The failure of the Royal Bank of Scotland

Financial Services Authority Board Report

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Contents

Chairman's Foreword

RBS's failure in October 2008 has imposed large costs on UK citizens. To prevent collapse the government injected £45.5bn of equity capital: that stake is now worth about £20bn.[1] But this loss is only a small part of the cost resulting from the financial crisis. The larger costs arise from the recession which resulted from that crisis, within which RBS's failure played a significant role. That recession has caused unemployment for many, losses of income and wealth for many more.

Quite reasonably, therefore, people want to know why RBS failed. And they want to understand whether failure resulted from a level of incompetence, a lack of integrity, or dishonesty which can be subject to legal sanction.

This Report aims to provide that account. It identifies the multiple factors which combined to produce RBS's failure. It describes the errors of judgement and execution made by RBS executive and management, which in combination resulted in RBS being one of the banks that failed amid the general crisis. These were decisions for whose commercial consequences RBS executive and Board were ultimately responsible. It sets out the FSA's Enforcement Division's assessment of whether any management and Board failures could be subject to regulatory sanction. It also describes deficiencies in the overall global framework for bank regulation which made a systemic crisis more likely, and flaws in the FSA's approach to the supervision of banks in general and RBS in particular which resulted in insufficient challenge to RBS.

The Executive Summary sets out the key conclusions; the full Report provides the supporting detail. I will not summarise the Report again here, but instead focus on answering two questions which I am sure many readers will ask.

- First, why has no-one in the top management of RBS been found legally responsible for the failure and faced FSA sanction? And if action cannot be taken under existing rules, should not the rules be changed for the future?
- Second, why was the global approach to bank regulation deficient and the FSA's supervisory approach flawed? And have regulations and supervisory approach changed radically enough in response to the crisis?

If RBS management errors led to failure, why has no-one been punished?

In 2009 the FSA launched investigations into each of the major banks that failed during the 2007 to 2008 financial crisis. These investigations aimed to identify whether there had been practices which were either dishonest, lacking in

1 Based on closing share price on 6 December 2011.

integrity or sufficiently incompetent to justify the use of FSA enforcement procedures and, potentially, sanctions. Some of these investigations resulted in charges being brought and sanctions (e.g. fines and bans) being imposed on specific individuals in other banks; some are still on-going. Our investigation into events at RBS was among the most intensive of all those we conducted. After detailed investigation, however, our Enforcement Division lawyers concluded that there was not sufficient evidence to bring enforcement actions which had a reasonable chance of success in Tribunal or court proceedings.[2]

Why has the FSA not taken enforcement action?

Many people will find this conclusion difficult to accept. If harm has been imposed on society, surely someone can and should be held responsible? Part 3 of this Report, 'FSA Enforcement', therefore seeks to explain the legal reasoning which led to Enforcement Division's conclusions. The crucial points of principle are that:

- There is neither in the relevant law nor FSA rules a concept of 'strict liability': the fact that a bank failed does not make its management or Board automatically liable to sanctions. A successful case needs clear evidence of actions by particular people that were incompetent, dishonest or demonstrated a lack of integrity.
- Errors of commercial judgement are not in themselves sanctionable unless either the processes and controls which governed how these judgements were reached were clearly deficient, or the judgements were clearly outside the bounds of what might be considered reasonable. The reasonableness of judgements, moreover, has to be assessed within the context of the information available at the time, and not with the benefit of hindsight.

The implication of these points is that an investigation can identify evidence of numerous poor decisions and imperfect processes, without that establishing a case for enforcement action which has reasonable prospects of success in Tribunal or court proceedings.

This Report describes many such poor decisions by RBS management and Board. Among the most striking was the decision to go ahead with the ABN AMRO acquisition. That acquisition, for reasons described in Part 2 of the Report, played a significant role in RBS's failure. And the Board decided to go ahead with it on the basis of due diligence which was clearly inadequate relative to the risks entailed. Many readers of the Report will be startled to read that the information made available to RBS by ABN AMRO in April 2007 amounted to 'two lever arch folders and a CD'[3]; and that RBS was largely unsuccessful in its attempts to obtain further non-publicly available information.

But while the Board can certainly be criticised for proceeding with such inadequate due diligence, the professional judgement of the FSA's Enforcement lawyers is that an enforcement case for inadequate due diligence would have minimal chances of

2 See www.fsa.gov.uk/pages/doing/regulated/law/pdf/enf_procedure.pdf for a description of the FSA's enforcement powers and procedures, the role of the Regulatory Decisions Committee, and the right of referral to the Upper Tribunal.

3 In addition to this material, information on LaSalle (which RBS did not ultimately acquire) was provided via an online data room (for details of the acquisition, see Part 2, Section 1.5 and Part 3 of the Report, in particular paragraphs 215 to 221 of the latter which cover the information on ABN AMRO made available to RBS).

success, given that there are no codes or standards against which to judge whether due diligence is adequate, and given that the limited due diligence which RBS conducted was typical of contested takeovers.

Enforcement Division also reached similar conclusions in relation to the other issues that it investigated. Part 3 of this Report explains the factors which led it to those judgements.

Those judgements could of course be questioned. But I am confident that the FSA's Enforcement Division decisions were based on intensive investigation of the evidence, and driven by a strong determination to bring enforcement actions if evidence could be identified which justified it. Starting four years ago, the FSA's Enforcement Division has transformed its approach to enforcement, pursuing cases far more aggressively. The number of major cases brought has significantly increased: the level of fines has more than trebled in the last three years. The same team which has led this change has concluded that there are not sound grounds to bring enforcement action in respect to RBS.

While it is possible that new evidence will become available which could support future FSA enforcement action, the current position is therefore that enforceable breaches of FSA rules have not been identified.[4]

The crucial issue that this raises, however, is whether the rules are appropriate: whether the decisions and actions which led to failure *should* ideally have been sanctionable, and whether we should put in place different rules and standards for the future.

Should the rules be changed for the future?

This issue deserves extensive public debate and Parliamentary consideration. Key to that debate should be a recognition that 'banks are different', and that society has a strong interest in bankers taking a different attitude to the balance between risk and return to that which applies in the rest of the economy.

RBS management and Board undoubtedly made many decisions which, at least in retrospect, were poor. They took risks which ultimately led to failure. But if they had taken similar risks in a non-bank company, the question of whether regulatory sanctions were applicable would not have arisen. That is because in non-bank companies the downside of poor decisions falls primarily on capital providers, and in some cases on the workforce, and to a much lesser extent on the wider society.

The ABN AMRO acquisition illustrates the point. The due diligence conducted was inadequate to assess the risks. But it was typical of all contested takeovers, and in non-bank sectors of the economy launching a bid on the basis of limited due diligence might be a reasonable risk to take if the Board believed that the upside opportunities justified it. If the acquisition went wrong, shareholders would suffer, and it would be for them to decide whether to sanction the management or Board by firing them.

4 There is a separate issue of whether disqualification proceedings could be brought against any former directors of RBS. The responsibility for bringing proceedings under the Company Directors Disqualification Act 1986 lies with the Department for Business, Innovation and Skills (BIS). The FSA passed the underlying evidence base received from PricewaterhouseCoopers to BIS in February 2011 so that it could decide whether to start such proceedings.

Banks are different because excessive risk-taking by banks (for instance through an aggressive acquisition) can result in bank failure, taxpayer losses, and wider economic harm. Their failure is of public concern, not just a concern for shareholders.

There is therefore a strong public interest in ensuring that bank executives and Boards strike a different balance between risk and return than is acceptable in non-bank companies. This argues for ensuring that bank executives face different personal risk return trade-offs than those which apply in non-banks.

Two broad ways to achieve this could be considered.

- A legal sanction based approach, introducing a currently absent 'strict liability' of executives and Board members for the adverse consequences of poor decisions, and making it more likely that a bank failure like RBS would be followed by successful enforcement actions, including fines and bans.
- An automatic incentives based approach. This would not rely on bringing enforcement cases which proved personal culpability, but would rather seek to ensure that executives and Boards automatically faced downside consequences from bank failure. Options here could include:
  - Establishing rules which would automatically ban senior executives and directors of failing banks from future positions of responsibility in financial services unless they could positively demonstrate that they were active in identifying, arguing against and seeking to rectify the causes of failure.
  - Regulating remuneration arrangements of executives and non-executive directors so that a significant proportion of remuneration is deferred and forfeited in the event of failure. Regulations of this form have already been introduced for executive directors: they could be strengthened by increasing both the proportion of pay deferred and the period of deferral.

There are pros and cons of these different ways forward. A 'strict liability' legal sanction based approach raises complex legal issues relating to burden of proof and human rights. It might in particular cases result in injustice, and might discourage some high quality and high integrity people from being willing to work in banks, given the large personal liability involved.

Automatic sanctions have the advantage of not requiring expensive and contentious legal processes, but may be insufficient to produce a major shift in personal incentives.

By one means or another, however, there is a strong argument for new rules which ensure bank executives and Boards place greater weight on avoiding downside risks. The options for achieving this merit careful public debate.

Why was global regulation deficient and the FSA's supervisory approach flawed? And have changes been sufficiently radical?

The Report describes an overall approach to the regulation and supervision of banks which made it more likely that poor decisions by individual bank executives and boards could lead to failure. In retrospect, it is clear that:

- The key prudential regulations being applied by the FSA, and by other regulatory authorities across the world, were dangerously inadequate; this increased the likelihood that a global financial crisis would occur at some time.
- In addition, the FSA had developed a philosophy and approach to the supervision of high impact firms and in particular major banks, which resulted in insufficient challenge to RBS's poor decisions. The supervisory approach entailed inadequate focus on the core prudential issues of capital, liquidity and asset quality, and insufficient willingness to challenge management judgements and risk assessments. Reflecting the overall philosophy, supervisory resources devoted to major banks and specialist skills in place were insufficient to support a more intensive and challenging approach.

Readers of this Report are therefore bound to ask why such regulation and flawed supervisory approach had developed. We address this issue in Section 3 of Part 2 of the Report.

Why were regulation and the supervisory approach deficient?

