdiction of the FCA is important. There are no enforceable regulatory rules, for example 'conduct of business'

rules, against which to assess GRG's treatment of SME customers. The relationship between RBS and its customers was principally governed by the terms and conditions of the commercial contract between them. The steps RBS could take under the law, while seeming unfair to many customers, were governed by the terms of the contract and not regulatory rules. The largely unregulated nature of GRG's business also means that, in this case, we do not have the power to take disciplinary action, such as imposing financial penalties on RBS or individuals.

Where we consider people are not fit and proper we may take action to prohibit them from the regulated financial services industry, even where their conduct took place in an unregulated area. So, we have considered whether there is a case for prohibiting any of GRG's senior management on the grounds that they are not fit and proper. In particular, whether any of them were dishonest, lacked integrity or showed an absence of competence and capability.

Taking all relevant matters into account, and after detailed investigations, we do not consider that bringing a prohibition case against any member of senior management of GRG, in role during the relevant period, would have reasonable prospects of success.

We found no evidence of dishonesty or lack of integrity, specifically, that senior management sought to treat customers unfairly. The lack of regulatory rules against which GRG could be assessed, in the context of the environment at the time and all the circumstances, means that we do not think we could bring a successful case for lack of competence and capability in relation to senior management. Senior management must be held to account where their behavior falls below the applicable standards; however, to do this requires the standards to exist and to be clear.

Where we do not make findings about misconduct, we do not ordinarily publish information about our inquiries.

However, this is an exceptional situation. There is a considerable public interest in the FCA's work on GRG and in us publishing as much detail about that work as the law allows. The public should have confidence that the decisions we have taken are for good reasons. Further, in addition to the public generally, there is clear value to the regulated industry in understanding the extent to which unregulated commercial lending activities can be taken into account for an authorised firm.

Findings of the independent review

In September 2016, we received a report prepared following the independent review under section 166 of the Financial Services and Markets Act 2000.

The independent review found no evidence that RBS artificially distressed and transferred otherwise viable SME businesses to GRG to profit from their restructuring or insolvency.

The independent review did identify a number of circumstances where it appeared GRG had not treated customers fairly or reasonably. The inappropriate treatment of SME customers which the independent review identified as being widespread included:

- a failure to comply with the Bank's own policy in respect of communicating with customers around transfer, where the standard of much SME customer communication was poor and in some cases misleading;
- a failure to support SME businesses in a manner consistent with good turnaround practice;
- placing an undue focus on pricing increases and debt reduction without due consideration to the longer term viability of customers;
- a failure to document or explain the rationale behind decisions relating to pricing following transfer to GRG;
- a failure to ensure that appropriate and robust valuations were made by staff, and carrying out internal valuations based upon insufficient or

inadequate work, especially where significant decisions were based on such valuations;

- a failure by RBS to adopt adequate procedures concerning the relationship with customers and to ensure fair treatment of customers;
- a failure to identify customer complaints and handle those complaints fairly;
- a failure to handle the conflicts of interest inherent in the West Register model and operation; and
- a failure to exercise adequate safeguards to ensure that the terms of certain upside instruments - Equity Participation Agreements and Property Participation Fee Agreements were appropriate.

These failures are significant and might ordinarily trigger disciplinary action if they occurred in a regulated business.

In November 2016, we began an investigation into the concerns raised by the independent review about RBS senior management's awareness and involvement in the matters highlighted. As part of that investigation, we identified evidence to carry out a further focused investigation into a narrow range of issues. These investigations have helped us understand the nature and extent of senior management's engagement in GRG during the relevant period.

Where we can and cannot intervene

We expect high standards from the firms we regulate. We do not have the power to set or enforce these high standards though in areas of unregulated

activity, where our jurisdiction to exercise our normal range of powers is limited, even where we have identified a firm's mistreatment of customers and the firm has accepted this. GRG's business was largely unregulated and so not subject to either our (or our predecessor's) regulatory conduct standards, for example the 'conduct of business' rules. In the circumstances of this case, the powers Parliament has given the FCA do not enable us to take disciplinary action such as fining RBS or an individual.

We can, however, take action against individuals who are not fit and proper to perform functions in relation to regulated activities. We can do so even if the relevant conduct took place in relation to unregulated activities.