Key elements of the answer are that the FSA's approach reflected widely held but mistaken assumptions about the stability of financial systems and responded to political pressures for a 'light touch' regulatory regime. In particular:

- The capital rules which the FSA was applying were in retrospect severely deficient: they allowed RBS to operate with dangerously high leverage.[5] As Section 1.1 of Part 2 describes, this was one of the most crucial drivers of RBS's failure. But these rules had been developed through the joint effort of central banks and regulators across the world and were believed to be state of the art, sophisticated and appropriate. In retrospect, both these global capital rules, and the FSA's decision to place low priority on the supervision of liquidity, were based on assumptions about the beneficial impact of financial sophistication and innovation, and about the inherently self-correcting nature of financial markets, which were simply wrong.
- The deficiencies identified in the FSA's supervision of RBS, unlike in the case of Northern Rock, were not (with one exception[6]) the result

5 See Part 2, Appendix 2D for an explanation of the division of responsibility between global authorities (e.g. the Basel Committee), the European Union and the UK authorities in the development and enforcement of prudential rules relating to capital and liquidity.

6 See Part 2, Section 1.1 for detail of the point, relating to the confirmation of RBS's precise end-March 2008 capital position.

of imperfect implementation of the FSA's defined approach, but rather flaws in the overall approach itself. FSA senior management had, for instance, consciously decided to place low priority on liquidity supervision and to allocate to prudential supervision resources that in retrospect were inadequate. They did so, however, within the context of prevailing assumptions about appropriate supervisory focus and style, of the FSA's inherited responsibilities, and of political demands for 'light touch' regulation. In particular:

– The erroneous belief that financial markets were inherently stable, and that the Basel II capital adequacy regime would itself ensure a sound banking system, drove the assumption that prudential risks were a lower priority than ensuring that banks were 'treating customers fairly'.

– The FSA's responsibility for both prudential and conduct regulation created the danger that attention would switch away from prudential issues in periods of apparent calm.

– And the FSA operated within the context of frequent political demands for it to avoid imposing 'unnecessary' burdens which could undermine the competitiveness of UK financial firms. In Section 3 of Part 2, we refer to a letter of June 2005 from Callum McCarthy, then Chairman of the FSA, to Prime Minister Tony Blair, assuring him that the FSA applied to the supervision of its largest banks only a fraction of the resource applied by US regulators to banks of equivalent size and importance. The letter reflects the assumptions of the pre-crisis period.

Have changes been sufficiently radical?

The crucial issue is whether lessons have been learned and sufficient reforms implemented. In general, I am confident that they have.

- Global prudential regulations have been changed radically, with Basel III introducing capital adequacy standards far above previous levels, and for the first time introducing quantitative global liquidity rules. The new capital standards require a bank like RBS to hold common equity tier 1 capital equal to at least 9.5% of risk weighted assets in normal economic conditions, or to face constraints on dividend payouts. On the Basel III definition, the FSA's Review Team has estimated that RBS's common equity tier 1 capital ratio at end-2007 would have been about 2%. If the Basel III standards had been in place, RBS would have been prevented from paying dividends at any time during the period reviewed in this Report (2005 onwards) and would have been unable to launch the bid for ABN AMRO.

- And the FSA's approach to supervision has been radically reformed in almost every respect – with more resources, better skills, a more intensive approach and far greater focus on the key prudential issues of capital, liquidity and asset quality. The creation of the Prudential Regulation Authority, focused exclusively on prudential issues rather than spanning both prudential and conduct concerns, will ensure that that focus is maintained even when most of the world assumes, as it did before the crisis, that prudential risks are low.

These changes to the FSA's supervisory approach have been accelerated and intensified since the crisis of autumn 2008 in which RBS failed. But it is important to record, as this Report does, that they had commenced earlier. The FSA had begun the reform of liquidity policy in 2007 and of its approach to capital adequacy requirements in spring 2008. It launched its Supervisory Enhancement Programme in April 2008. Before I became Chairman in September 2008, I was briefed by the top management of the FSA on the major reforms which they knew were essential and on which they had already commenced.

In retrospect, those reforms came too late to prevent either the overall financial crisis or the failure of RBS – as the Report makes clear, the factors which made RBS's failure almost inevitable were already in place by early autumn 2007. And even more radical reforms than those initially envisaged have subsequently been identified as essential. But when I arrived as Chairman, I found an organisation already strongly committed to learning the lessons of the past and to changing its approach.

In addition to the reforms already in hand, this Report makes recommendations for further change. These mainly relate to detailed supervisory processes, and/or to the refinement of measures already in hand. I would, however, like to highlight one major recommendation – that in future major bank acquisitions should be subject to formal regulatory approval. As the Report describes, the FSA did not formally consider whether the risks in the ABN AMRO acquisition were acceptable, because RBS did not have to seek the FSA's regulatory approval for the contested takeover of ABN AMRO. Arguably the FSA, if really determined, could have blocked the takeover by other less direct means; and the FSA has already significantly enhanced its oversight of major financial takeovers. But a clear requirement for regulatory approval for major bank acquisitions would reflect the underlying principle – that society has an interest in the major risks which banks take, not just management, Board and shareholders.

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In concluding this Foreword, I would like to say some words of thanks to FSA staff members. First to the members of the Review Team responsible for the production of Parts 1 and 2 of the Report, and to the team within the Enforcement Division who have produced Part 3. Both teams have worked with great energy and commitment to produce reports which I believe will stand as exemplars of high quality analysis and dispassionate judgement. In addition, however, I would also like to thank the many members of the FSA supervisory and policy staff, including those on the RBS supervision team who, since the financial crisis developed in summer 2007, have worked with great professionalism and dedication to contain its consequences and to design and implement better regulation and supervisory approaches which will create a sounder system for the future.

Introduction

Report background, structure, coverage and process

1 In October 2008, RBS in effect failed and was part nationalised. From 7 October, it relied on Bank of England Emergency Liquidity Assistance (ELA) to fund itself; and on 13 October, the government announced that it would provide up to £20bn of new equity to recapitalise RBS. Subsequent increases in government capital injections amounted to £25.5bn.[1] RBS's failure thus imposed significant direct costs on British taxpayers. In addition, the failure played an important role within an overall financial crisis which produced a major recession.

2 There is therefore a strong public interest in understanding what occurred and who was responsible. In response, this Report aims to do three things:

- explain why RBS failed;
- identify any deficiencies in the FSA's regulation and supervision[2] of RBS in the period leading up to its failure; and
- explain the decisions reached by the FSA's Enforcement and Financial Crime Division ('Enforcement Division') on whether there were grounds for bringing 'enforcement actions', i.e. charges for breaches of FSA rules.

3 In this Introduction, we describe the background to the Report, its structure, what it does and does not cover, and the arrangements put in place to ensure a rigorous and transparent account of what occurred.

Background to the Report

4 The background to the Report has implications both for the balance of its focus on different issues, and for its structure. In essence, the Report's genesis lies in:

- Three specific 'enforcement investigations' conducted by Enforcement Division between early 2009 and December 2010. Those investigations were not initiated to produce a comprehensive or a public account of RBS's failure, but were legal investigations focused specifically on three areas where it seemed most likely that there might be potential to bring successful enforcement cases against senior individuals within RBS.

1 Source: UKFI annual report and accounts, 2010/11.

2 The term 'regulation' is used to refer to the set of rules (e.g. relating to required capital and liquidity resources) which firms are required to meet. 'Supervision' refers to the process by which the FSA oversees and, in various ways, influences the activities of specific firms. The framework for prudential regulation for banks is, to a significant extent, set or influenced by global agreements (e.g. in the Basel Committee), and some specific regulations (in particular on bank capital) are legally defined at European Union level. Appendix 2D describes the relative roles of global, European and national authorities in the setting of prudential regulations. The decisions on the intensity and focus of supervision are almost entirely national in nature.

- Public concerns when the FSA announced in December 2010 that it had not found grounds for bringing enforcement action.
- The FSA's decision, following a letter from Andrew Tyrie, MP, Chairman of the Treasury Select Committee, to produce a summary account of its enforcement investigations and to supplement this with a more comprehensive report on the reasons for RBS's failure, identifying in addition any key deficiencies in FSA regulation and supervision.

Enforcement investigations and review work from March 2009 to December 2010

5 In March 2009, the FSA's Enforcement Division initiated enquiries into a number of firms which had in effect failed during 2007 to 2008.[3] These investigations were not intended to produce comprehensive or public reports on the causes of failure, but to identify whether there were grounds for bringing enforcement action.[4] In some cases, these enquiries resulted in successful enforcement action, with fines or other sanctions imposed. In some cases, investigations are ongoing.

6 In the case of RBS, enquiries were initiated in March 2009 into three specific areas.[5] These were:

- issues relating to the conduct of Mr Johnny Cameron in his former role as RBS Executive Director and Chairman of RBS's Global Banking and Markets Division;
- the decisions made by RBS during the acquisition of ABN AMRO in 2007; and
- various investment circulars issued by RBS in connection with the acquisition of ABN AMRO, the rights issue of April 2008, and the open offer of November 2008.

7 Enforcement Division decided to focus initially on these three areas because *prima facie* investigation suggested that it was in these that there was most likely to be potential for successful enforcement action. The criteria used by Enforcement Division to decide the focus of its investigations, both in general and in the specific case of RBS, are described at the beginning of Part 3 of this Report.

8 Each of the investigations involved gathering a very large volume of detailed and complex material. A team of specialists at PricewaterhouseCoopers (PwC) was instructed to assist with this work. Its reports on each of the three issues formed the majority of the evidence base which Enforcement Division considered in reaching its decisions on whether to proceed further with enforcement actions.

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3 The term 'failure' here refers to a variety of circumstances in which a firm is no longer able to meet FSA 'threshold conditions' and/or to fund itself in the market. Firms which 'failed' on this definition, and where the FSA launched enforcement enquiries, also included Northern Rock and HBOS.

4 In the case of Northern Rock, the FSA did produce and publish in April 2008 a separate Internal Audit Report which assessed the adequacy of the FSA's regulation and supervision of the firm in the period before failure.

5 In formal legal terms there was a distinction between the status of the three enquires. The one that focused on the conduct of Johnny Cameron was a formal 'enforcement investigation' to establish whether disciplinary action should be taken. The other two were earlier-stage 'reviews' to establish whether the FSA should proceed to formal enforcement investigations. In practice, however, this legal distinction made little substantive difference to the volume of evidence collected or the depth of analysis conducted.

9 The FSA's standard practice is to announce details of enforcement actions only if and when these have resulted in disciplinary action against individuals or firms. Decisions *not* to proceed with enforcement action are not normally published. Given the strong public interest in the failure of RBS, however, the FSA made two announcements:

- The first was that it had reached a settlement agreement with Mr Johnny Cameron, which was announced in June 2010.
- The second was that, in relation to the other issues under investigation, Enforcement Division had not found sufficient grounds to bring enforcement actions which had a reasonable chance of success. This was announced in December 2010, together with a very brief statement of the reasons which had led to this decision.

Announcement of summary report on the enforcement investigation and of wider report into RBS's failure

10 Following the announcement on 2 December 2010, there was considerable public concern both that no charges had been brought and that the evidence on the basis of which Enforcement Division had reached its decision (including the PwC reports) was not published.

11 The FSA is subject to very significant legal constraints on its ability to release evidence gathered in those cases where it decides not to bring enforcement action. Conversely, however, the FSA recognised that the particularly strong and legitimate public interest in the RBS case made it desirable to provide further detail if at all possible.

12 Balancing these considerations and in response to a letter from Andrew Tyrie MP, Chairman of the Treasury Select Committee, Lord Turner, Chairman of the FSA, proposed that, while it was not appropriate to release the underlying PwC reports, the FSA should produce a summary of the main points of the PwC reports, and a summary account of the reasons which had led Enforcement Division to conclude against enforcement action.[6] In addition, he proposed that the FSA should produce a more comprehensive report into the causes of RBS's failure, and should identify and report on any key deficiencies in the FSA's own regulation and supervision of RBS in the years running up to failure.

Structure of the Report

13 The Report has three parts:

- Part 1, 'Why did RBS fail?', outlines the complex combination of factors which led to RBS's failure. These include both some factors which were common to many banks, and which contributed to the overall financial crisis, and some which resulted in RBS being one of the specific firms which failed during the crisis;

6 Lord Turner's letter of 15 December 2010 to Andrew Tyrie, MP (included as General Appendix A).

- Part 2, 'Lessons for the regulatory framework and supervision, and for the management of firms', analyses the causes of failure in more detail and seeks to identify:
  - the poor decisions made by RBS management and Board which made RBS highly vulnerable to failure, and the underlying aspects of RBS's management style, governance and culture which may have contributed to those poor decisions;
  - any deficiencies in the overall regulatory framework, agreed largely at global level, which made systemic errors and therefore bank failures more likely; and
  - any flaws in the FSA's supervision of banks in general and RBS in particular which resulted in insufficient challenge to RBS.

  Each relevant section of Part 2 concludes by identifying the lessons learned from the deficiencies of the FSA's prevailing approach and the extent to which these have already been reflected in changes to that approach, and makes recommendations for further reform.
- Part 3, 'FSA Enforcement', focuses on the three specific areas which were the subject of Enforcement Division's investigations. It summarises the evidence considered in the course of those investigations and explains the reasons that led Enforcement Division to conclude that there were not grounds for bringing enforcement actions which had a reasonable chance of success.

Duplication in and differences between Parts 1 and 2 and Part 3

14 In Parts 1 and 2, we aim to provide an account of why RBS failed that satisfies the legitimate public interest in understanding what occurred, and identifies lessons for the management, regulation and supervision of banks which will help ensure that taxpayers will not in future face the costs that RBS's failure imposed. These Parts form a 'public interest report'. Part 3, by contrast, explains the conclusions that Enforcement Division reached on whether it was possible to bring enforcement action against individuals which had a reasonable chance of success. This Part is a summary account of the conclusions of a legal investigation.

15 Between Parts 1 and 2 and Part 3, there is significant but unavoidable duplication.[7] In Parts 1 and 2 we aim to provide a comprehensive account of all the main factors which played a role in RBS's failure. In Part 3, we focus on those specific issues that were subject to enforcement investigation. Part 3 therefore covers a sub-set of the issues considered in Parts 1 and 2.

16 The nature of the judgements that we reach in Parts 1 and 2 is, moreover, quite different from those reached in Part 3.

7 These comments about differences between Parts 1 and 2 and Part 3 apply also to relevant sections of the Executive Summary. Paragraphs 1-38 of the Executive Summary present a summary of Parts 1 and 2, paragraphs 39-49 present a summary of Part 3.

- Part 3 applies a forensic legal standard to the assessment of evidence, since it is seeking to answer a legal question – whether there were actions by individuals which breached FSA rules and/or which displayed incompetence or lack of integrity that can be subject to legal sanction. For legal sanction to be appropriate, it has to be clear that there was strong evidence that individuals broke specific rules, and/or that decisions were made which were not only mistaken in retrospect but were outside the bounds of reasonableness at the time they were taken.

- Parts 1 and 2 in contrast seek to apply the approach of the historian. The facts presented have been carefully checked. And while any historical account necessarily entails a selection of facts from all those that might be relevant, we have not deliberately selected facts to support a particular explanation; and areas where the factual record could support alternative interpretations, or where there is uncertainty, are clearly identified. But the account presented necessarily makes judgements about the relative importance of different factors, and about the quality of decisions made by either RBS or the FSA at the time. Without making such judgements, it would be impossible to meet the public interest in receiving a 'best efforts' account of what led to RBS's failure.

17 In Parts 1 and 2, we do therefore make some judgements about the quality of decisions made. All of these judgements are inevitably formed in some degree with the benefit of hindsight, since it is only with hindsight that we know the consequences which followed from the decisions. But in some cases a reasonable argument can be made that decisions were poor even at the time, for instance if they were based on insufficient information or analysis. We have therefore, at several points in Parts 1 and 2, sought to distinguish between:

- decisions which were mistaken in retrospect, but only because events occurred which were either explicitly and reasonably considered very unlikely at the time, or which could reasonably have been so considered;

- decisions which were based on assumptions which in retrospect appear unjustified, but which were widely held by the majority of market participants and by public authorities; and

- decisions which can reasonably be judged to have been poor at the time (even if in many cases the full consequence of the poor decisions could not have been envisaged), because based on incomplete analysis of all available information or because influenced by some bias (e.g. towards optimism or in favour of growth).

18 The fact that some decisions are described as poor or mistaken (either in retrospect or at the time) in Parts 1 and 2, however, carries no implication that either RBS or any individual was guilty of any regulatory breach. Nor does it imply that we suspect there was a regulatory breach but that we simply lack the evidence to prove it. The judgements reached in Parts 1 and 2 are views expressed in an attempt to understand and describe the causes of RBS's failure for the purposes of satisfying a legitimate public interest. They can reasonably be subject to public debate.

Timescale of coverage, and matters not covered by this Report

19 The Report considers events up to the day RBS first received ELA from the Bank of England – 7 October 2008 – since this was in effect the point of failure. Its coverage (the 'Review Period') commences at the beginning of 2005: this reflects a judgement about the timescale that needs to be covered if we are to understand the steady build-up of factors that led to RBS's failure.

20 The Report does not consider the effectiveness of the other Tripartite authorities in the period before RBS's failure. Nor does it consider the effectiveness of the actions which the Tripartite authorities took to respond to RBS's failure and to the wider financial crisis in autumn 2008.

21 The Report describes changes made in the FSA's regulation and supervision of banks in response to the crisis, covering changes both in the overall global regulatory regime and in the FSA's supervisory approach and resources. The Chairman's Foreword responds to the question of whether these changes have been sufficiently radical. It was not, however, part of the remit of the Review Team to assess in detail the effectiveness of these changes, and Part 2 therefore does not include such an assessment.

Report production process, responsibilities and quality assurance

22 The Report was considered by the FSA Board at its meeting on 10 November 2011. The Board noted that a carefully designed process of quality control had been adopted for the production of the Report. It had been prepared under the overall leadership of Lord Turner, Chairman of the FSA. Parts 1 and 2 had been produced by a separate Review Team, independent of executive management, led by Rosemary Hilary, the FSA's Director of Internal Audit. Part 3 had been prepared by the case team within the Enforcement and Financial Crime Division, led by William Amos (a Head of Department in that Division), which took forward the original investigation. Both teams reported directly to Lord Turner for their work on the Review, and Lord Turner was personally involved in challenging both the content and findings of the Report. The Report had been reviewed in detail by a sub-group of the Board's non-executive directors, chaired by Brian Pomeroy.[8] The sub-group had been set up by the Board for the purpose of providing direct Board-level scrutiny of the Report and of the independence and objectivity of the process by which it had been produced. The Board also noted that in May two specialist advisers had been appointed to advise on the preparation of the Report. The advisers had been supported by legal and accountancy experts. They had had full access to the information held by, and to the members of, the Review Team, had been able to make recommendations on the contents of the Report, including any further inquiries or documents which should be made or obtained respectively,

8 In addition to Brian Pomeroy, the members of the NEDs sub-group were Carolyn Fairbairn, Karin Forseke and Andrew Scott.

and had held meetings with RBS and other interested parties. The specialist advisers' terms of reference asked them to report on the extent to which, in their view, the FSA report is a fair and balanced summary of the evidence gathered by the FSA and PwC during their review of the failure of RBS, whether it fairly reflects the findings of the FSA's investigation, and whether it is a fair and balanced summary of the FSA's own analysis of its regulatory and supervisory activities in the run-up to the failure of RBS. The Report as a whole, and the judgements made within it, had been reviewed by the full Board.

23 On the basis of the quality assurance processes described above and its own discussions of key conclusions and judgements, the Board agreed to confirm to the specialist advisers that, in its opinion, the Report represents a fair and balanced summary of the evidence gathered by the FSA and by PwC during their review of the failure of RBS, that it fairly reflects the findings of the FSA's investigation and that it is a fair and balanced summary of the FSA's analysis of its regulatory and supervisory activities in the run-up to the failure of RBS.

24 The Board also noted that the executive management of the FSA had agreed that the recommendations included in Part 2 would be taken into account in the design, in collaboration with the Bank of England, of the Prudential Regulation Authority, and as appropriate, of the Financial Conduct Authority.

25 As mentioned above, following discussions with the Treasury Select Committee during April 2011, two specialist advisers – Bill Knight and Sir David Walker – were appointed to provide challenge and external perspective, and assurance that the review had been conducted in a rigorous fashion. The specialist advisers offered comments on the Report at draft stage, which were considered by the Review Team in finalising the Report, and will report on it by way of evidence to the TSC. This multi-layered quality assurance process has inevitably increased the time required to produce the Report, but we believe it has been justified by the need to ensure transparency and effective challenge.

26 The production timetable has also had to allow an opportunity for all parties referred to or criticised in the Report (whether individuals or companies) or their lawyers to review it. That process (known as 'Maxwellisation') provides an opportunity for those parties to see a draft of the Report, to consider what is said about them and provide any comments.