Accordingly, we have considered the evidence from our investigations and the independent review to determine whether we can bring a case that has reasonable prospects of success to impose a full or partial prohibition on any of GRG's senior management in role during the relevant period.

When we assess whether a person is fit and proper, our published guidance makes clear that the most important factors we consider are: honesty, integrity and reputation, competence and capability, and financial soundness. In this case the last factor – financial soundness – is not relevant and we have not considered it.

Integrity does not have a comprehensive definition, but the courts have given useful guidance about what a lack of integrity might include. While a lack of integrity can involve deliberate or dishonest misconduct, it can also be where someone acts recklessly or whose ethical compass to a material extent points them in the wrong direction. If we find dishonesty or lack of integrity this is usually sufficient for us to prohibit an individual. For a lack of competence and capability, the position is more nuanced. Competent people, for example, may make mistakes. Where there is no evidence of lack of honesty or integrity, we

generally focus on conduct that demonstrates sufficiently serious, repeated, prolonged and obvious failures, which we measure against the standards expected of the person at the time and in the circumstances they faced.

The information we assessed

Our investigations concerned the activities of GRG over a significant period of time that included the financial crisis and its impact on both large and smaller businesses. The impact of the financial crisis overshadows these events.

We reviewed large amounts of material and interviewed senior RBS executives using our formal powers to require individuals to attend interviews and answer questions.

We met with former GRG customers to get evidence of their experiences and reviewed relevant material they gave us, as well as material customers had given to the independent review and RBS.

Below we summarise the findings of our investigations. We also explain how we have approached taking unregulated commercial lending activities into account for an authorised firm.

What we found

We found no evidence that any member of senior management was dishonest or lacking in integrity. Specifically, we have not found a credible basis to conclude that senior management sought to treat customers unfairly or to have behaved in any other way that could call their honesty or integrity into question.

Regarding GRG's oversight of how it treated its customers, we found the following:

- There was a significant tension between GRG's twin commercial and turnaround objectives. All SMEs referred to GRG were required to be assessed by frontline staff to determine whether the firm was 'viable' i.e. suitable for turnaround. The independent review found that almost all customers referred to GRG were exhibiting clear signs of financial difficulty. For some of them, turnaround was not a practical possibility. Staff did not appear to fully understand how to balance these two objectives and what this looked like in practice, or how to communicate with customers in financial difficulty. Communications with customers on referral to GRG often created an expectation of turnaround that could not be met, especially given the economic conditions of the financial crisis.
- RBS took a decision to roll out the FCA's 'treating customers fairly' principles (TCF) within GRG, although it was not a regulatory requirement to do so. While there is evidence of steps being taken in relation to TCF, GRG did not implement it effectively in practice. TCF was not designed to cover commercial lending. It is part of a broader regulatory framework that was not applied to GRG including requirements around, for example, conflicts of interest, communications with customers, record-keeping and governance. In order to be effective, consideration needed to be given to what TCF meant in the context of GRG's SME customers.
- GRG's business and RBS's rights, obligations and responsibilities in relation to its customers were governed by the terms and conditions of commercial lending contracts. These agreements give the lender certain legal rights when the customer is in default (as many SME customers already were when they were referred to GRG), which could lead to the sale of a customer's business and assets, including sometimes their personal assets. In these serious cases, a lender enforcing their rights causes outcomes that seem clearly unfair to customers, although the

lender is acting within the terms and conditions of the contracts that govern the relationship.

- We have seen limited examples of correspondence within GRG that is clearly inconsistent with ensuring that customers are being treated fairly, for example the “Just Hit Budget” document annexed to the report of the independent review. This document clearly should not have been produced and circulated. However, we have not seen any evidence that senior management knew about or approved of this correspondence.
- The lack of regulation around commercial lending means there is no clear objective yardstick, in place at the time, by which standards of conduct within GRG could be measured, for example around the fees and charges that GRG could impose.

Systems and controls within GRG

The control framework within GRG was evolving over the course of the relevant period, with senior management introducing some measures that show an awareness that the business needed better systems and controls including:

- Additional controls for GRG Relationship Managers. These included policies, guidance notes and training modules, covering handover procedures, assessing turnaround, valuations and pricing. These controls, however, were not always followed in practice, sometimes lacked detail and did not have a particular focus on the fair treatment of customers.
- As part of the implementation of TCF within GRG, senior staff objectives were changed to include compliance with TCF as a measure of performance. A customer satisfaction survey was introduced, the GRG mission statement was changed to include customer focus and other

changes to policies and procedures were made to include reference to TCF. Following feedback from the customer satisfaction survey in 2012, for example, GRG recommended making changes to its approach to fees.