27 In addition, the relevant legislation requires the FSA to seek the consent of RBS and certain individuals to the use of their confidential information in the Report. The FSA has obtained the necessary consents from those parties. However, RBS has indicated that it has not undertaken an exercise to verify the FSA's statements and conclusions in the Report and, by providing consent, should not be taken as accepting the accuracy of those statements and conclusions.

28 In the course of the past year, as the Report has been developed, there have occasionally been press reports suggesting that it was being blocked by unreasonable legal action on the part of interested parties. This is not the case. In particular, publicity was given to an injunction obtained by RBS's former

chief executive, Sir Fred Goodwin, in relation to his private life. This injunction has had no impact on the ability of the Review Team or Enforcement Division to conduct their work and, having investigated the subject matter of the injunction, we are confident that it is irrelevant to the story of RBS's failure.

Executive summary

1 This Executive Summary sets out:

- our conclusions on why RBS failed. RBS's failure amid the systemic crisis resulted from poor decisions by its management and Board. But deficiencies in global regulations made such a crisis more likely, and flaws in the FSA's supervisory approach provided insufficient challenge to RBS;
- the changes already introduced to the FSA's regulation and supervision of major firms, and recommendations for further change;
- the reasons why the FSA's Enforcement Division decided that there were not grounds for bringing enforcement cases with a reasonable chance of success; and
- a wider public policy issue raised by the fact that a massive bank failure has not resulted in enforcement action.

2 In an annex to this summary, we also record summary conclusions from the Review Team's assessment of the work of the UK Listing Authority in respect of the market communications covered within the enforcement enquiries.

Why did RBS fail?: poor management decisions, deficient regulation and a flawed supervisory approach

3 The failure of RBS can be explained by a combination of six key factors:

- significant weaknesses in RBS's capital position during the Review Period, as a result of management decisions and permitted by an inadequate regulatory capital framework;
- over-reliance on risky short-term wholesale funding;
- concerns and uncertainties about RBS's underlying asset quality, which in turn was subject to little fundamental analysis by the FSA;
- substantial losses in credit trading activities, which eroded market confidence. Both RBS's strategy and the FSA's supervisory approach underestimated how bad losses associated with structured credit might be;
- the ABN AMRO acquisition, on which RBS proceeded without appropriate heed to the risks involved and with inadequate due diligence; and
- an overall systemic crisis in which the banks in worse relative positions were extremely vulnerable to failure. RBS was one such bank.

4 Although poor capital and liquidity regulation made it more likely that there would be a systemic crisis and thus set the context for the failure, and while a flawed supervisory approach provided insufficient challenge, ultimate responsibility for poor decisions must lie with the firm. The multiple poor decisions that RBS made suggest, moreover, that there are likely to have been underlying deficiencies in RBS management, governance and culture which made it prone to make poor decisions. We therefore consider whether such underlying deficiencies should be treated as a seventh key factor in explaining RBS's failure.

5 Key conclusions in respect of these seven key factors are set out below, followed by an assessment of the FSA's overall approach to supervision in the pre-crisis period.

RBS's capital position and the underlying regulatory framework

6 The immediate cause of RBS's failure was a liquidity run. But concerns about the firm's capital adequacy (as well as about capital adequacy across the banking system) were crucial to its failure. The global regulatory capital framework in place before the crisis was severely deficient, and the reforms introduced by Basel II in retrospect added major complexity without addressing the fundamental problem of inadequate capital across entire banking systems. Even in the context of that capital regime, moreover, RBS chose to be lightly capitalised relative to its peers and made considerable use of lower-quality forms of capital. The acquisition of ABN AMRO further weakened its capital position.

7 The Review Team did not find any evidence of breaches by RBS of the prevailing regulatory minimum capital requirement during the Review Period. But one way of illustrating the deficiencies of the global framework that established that minimum requirement is by contrasting what RBS's position would have been if the Basel III definitions of capital had been in place before the crisis. The Review Team estimated that RBS would have recorded a common equity tier 1 ratio at end-2007 of around 2%.[1] This compares to an absolute minimum, under the new standards, of 4.5%, and a higher level of 9.5% which the Financial Stability Board (FSB) and the Basel Committee have now agreed that the largest systemically important banks (as RBS was in 2008) should hold during normal times in order to operate without restrictions on dividends and other distributions.[2] With hindsight, RBS's capital before the crisis was grossly inadequate to provide market assurance of solvency amid the general financial crisis of autumn 2008.

8 In addition to the deficiencies in the Basel capital adequacy regimes in force during the Review Period, the FSA's supervision of capital was mainly reactive. From late 2007 onwards, the FSA was increasingly developing and applying a more rigorous capital regime, and it pushed RBS to make a large rights issue in

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1 This estimate was prepared for illustrative purposes only, and could not have been calculated at the time: the Basel III definitions were agreed only in 2010. It takes no account of any behavioural shifts that RBS might have made in response to the Basel III regime.

2 To supplement the minimum common equity tier 1 requirement of 4.5%, the Basel III reforms include a capital conservation buffer of 2.5% of risk-weighted assets, which firms need to hold in order to avoid restrictions on distributions. The size of this buffer could be increased to reflect cyclical conditions. In addition, the FSB and the Basel Committee have agreed a framework under which the loss absorbency capacity is further extended by 1%-2.5% for systemically important banks. For the largest, most systemically important banks, this could require a common equity tier 1 ratio of at least 9.5% during normal times in order to operate without additional constraints on distributions.

April 2008. In retrospect, however, the changes in the FSA's capital regime came too late to prevent the developing crisis. And RBS's £12bn rights issue, while it seemed large at the time, turned out to be insufficient to ensure market confidence during the autumn 2008 funding crisis.

RBS's liquidity position, the FSA's regulatory framework and supervisory approach

9 RBS entered the crisis with extensive reliance on wholesale funding. Its short-term wholesale funding gap was one of the largest in its peer group, and it was more reliant on overnight funding and unsecured funding than most of its peers. The acquisition of ABN AMRO increased its reliance on short-term wholesale funding. In the context of very limited international agreement in the area of liquidity, the FSA's prevailing regulatory and supervisory frameworks for liquidity were not adequate to identify and limit this dependence, in particular RBS's significant use of non-sterling short-term wholesale funding. Once the crisis had started, it was difficult for RBS to improve its liquidity position significantly.

10 As with the regulatory capital framework, one way of illustrating the deficiencies of the prevailing regulatory framework for liquidity is by estimating what RBS's position would have been at the time if the Basel III Liquidity Coverage Ratio (LCR) had been in place before the crisis. The Review Team estimated that RBS's liquidity position at end-August 2008 would have translated to an LCR (as currently calibrated) of between 18% and 32%, versus a future standard requirement of 100%.[3] RBS would, therefore, have had to increase by between £125bn and £166bn its stock of high-quality unencumbered liquid assets or, alternatively, reduce its reliance on short-term wholesale funding in order to comply with the LCR standard. RBS's position was therefore significantly below the future Basel III requirement and, applying that measure in retrospect, RBS had a liquidity position at the onset of the August to October 2008 market crisis which was excessively dependent on short-term wholesale funding (as did a number of other banks). In addition, that dependence on short-term wholesale funding was greater than most of its large UK banking peers. It was more vulnerable than its peers to a collapse in confidence and a self-reinforcing bank run.

11 The FSA's regulation of and overall approach to the supervision of liquidity for major firms in the pre-crisis period was more deficient than its approach to capital. It was applying deficient rules; and it had explicitly accorded a relatively low priority to liquidity, which should be at the core of good prudential supervision. In 2003 the FSA recognised in a Discussion Paper on liquidity risk that there were deficiencies in the existing Sterling Stock Regime (SSR) approach to monitoring bank liquidity, but in April 2004 decided not to follow up with a Consultation Paper on possible changes to liquidity regulation, in part because of the greater priority given to capital reform at that time. From then onwards, progress in liquidity reform was sought only via the track of international work, which has historically been slow.

3 This estimate of RBS's position does not attempt to make any allowance for any behavioural shifts that RBS might have made in response to the Basel III regime.

12 From September 2007 onwards, in response to the crisis, the FSA greatly increased its supervisory focus on liquidity, putting in place improved monitoring systems and playing a leading role in developing more robust liquidity regulations, first at national and then at global level. The FSA Chairman was also closely engaged in discussions among the Tripartite authorities about issues relating to overall public authority liquidity support. However, the increased FSA emphasis on, and changed approach to, liquidity risk proved too late to prevent failure. This reflected the reality that once banks are already in stressed liquidity positions, it is extremely difficult to correct them.

Asset quality: concerns and uncertainties

13 RBS's balance sheet and leverage increased rapidly in the years leading up to the financial crisis, in a period of fast growth in credit extension and leverage across the banking sector. While RBS's investment banking division, Global Banking and Markets (GBM), was the most rapidly growing area, RBS's loan portfolio in its other divisions also expanded. Significant loan losses were subsequently suffered in many areas of business, with a particular concentration in commercial property. Indeed, impairments incurred on loans and advances eventually amounted to £32.5bn over the period 2007-10, significantly exceeding the £17.7bn of losses on credit trading activities. The full extent of those losses would not have been clear to the market in autumn 2008. However, uncertainties about the scale of future losses and concerns about asset classes held by RBS contributed to the loss of confidence in the firm at that time.

14 The FSA's supervisory approach for most of the Review Period involved little fundamental analysis of balance sheet composition or asset quality.

Losses in credit trading activities

15 By early 2007, RBS had accumulated significant exposures containing credit risk in its trading portfolio, following its strategic decision in mid-2006 to expand its structured credit business aggressively. The acquisition of ABN AMRO increased RBS's exposure to such assets just as credit trading activities were becoming less attractive. This increased the firm's vulnerability to market concerns.

16 Structured credit markets deteriorated from spring 2007 onwards. RBS, like many others, was by then holding positions which were bound to suffer some loss. The crucial determinant of how much loss was the extent to which a firm could distribute its existing positions, or was willing to take losses earlier by hedging or closing those positions out. RBS was among the less effective banks in managing its positions through the period of decline.

17 Before the onset of the market disruption in August 2007, the FSA's overall approach involved little fundamental analysis of trading book inventory and did not focus on valuation issues. There were also deficiencies in the market risk capital regime, including its over-reliance on value-at-risk (VaR) models.

The ABN AMRO acquisition: an extremely risky deal

18 The acquisition of ABN AMRO by a consortium led by RBS greatly increased RBS's vulnerability. The decision to fund the acquisition primarily with debt, the majority of which was short-term, rather than equity eroded RBS's capital adequacy and increased its reliance on short-term wholesale funding. The acquisition significantly increased RBS's exposure to structured credit and other asset classes on which large losses were subsequently taken. In the circumstances of the crisis, its role as the leader of the consortium affected market confidence in RBS.

19 RBS decided to make a bid for ABN AMRO on the basis of due diligence which was inadequate in scope and depth, and which hence was inappropriate in light of the nature and scale of the acquisition and the major risks involved. This was the inevitable result of making a contested takeover, where only limited due diligence is possible. In proceeding on that basis, however, RBS's Board does not appear to have been sufficiently sensitive to the wholly exceptional and unique importance of customer and counterparty confidence in a bank. As a result, in the Review Team's view, the Board's decision-making was defective at the time. RBS believed in its ability to integrate businesses successfully after the acquisition of NatWest; in the case of ABN AMRO, it underestimated the challenge of managing the risks arising from the acquisition.

20 In its response to the largest ever cross-jurisdictional acquisition in history, the FSA took only limited account of the substantial uncertainties and risks, which were compounded by the restricted due diligence that the firm could perform. The FSA was not sufficiently engaged from April 2007, when it was informed of the consortium's intention to make a bid for ABN AMRO, in testing in detail the potential capital and liquidity implications of the acquisition. Nor did it challenge sufficiently the adequacy of RBS's due diligence. This reflected the fact that the FSA had neither a responsibility to approve the acquisition, nor a defined approach towards major takeovers (contested or otherwise). It also reflected the FSA's supervisory philosophy at the time, which encouraged supervisors to place reliance on assurances from firms' senior management and boards about strategy, business model and key business decisions. Later in the process, in autumn 2007, the FSA concluded that RBS would be able to manage the acquisition from a capital perspective, and would run into liquidity difficulties only in the event of an extreme scenario, which was considered at that time to be '*very unlikely*'. The FSA's approach to major corporate takeovers is now considerably more intrusive.

Systemic vulnerabilities and confidence collapse

21 The intensification of market uncertainties during the summer of 2008, culminating in the acute loss of confidence following the collapse of Lehman Brothers in September, affected all banks in some way. But those most affected were those that were, or were perceived as being, in a worse position, in terms of capital, liquidity or asset quality. They included RBS.

22 In the weeks following Lehman Brothers' collapse, the run on RBS's liquidity reached extreme proportions. While it appeared at the time that the rights issue announced in April 2008 had placed RBS in a strong capital position, it is clear

with hindsight that its true loss-absorbing capital in fact remained weak. RBS's 2008 half-year results signalled emerging asset quality problems, including continuing large losses on credit market exposures. And it continued to have a greater dependence on short-term wholesale funding, in particular from the overnight markets, than most of its peers. While it is difficult to say to what extent these factors were known by market participants at the time, it is clear that there were significant market concerns about RBS's capital position and asset quality, which made it logical to perceive RBS as one of the most vulnerable UK banks.

23 Following the onset of the crisis period, building on the changes to liquidity monitoring put in place from September 2007, the FSA further increased the intensity of its monitoring and supervision of liquidity, enhancing the scope and granularity of liquidity data it requested from certain firms, including RBS. But by that time there was little, if any, action that could be taken to improve RBS's deteriorating position. After the collapse of Lehman Brothers, for the most part RBS could access only the overnight markets as market participants were unwilling to fund longer term. Even overnight funding became difficult to access, and RBS became dependent on Bank of England Emergency Liquidity Assistance on 7 October 2008.

RBS's management, governance and culture

24 Some of the causes of RBS's failure were systemic – common to many banks or the consequence of unstable features of the entire financial system. And a deficient global framework for bank capital regulation, together with an FSA supervisory approach which assigned a relatively low priority to liquidity, created conditions in which some form of systemic crisis was more likely to occur. But with hindsight it is clear that poor decisions by RBS's management and Board during 2006 and 2007 were crucial to RBS's failure.

25 Individual poor decisions can result from flawed analysis and judgement in particular circumstances: many of the decisions that RBS made appear poor only with the benefit of hindsight. But a pattern of decisions that may reasonably be considered poor, at the time or with hindsight, suggests the probability of underlying deficiencies in: a bank's management capabilities and style; governance arrangements; checks and balances; mechanisms for oversight and challenge; and in its culture, particularly its attitude to the balance between risk and growth.

26 It is difficult, from the evidence now available, to be certain how aspects of RBS's management, governance and culture affected the quality of its decision-making, but the Review Team's analysis prompts the following questions, in addition to the conclusion (discussed in paragraph 19) about the ABN AMRO bid:

- Whether the Board's mode of operation, including challenge to the executive, was as effective as its composition and formal processes would suggest.
- Whether the CEO's management style discouraged robust and effective challenge.

- Whether RBS was overly focused on revenue, profit and earnings per share rather than on capital, liquidity and asset quality, and whether the Board designed a CEO remuneration package which made it rational to focus on the former.
- Whether RBS's Board received adequate information to consider the risks associated with strategy proposals, and whether it was sufficiently disciplined in questioning and challenging what was presented to it.
- Whether risk management information enabled the Board adequately to monitor and mitigate the aggregation of risks across the group, and whether it was sufficiently forward-looking to give early warning of emerging risks.

27 Potential areas of concern about RBS's management, governance and culture were identified by the FSA Supervision Team during the Review Period. The degree of supervisory intensity applied to these issues, however, while consistent with the FSA's prevailing practices and approach, was less than the FSA now considers appropriate.

The FSA's overall approach to supervision: priorities, processes and resources

28 As described above, while less significant to RBS's failure than the framework of regulatory standards, many aspects of the FSA's approach to the supervision of systemically important firms in the pre-crisis period were inadequate. This reflected the fact that the FSA's overall philosophy and approach was flawed. There was insufficient focus on the core prudential issues of capital and liquidity, and inadequate attention given to key business risks and asset quality issues. Too much reliance was placed on assessments that appropriate decision-making processes were in place, with insufficient challenge to management assumptions and judgements. And a flawed concept of a 'regulatory dividend' rewarded firms with less intensive supervision if they could demonstrate effective controls and displayed a degree of cooperation with the FSA that ought to have been a non-negotiable minimum. Reflecting this philosophy, insufficient resources were devoted to high impact banks and in particular to their investment banking activities. In addition, supervision teams were responsible for both prudential and conduct issues: as a result, a focus on priority conduct issues – such as the 'Treating Customers Fairly' initiative – could result in inadequate focus on key prudential concerns.

29 Unlike in the case of Northern Rock, however, the Review Team did not find that the way in which the Supervision Team implemented the FSA's defined supervisory approach was materially deficient. Save with one specific exception, relating to the confirmation of RBS's precise end-March 2008 capital position[4], the Supervision Team was, in the RBS case, largely doing what was expected of it, according to the priorities, processes, practices and approach set by FSA senior management, and working within the constraints of the resources allocated to it.

4 This issue is discussed in Part 2, Section 1.1. As explained there, although this was an exception to defined process, at the time the FSA was pressing RBS to raise as much capital as possible, and thus addressing the key priority of ensuring that RBS was adequately capitalised.

30 There were, however, a number of points on which, while agreeing that the decision taken was in line with the prevailing practices or, in the case of the acquisition of ABN AMRO, that there was no precedent, the Review Team questioned some judgements made by the FSA during the Review Period:

- The FSA did not assess in sufficient detail the risks arising from the ABN AMRO bid, in the period before RBS and its consortium partners published their offer documents on 20 July 2007, and the ARROW letter communicated to the Board on 25 October 2007 placed little focus on the risks involved in the ABN AMRO bid.[5] This led the Review Team to question whether:
  - despite the lack of a prescribed FSA procedure in respect of major acquisitions, the FSA should have established a dedicated team to assess the risks involved either soon after RBS informed the FSA of the intention to bid for ABN AMRO, or after the intention to bid was made public, in April 2007; and
  - the ARROW process should have been adjusted to ensure significant focus on the risks arising from the acquisition.
- Other noteworthy, but less important, judgements related to:
  - the absence of a process for supervisors to monitor the non-sterling funding of those banks, subject to the SSR, which were materially reliant upon it;
  - the assessment of governance and oversight within RBS, both in respect of concerns identified that the CEO was dominant and received insufficient challenge from the Board, and in ensuring that messages to the RBS Board were clear and unambiguous; and
  - not continuing to push for further evidence of the Board's scrutiny and challenge of the firm's macroeconomic stress-testing, particularly as the development of such stress-testing had been agreed as a specific mitigant to the risks posed by RBS's commercial property exposures.

31 With the exception of the issues noted in paragraphs 29 and 30, however, what was wrong in the case of RBS was the FSA's overall approach to prudential supervision, rather than the execution of this approach in relation to RBS.

32 Clearly, the decisions on processes, priorities and resources that defined this approach were made by the senior management of the FSA. They were also subject to oversight by the FSA Board, which approved the annual Business Plan, within which were decisions about the level and allocation of resource. Ultimately, the FSA management and Board were responsible for a flawed approach which relied too much on relatively high-level risk assessment of the key issues affecting a high impact firm, and was too reactive in the absence of indicators of heightened risk. It is important to note, however, that the judgement that it was flawed is made with hindsight, and that the FSA's management and Board were operating within a context which entailed:

5 'ARROW' refers to the FSA's risk assessment process. RBS was subject to an ARROW risk assessment between April and September 2007. Findings were communicated to the firm in October 2007.

- global regulatory standards which were severely deficient but believed to be appropriate and sophisticated;
- a consensus, among practitioners and policy-makers, which confidently asserted that financial innovation and complexity had made the financial system more stable;
- a regulatory structure which made the FSA responsible for the entire range of financial regulation issues – from the prudential soundness of major systemically important banks to the conduct of some 25,000 financial intermediaries; and
- a strong focus on the importance of the 'competitiveness' of the UK financial services sector and so of avoiding 'unnecessary' regulation. This focus reflected in part the FSMA requirement to have regard to competitiveness issues.

Within this context, it is likely that, if the FSA had proposed before the first signs of the crisis (i.e. before summer 2007) the measures that in retrospect appear appropriate, such proposals would have been met by extensive complaints that the FSA was pursuing a heavy-handed, gold-plating and unnecessary approach.

Changes to regulation and supervisory approach already made, and further recommendations

33 At the end of each relevant section of Part 2 of the Report, we set out the lessons learned from the Review Team's assessment of the FSA's regulation and supervision of RBS in the Review Period. The Review Team then identified whether changes had already been made and recommended further change where not. Table 1 in Appendix 2A provides a consolidated list of the changes that are already in hand. Table 2 in that Appendix lists the further changes required.