- Throughout the relevant period GRG did not have a dedicated second line of defence in relation to SME customers. Senior management were aware of the risks this created and steps to embed a second line were being taken, with an initial focus on larger customers who comprised the majority of RBS's portfolio. In place of a dedicated second line for SME customers, a periodic 'strategic credit review' was conducted of each customer file by a panel of experienced GRG staff. Additionally, GRG's structure required that relationship managers' credit decisions had to be approved by more senior individuals (a process known as the 'four eyes' process).

These changes in systems and controls did not keep pace with what was needed in light of the substantial increase in the volume of customers referred to GRG. This increase, which was a consequence of the financial crisis rather than any strategy on the part of GRG, was a substantial challenge for senior management during the relevant period. In this regard, we note that:

- SME referrals to GRG increased by approximately 50% from 2008 to 2009 and continued to increase during the relevant period. As a result, staff numbers needed to grow quickly, along with recruitment and training processes. For example, in 2008 GRG had just under 200 staff. At its peak in 2012, this number increased by 500% to over 1,200. This rapid growth exceeded the capacity of GRG's systems and controls at the start of the relevant period, and GRG's lines of defence required strengthening accordingly.

- While senior management were aware of this and made changes to the control environment within GRG, it now appears the changes were not enough. The measures in place pending the introduction of a second line of defence for SME customers were not sufficient to ensure that senior management received a complete picture of the way GRG was treating its SME customers.
- A key aspect of GRG's business was valuations. The value of property and businesses could critically affect RBS's decisions about whether to continue to support a borrower and, if so, on what terms. Our investigations have not found evidence that RBS used an approach that would have systematically resulted in valuations that were too low. While a policy was drafted requiring the basis and rationale of valuations to be recorded, it was never actually finalised at any point in the relevant period. Additionally, the draft policy seems to have not been followed on many occasions (for example with very little evidence on the customer files of valuation calculations and rationales).
- GRG's record keeping was poor, compared with what we would expect to see in a regulated business. This was particularly true in relation to recording the rationale for valuations, its communications with customers during the referral stage and the reasons for pricing decisions. This also impacted GRG's ability to conduct checks on customer files.
- The significant tension between the turnaround and commercial objectives created challenges. If senior management, for example, insisted that GRG take the side of the customer, they would have been failing in their duty to RBS, its shareholders and depositors. If they had focused all their attention on changing processes, they could have been seen as ignoring urgent practical demands. There was no legal or regulatory requirement

for GRG to prioritise the interests of a customer over what were, in effect, RBS shareholders' interests, where the referred customer was already in default of a commercial lending agreement and in financial difficulties.

Our conclusion

In light of all these considerations, we do not consider that prohibition proceedings brought in relation to any member of GRG senior management, in role during the relevant period, would have reasonable prospects of success.

We did not find evidence of dishonesty or lack of integrity. The absence of regulatory rules against which the performance of senior management within GRG could be measured, in the context of the environment at the time and in all the circumstances, means we do not think a successful competence and capability case could be brought.

We have consulted with independent, external leading counsel who has confirmed that the FCA's conclusions are legally correct and reasonable.

Since these events happened, Parliament has introduced the Senior Managers Regime (SMR). The aim of the SMR is to make individuals more accountable for their conduct and competence, and to ensure that we have the tools to enable us to advance that goal. The Conduct Rules that Senior Managers must comply with will play an important part in driving up standards of conduct by approved persons when performing functions relating to the carrying on of activities (whether regulated or not) by their firm. In appropriate cases, we can fine senior managers in relation to unregulated activities, in contrast to the regime in place during the relevant period. We cannot apply those rules retrospectively to GRG, but these changes mean that, while commercial lending remains unregulated, the overall regulatory situation today is different from what it was during the relevant period.

We will publish a fuller account of our findings. Recognising the significant public interest in this matter we will publish as much detail as we can, to the extent permitted by the law and after allowing for any 'Maxwellisation' process (consistent with the recommendations of Andrew Green QC dated November 2016) as may be required.