34 Those tables reveal that the vast majority of changes required have already been made. This reflects the radical overhaul of the FSA's approach to supervision, and of global regulatory standards, which had begun even before the failure of RBS and has continued since.

35 Radical reform of the FSA's approach to the supervision of high impact firms started with the launch in April 2008 of the Supervisory Enhancement Programme, which incorporated the findings of the FSA's Internal Audit Report into the failure of Northern Rock. It was further intensified in response to the findings of *The Turner Review* in March 2009, and to international reviews of appropriate regulatory and supervisory standards. This intensification has been implemented via the Core Prudential Programme launched in the first quarter of 2010. Together these programmes of reform have resulted in:

- Dramatic increases in the scale of total resources devoted to the supervision of high impact firms. RBS is now supervised by a team of 23 people, rather than six in August 2007, just before the onset of the market crisis. In addition, this team is able to draw on greatly increased specialist resources.

- Far greater focus on the core prudential issues of capital adequacy and liquidity, supported by increased specialist skills and informed by far more detailed firm reporting.
- Far greater focus on asset quality issues, including through the use of detailed stress-testing.
- A more intensive and intrusive style of supervision, with the FSA more willing to challenge management judgements and decisions.
- A far greater focus on the competence and expertise of top management and non-executive directors involving, for instance, pre-approval interviews for all those occupying significant influence functions.

36 National and global prudential regulatory standards have also been radically changed. The FSA had already commenced reforms to its capital and liquidity regimes during the course of 2007, before RBS's failure, and the capital standards against which UK banks were judged were raised still further at the time of the October 2008 recapitalisations. The case for further reforms was also stressed by *The Turner Review* in March 2009. Subsequent work by the Basel Committee and the global Financial Stability Board, in which the FSA along with the Bank of England has played a leading role, has resulted in:

- greatly increased capital requirements both overall and in particular for some categories of trading activity; and
- the establishment for the first time of global quantitative liquidity standards.

37 As a result of these programmes of radical change, most of the deficiencies of FSA regulation and supervision of RBS in the pre-crisis period have already been addressed. Most of the recommendations for further change set out in Table 2 of Appendix 2A are therefore not fundamental, but rather refinements and extensions of changes already in hand. The executive management of the FSA has agreed that these further recommendations will be taken into account in the design, in collaboration with the Bank of England, of the Prudential Regulation Authority and, as appropriate, of the Financial Conduct Authority.

38 Two recommendations, however, merit highlighting.

- The first relates to the regulatory oversight of large bank takeovers. As Section 1.5 of Part 2 discusses, FSA approval was not required for the acquisition of ABN AMRO. Irrespective of the formal position, however, it is arguable that the FSA could and should have used other mechanisms to prevent the acquisition. Even under existing powers the FSA has, since the crisis, changed its approach to the oversight of major acquisitions, demanding, for instance, that firms prove that they have the capital resources to meet large and uncertain risks.

  We believe, however, that there would be merit in making it a formal requirement that banks obtain regulatory approval for major acquisitions (relative to the size of the acquiring bank).

- The second relates to the provision of independent advice in respect of major acquisitions by regulated firms. The recommendation here is that the FSA should consider whether and how the Board of a firm considering a major acquisition should obtain independent advice, from an adviser whose remuneration is not linked to successful completion of the transaction.

FSA decisions on whether to bring enforcement actions

39 Poor decisions made by RBS's management and Board clearly played a major role in RBS's failure. The FSA's Enforcement Division concluded, however, that it was not appropriate to bring an enforcement case against the firm and that there were not sufficient grounds to bring enforcement cases against individuals which had a reasonable chance of success before a tribunal.

40 In deciding whether to take enforcement action for the matters investigated, Enforcement Division took into account a number of factors, including the following:

- The FSA considered that, in the circumstances, disciplinary action against the individuals responsible for any misconduct would serve as a greater deterrent than a sanction against a bank that had already failed, was in public ownership and had new management in place. The investigation work was therefore primarily focused on potential cases against individuals rather than the firm.
- Cases against an individual require a high standard of evidence, and in particular strong evidence of an individual's personal culpability. The FSA does not have the power to take enforcement action simply because a failure occurs in an area for which an individual is responsible (i.e. there is no requirement of strict liability).
- While RBS's governance, systems and controls and decision-making may have fallen short of best practice, and below the practices of a number of peer firms, the FSA could not take action where decisions made or systems in place were not outside the bounds of reasonableness given all the circumstances at the time, including FSA awareness of issues and the approach it took at that time. The FSA may not apply standards of conduct retrospectively against the firms and individuals it regulates, on the basis that to do so would raise serious issues of unfairness.

As a result of these factors, Enforcement Division had to make careful judgements when choosing whether to take enforcement action. Its reasons for reaching the conclusions it did in each of the major areas of investigation are set out below.

Decision-making and controls within GBM

41 One of the three areas investigated by Enforcement Division was the conduct of Mr Johnny Cameron, Chairman of RBS's Global Banking and Markets (GBM) division, in respect of key decisions made and potential control failings within

GBM. This focus reflected the significance of GBM's losses in the failure of the bank. Losses incurred by GBM (excluding ABN AMRO) on credit trading activities played a major role in eroding RBS's capital base and undermining confidence. Over 2007 and 2008, these losses amounted to £2.5bn in structured credit (e.g. CDOs), £2.3bn in related monoline insurance and £1.4bn in leveraged finance.

42 The scale of these losses reflected both a poor strategic decision to expand the business and a flawed response to emerging problems. In particular:

- The scale of losses was exacerbated by a strategic decision made in June 2006 and endorsed by the group Board to expand GBM's structured credit and leveraged finance aggressively.
- While GBM ceased taking on new positions in late 2006 as problems in the sub-prime housing markets became apparent, it initially assumed that the super senior tranches (rated AAA) of CDOs which it had retained would not suffer loss.
- Over the subsequent 18 months, as the value of structured credit trading positions constantly declined, RBS was less effective than some other banks in distributing or hedging its exposures. This in part reflected a bias to optimism in its assessment of values and market prospects at any particular time.
- Several aspects of GBM's risk management, control and reporting processes were flawed, and senior management on some occasions displayed flawed understanding of key aspects of the risks being taken.

43 Enforcement Division concluded, however, that there were not grounds for enforcement actions, given that:

- while the decision to expand the business in 2006 was in retrospect poor, it was not outside the bounds of reasonableness at the time, given in particular that the scale of the risks taken looked relatively small compared to the total size of the RBS group;
- while the assessment that the risks involved in retaining super senior tranches of CDOs were very low was in retrospect wrong, it was widely shared by the industry at the time, and indeed by regulators and respected economic authorities;
- RBS's Board was kept informed of emerging losses from July 2007 onwards and in greater detail from September 2007. While earlier reporting might in retrospect have been preferable, it was not clear at the time that that was necessary, given losses which then seemed small relative to the size of the group's balance sheet and P&L; and
- although with hindsight it would have been better for RBS to have closed out its positions earlier, crystallising losses and containing risks, the decisions not to do so were not, as viewed at the time, clearly unreasonable.

44 These findings informed the settlement reached with Mr Cameron, in which he committed not to perform any significant influence function in relation to any

regulated activity or to undertake any further full-time employment in the financial services industry. As part of this settlement, the FSA agreed it would not take any disciplinary action against Mr Cameron. The FSA did not make any findings of regulatory breach against Mr Cameron and he did not make any admissions.

The decision to proceed with the ABN AMRO acquisition

45 A second area investigated by Enforcement Division was the ABN AMRO acquisition, which significantly increased RBS's vulnerability to deteriorating market conditions. Its funding primarily with debt, the majority of which was short-term, rather than equity eroded RBS's already light capital adequacy and increased its reliance on short-term debt. It significantly increased RBS's exposure to structured credit and other asset classes on which large losses were subsequently taken. It was not the only, but certainly a significant, factor among the causes of RBS's failure.

46 Enforcement Division's investigation of the bid process (drawing in particular on the report commissioned from PwC) concluded that the due diligence conducted by RBS in relation to this acquisition was insufficient in scope and depth, and inadequate given the risks involved. However, that conclusion did not in itself provide a strong case for successful enforcement action, since it did not lead to a finding that either the FSA's Rules, or its Principles of Business or Statement of Principles for Approved Persons, were contravened. In particular:

- There was no failure of formal governance process in terms of the relationship between the executive management and the Board. It was transparent to the Board that the proposal to proceed was made on the basis of very limited due diligence, and the Board and Chairman's Committee considered the acquisition on numerous occasions. The Board was also professionally advised on the issue of whether it had given the proposed transaction proper consideration.

- The level of due diligence conducted was in line with market practice for contested bids. The regime for public contested bids did not (and does not now) make it possible for bidders to insist on more thorough due diligence than RBS conducted. And market practice for contested bids in the UK and other European countries did not (and does not now) require higher standards of due diligence in the case of bank acquisitions than non-banks.

- More due diligence would have provided greater depth of information concerning ABN AMRO's risk profile. It is unclear however whether, even if RBS had had access to a greater level of information, its due diligence would have resulted in estimates of future potential losses anywhere near the losses that actually arose, or even that it would have resulted in estimates of losses to any material degree, particularly given the judgements that RBS was making in relation to its own business.

- Like many other market participants, RBS did not foresee the crisis, the severity of which eventually exposed weaknesses in the balance sheets of many banks across the world. In the context of an enforcement action, it would be inappropriate to apply hindsight about what subsequently occurred to the actions of firms and individuals prior to the crisis.

Investment circulars

47 The third area investigated by Enforcement Division was the preparation of various investment circulars issued by RBS. While Enforcement Division identified some shortfalls in the processes involved in the preparation of the investment circulars, it did not find materially important deficiencies. It therefore concluded that the deficiencies identified did not justify enforcement actions.

Other issues considered in the course of the investigations

48 In assessing evidence under the three headings above, Enforcement Division also kept under continuous review whether the evidence suggested other potential areas for enforcement action. In particular, it considered two issues:

- Whether the flaws in senior management's oversight of GBM provided grounds for bringing enforcement action against Sir Fred Goodwin for failing to appoint suitably qualified individuals to run the GBM business. In particular, it focused on whether the decision to appoint a Chairman (Mr Cameron) with a credit background rather than a markets background was reasonable. Enforcement Division concluded, however, that there was little chance of successful enforcement action on this basis, given that Mr Cameron, as Chairman, did not lead GBM alone and had assistance from others with the relevant expertise. The overall mix of skills and experience among GBM management was acceptable.

- Whether approaches to the valuation of trading positions (e.g. of the CDOs) and to the public disclosure of emerging losses were unreasonable and could be subject to enforcement action. Here Enforcement Division concluded that there was a bias to optimism which might not reflect well on the judgements made by senior management, RBS's auditors and its Group Audit Committee, but did not identify clear evidence that the valuations were outside the limits of what was plausible at the time. The issue did not, therefore, form a reasonable basis for enforcement action.

Enforcement approach to further failings identified in this Report

49 Judgements made in Parts 1 and 2 of the Report about the quality of decisions made by RBS carry no implication that there was any regulatory breach. In the light of the findings presented in those Parts, however, Enforcement Division has considered whether it should undertake further investigations into areas not covered by the original enforcement work. The conclusion reached was that further enforcement investigations were not appropriate. In particular, Enforcement Division was mindful that while governance, systems and controls

and decision-making may have fallen well short of best practice, and below the practices of a number of peer firms, the decisions taken and systems in place were not outside the bounds of reasonableness given all the circumstances at the time, including the approach of the FSA to various matters.

Large bank failure but no enforcement action: wider policy issue raised

50 The decisions not to bring enforcement action reflected Enforcement Division's professional assessment of the likely chances of success given the legal position as it now stands. The fact that no successful enforcement action has been possible, however, raises a wider policy issue: *should* it have been possible to sanction relevant executives and/or Board members for the failure of RBS? Should the law change?

51 This issue is discussed in the Chairman's Foreword, which argues that:

- 'Banks are different' in the sense that their distress or failure can have far wider economic consequences than typically result from the failure of non-bank firms.
- Policy options which more clearly recognise this fact merit public debate.

Annex: UKLA supervision of RBS's market communications

52 In reviewing the effectiveness of FSA supervision before the crisis, the primary focus of the Review Team has been on the prudential oversight of RBS by the FSA's units responsible for the regulation and supervision of major UK banks. Enforcement Division's investigation of the quality of RBS investor communications, however, raised the issue of whether the UK Listing Authority (UKLA, which forms a separate part of the FSA) effectively executed its responsibilities with respect to those communications.

53 The Review Team therefore conducted its own assessment of the work of the UKLA in relation to the Rights Issue Prospectus and Circular, and the Working Capital Statement. It looked into the UKLA's performance of its statutory functions in relation to the adequacy of RBS's disclosures to the market.

54 That assessment is described in Appendix 2B to Part 2 of this Report. It is the responsibility of listed companies and their directors to ensure that the market is kept properly informed of all material information concerning the financial condition of the listed entity and its group. Where a circular of the kind considered in this Report is issued by a listed company, the FSA requires that the directors of the company confirm that the document is accurate and comprehensive; and that the company's advisers – its 'sponsors' – have come to a reasonable opinion that the company has satisfied the requirements of the listing rules. The FSA, as listing authority, requires the company and its advisers to confirm that the directors are in a position to provide the required assurances. The FSA does not independently verify the underlying due diligence or the accuracy of the disclosures. Given that context, the Review Team's key conclusions were that the actions of the UKLA were appropriate and carried out in accordance with the established processes and approach.

Part 1

Why did RBS fail?

1 In October 2008, RBS failed. If it had not been given exceptional public support, it would probably have gone into resolution.[1] This exceptional public support was in two forms:

- **Liquidity**: from 7 October 2008, RBS was funded in part by Emergency Liquidity Assistance (ELA) provided by the Bank of England.[2] The wholesale markets, and to a lesser extent retail and corporate depositors, were no longer willing fully to fund the bank.
- **Solvency**: to restore capital to adequate levels, RBS launched a £20bn capital raising on 13 October 2008 (comprising a £15bn rights issue and a £5bn issue of preference shares). But only 0.24% of the rights issue was subscribed by private investors. The rest entailed an injection of public funds.

2 Why did this failure occur? Many accounts of the events refer to RBS's record £40.7bn operating loss for the calendar year 2008. But that loss is not in itself an adequate explanation of failure. Most of it indeed had no impact on standard regulatory measures of solvency:

- Of the £40.7bn loss, £32.6bn was a write-down of intangible assets, with impairment of goodwill contributing £30.1bn. Such a write-down signals to shareholders that past acquisitions will not deliver future anticipated value. But in itself, it had no impact on total or tier 1 capital resources, from which goodwill had already been deducted.[3] It did not reduce the value of RBS's financial assets nor increase the value of its financial liabilities.
- And of the £30.1bn of goodwill written off, £14.5bn related to the Fortis share of ABN AMRO and was offset by a decline in Fortis's minority interest claim on the consolidated results. This loss was eventually faced by Fortis's shareholders (in effect, Dutch taxpayers[4]) rather than RBS shareholders (primarily UK taxpayers).
- In fact 'only' £8.1bn of the £40.7bn (pre-tax) operating loss resulted in a reduction in standard regulatory capital measures.

3 Given that RBS's stated total regulatory capital resources had been £68bn at end-2007, and that it raised £12bn in new equity capital in June 2008 (when the rights issue announced in April 2008 was completed), an £8bn loss should have been absorbable.

1 Resolution refers to the process of achieving an orderly solution to a failing bank's problems at a pre-insolvency stage. Normal insolvency procedures are inadequate for certain banks for several reasons (see HM Treasury announcement, *Banking Act 2009 and the establishment of the Special Resolution Regime*). In February 2008, emergency legislation was introduced in the form of the Banking Special Provisions Act which created a temporary resolution regime (used in the case of Bradford and Bingley). The 2009 Banking Act replaced this temporary regime and created the new bank resolution scheme in the UK.

2 Emergency Liquidity Assistance was provided to RBS until 16 December 2008.

3 Although, in some cases, a write-down of intangible assets could have an effect on capital resources as a result of the gearing rules applied to different types of capital resources, it is the Review Team's understanding that the gearing rules were not triggered in the case of RBS.

4 From 3 October 2008, the relevant parts of Fortis were owned by the State of the Netherlands.

4 The 2008 loss is not therefore a sufficient explanation of RBS's failure. Instead, failure resulted from a complex combination of factors, some common to all banks, others specific to RBS. Several were made possible by an inadequate regulatory approach; others reflected RBS's poor management and Board decisions. Six factors were key:

1) RBS's capital position was far weaker, in terms of its ability to absorb losses, than its published total regulatory capital resources suggested. This reflected a definition of regulatory capital, which was severely deficient, combined with an RBS strategy of being lightly capitalised relative to its peers.

2) The whole banking system, but RBS in particular, was excessively dependent on short-term wholesale funding. This dependence was allowed by deficient regulatory and supervisory frameworks, with a seriously flawed liquidity regime to measure, monitor and limit firms' liquidity risks. It also reflected RBS's belief that it would always be able to fund itself, a belief which subsequently proved mistaken.

3) There were asset quality concerns and uncertainties arising from aggressive growth. Uncertainties about the scale of future loan losses, in addition to already incurred and potential further credit trading losses, contributed to the loss of confidence in RBS in autumn 2008. Although the full extent of lending losses subsequently recognised would not have been clear to the market at that time, such concerns were justified by the £14.1bn of loan impairments subsequently taken in 2009 and £9.1bn taken in 2010.

4) Large fair value losses in credit trading activities, both in RBS and in other banks, directly eroded equity buffers and created huge uncertainty about how large the eventual losses might be. The scale of RBS's losses in this area reflected deficient strategy and execution at the firm.

5) The ABN AMRO acquisition significantly increased RBS's exposure to risky asset categories, reduced an already relatively low capital ratio, increased potential liquidity strains and, because of RBS's role as the consortium leader and consolidator, created additional potential and perceived risks. RBS's decision to proceed with this acquisition was made on the basis of due diligence which was inadequate in scope and depth given the nature and scale of the acquisition and the major risks involved. The FSA's overall supervisory response to the acquisition was also inadequate.

6) The collapse of banking system confidence in autumn 2008 resulted from belated market awareness of the risks arising from the complex interconnectedness of the banking and shadow banking systems. Amid this collapse of confidence, almost all banks faced liquidity pressures; but these were most extreme for those banks which were perceived to be (and in many cases actually were) worse positioned in terms of asset quality, capital adequacy and liquidity. RBS was one such bank.

5 Poor regulation made it more likely that there would be a systemic crisis and thus set the context for RBS's failure, and a flawed supervisory approach provided insufficient challenge. But ultimate responsibility for poor decisions must lie with the firm, and the pattern of poor decisions which RBS made suggests that there are likely to have been underlying deficiencies in RBS's management, governance and culture which made it prone to make poor decisions. We therefore consider that these underlying deficiencies should be treated as a seventh key factor in explaining RBS's failure.

6 These seven key factors are considered in turn below.

1. RBS's capital position and the underlying regulatory framework

7 RBS's capital position as at end-2007 clearly met the minimum 8% requirement of the then existing regulatory capital regime (see Graph 1.1). Total capital of £68bn resulted in a published total capital ratio of 11.2%, well in excess of the Basel I and Basel II 8% Pillar 1 minimum capital requirement. Similarly, RBS's published tier 1 ratio of 7.3% was well in excess of the 4% tier 1 minimum required under Basel I and Basel II.[5]

8 As the crisis developed, however, this capital proved inadequate to reassure investors and funders that actual and future possible losses could be absorbed. This reflected three facts:

- Even within the context of the regime in place at the time, at end-2007 RBS went into the crisis period towards the lower end of peer comparisons of capital adequacy (see Graph 1.1 and Graph 1.2). This reflected a deliberate policy of, in the RBS CEO's words, '*capital efficiency*'.[6] This relatively light capital position was made worse by the decision to fund the ABN AMRO acquisition primarily with debt rather than equity, accepting a reduction in capital ratios below RBS's own 5.25% core tier 1 target, with an intention to rebuild gradually over subsequent years. When market confidence collapsed in autumn 2008, all banks perceived as relatively risky were particularly vulnerable to liquidity problems.
- The capital regime that regulators were applying, however, was also severely deficient. In the wake of the crisis, the international regulatory community has agreed a new global capital standard – Basel III. This regime sets a new higher absolute minimum of 4.5% common equity tier 1, combined with a capital conservation buffer and additional loss absorbency capacity for the largest systemically important banks, which will mean that such banks (as RBS was at the time of its failure) will have to hold 9.5% common equity tier 1 capital during normal times in order to operate without restrictions on dividends and other distributions. The Basel III regime also increases risk weights for some assets and changes

5 While Basel II introduced significant changes to the way that capital requirements were calculated for particular exposures, the minimum capital requirement of 8% of risk-weighted assets (RWAs) remained unchanged and the intention was to maintain a similar level of capital in the banking system as a whole.

6 Full Year 2005 RBS earnings conference call, 28 February 2006. Transcripts sourced from Thomson StreetEvents.

the definition of core capital to ensure that it includes only capital resources available to absorb losses on a going concern basis.

- To illustrate the deficiencies in the Basel II framework, the Review Team assessed how RBS's capital position would have appeared against the common equity tier 1 capital requirements incorporated in Basel III. The Review Team estimated that RBS's Basel III common equity tier 1 ratio as at end-2007 would have been 1.97% (see Table 1.1). The whole banking system, but in particular relatively lightly capitalised banks such as RBS, had been permitted by the regulations then in force to run with capital levels which were, in retrospect, insufficient to deal with the inherent uncertainties of loss levels over time.

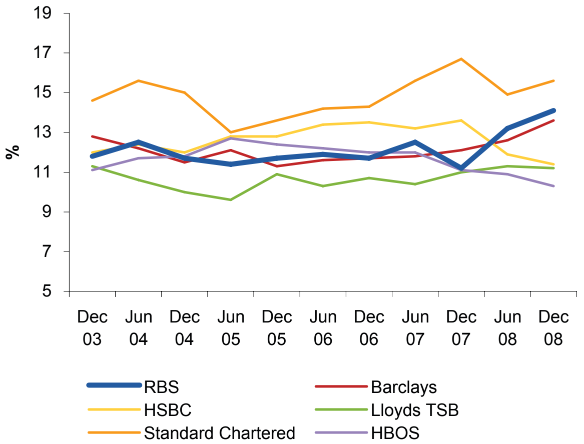
- From early 2008 onwards, the FSA was active in developing and enforcing a more robust capital adequacy regime. This was a key driver of RBS's £12bn rights issue in April 2008. But the FSA's action proved too late to avert the crisis. With hindsight, if the Basel III regime (which the FSA now considers appropriate) had been in place before the crisis, RBS would have remained below the absolute minimum common equity tier 1 capital requirement even after the rights issue completed in June 2008. Under Basel III, RBS would not have been permitted to pay dividends at any time during the Review Period.

- The capital regime was most deficient, moreover, in respect of the trading books of the banks, where required capital for many instruments was estimated using value-at-risk (VaR) approaches. The acquisition of ABN AMRO meant that RBS's trading book assets almost doubled between end-2006 and end-2007.[7] Even assuming a 5.25% target core tier 1 ratio (as against the 2% minimum), the low risk weights assigned to trading assets suggested that only £2.3bn of core tier 1 capital was held to cover potential trading losses which might result from assets carried at around £470bn[8] on the firm's balance sheet. In fact, in 2008, losses of £12.2bn arose in the credit trading area alone (a subset of total trading book assets). A regime which inadequately evaluated trading book risks was, therefore, fundamental to RBS's failure. This inadequacy was particularly significant for RBS, given that the purchase of ABN AMRO significantly increased RBS's trading book assets. RBS was allowed by the existing regulations massively to increase its trading risk exposure counterbalanced only by a small increase in capital buffers available to absorb loss.

7 Because of limitations in available data, the end-2007 figure was estimated by the Review Team (see also Table 1.2).

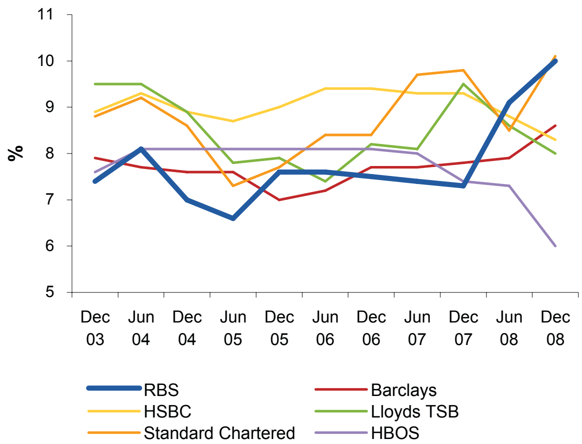
8 This figure was estimated by the Review Team as the split between banking and trading book assets as at end-2007. It was not provided in RBS's returns at that time, and RBS has not been able to provide a breakdown. For the assumptions made by the Review Team, see the notes to Table 1.2.

Graph 1.1: UK banks' published total capital ratios



Source: 2003 to 2008 published annual reports and interim results.

Graph 1.2: UK banks' published tier 1 capital ratios



Source: 2003 to 2008 published annual reports and interim results.

Table 1.1: Estimates of a proxy Basel III common equity tier 1 measure for RBS, as at 31 December 2007[9]	
	£bn
Gross core tier 1 capital (net of prudential filters)[10]	79.8
Of which: minority interest in core tier 1	(39.1)
Gross core tier 1 capital attributable to RBS shareholders (net of prudential filters)	**40.8**
Recognition of minority interest equity	35.1
Regulatory adjustments[11]	
Deduction of excess minority interest equity attributable to third-party owners	(4.5)
Deduction of intangible assets	(52.5)
Deduction of material holdings[12]	(2.9)
Adjustments for prudential filters[13]	(0.6)
Net common equity tier 1 (including partial recognition of minority interests)	**15.4**
Net common equity tier 1 (excluding minority interests)	**6.5**
Basel I risk-weighted assets (RWAs)	609.0
Market risk and counterparty risk changes	155.6
Add securitisation exposures weighted 1250%	18.1
Basel III RWAs (Review Team estimate)	**782.6**
Common equity tier 1 attributable to RBS shareholders/estimated RWAs	**0.83%**
Basel III common equity tier 1 capital ratio (Review Team estimate)	**1.97%**

9 These data were provided in the context of this Review and were supplemented with data obtained from other sources comprising the following: Review Team analysis of FSA returns; FSA records; and data provided by RBS in March to September 2011. The Review Team's methodology in coming to these estimates is given in Appendix 2E. This analysis was necessarily conducted with the benefit of hindsight and does not take into account behavioural effects that the Basel III rules might have had, had they been in place at the time. The table does not cast due to the rounding of figures.

10 Gross core tier 1 capital comprises ordinary shares and reserves attributable to RBS shareholders, plus minority interests, net of prudential filters.

11 Only adjustments that were not zero at end-2007 are shown in the table.

12 The Review Team treated material holdings as significant investments in common stock, hence an amount was allowed up to 10% of common equity tier 1 (including minority interests) after other deductions, in line with the Basel III framework.

13 Basel III requires the removal of prudential filters on unrealised gains and losses.

Table 1.2: RBS's banking book and trading book assets and RWAs from end-2004 to end-2008[14]

	Basel I				Basel II
£bn	31/12/2004	31/12/2005	31/12/2006	31/12/2007[15]	31/12/2008
Banking book assets	392.9	444.0	459.4	1,140.9	1,338.0
Trading book assets[16]	186.4	200.0	243.5	470.9	1,018.3
Total assets of the UK regulatory consolidation group (including ABN AMRO from end-2007)	**579.4**	**644.1**	**702.9**	**1,611.8**	**2,356.3**
Banking book RWAs	306.7	354.8	378.0	564.8	551.4
Trading book RWAs	17.1	16.2	22.3	44.2	107.5
Operational RWAs					36.9
Total RWAs	**323.8**	**371.0**	**400.3**	**609.0**	**695.8**
Amount of core tier 1 capital that would have been held against banking and trading book assets, using RBS's target core tier 1 capital ratio of 5.25% (5.25% x RWAs)					
Banking book	16.1	18.6	19.8	29.7	28.9
Trading book	0.9	0.9	1.2	2.3	5.6
Operational risk	0.0	0.0	0.0	0.0	1.9
Total core tier 1 capital	**17.0**	**19.5**	**21.0**	**32.0**	**36.5**

2. RBS's liquidity position, the FSA's regulatory framework and supervisory approach

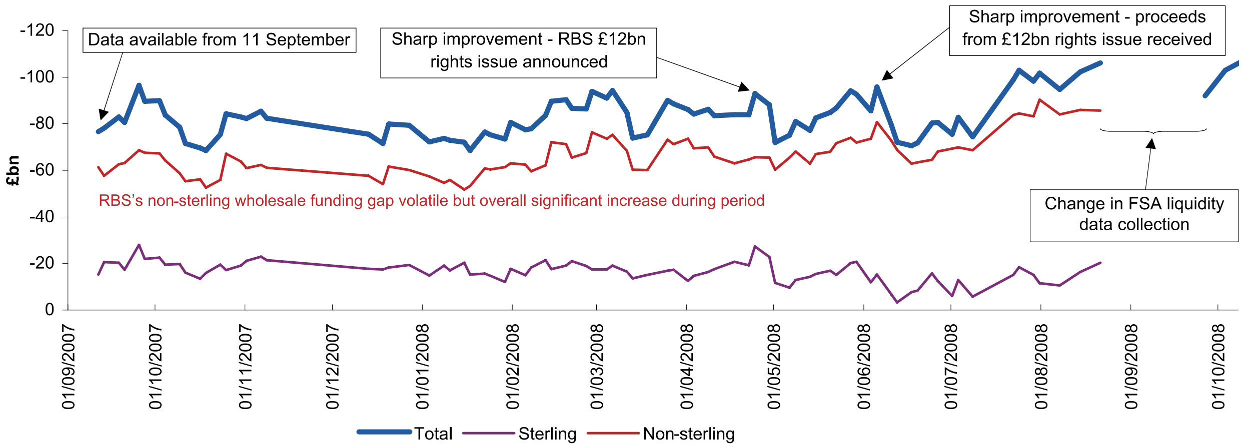
9 The immediate driver of RBS's failure was not, however, inadequate capital but a liquidity run (affecting both RBS and many other banks). Potential insolvency concerns (relating both to RBS and other banks) drove that run, but it was the unwillingness of wholesale money market providers (e.g. other banks, other financial institutions and major corporates) to meet RBS's funding needs, as well as to a lesser extent retail depositors, that left it reliant on Bank of England ELA after 7 October 2008.

14 The table does not cast due to rounding of figures taken from regulatory returns.

15 The split between banking book assets and trading book assets has been estimated by the Review Team using information from published accounts. Data were not available from FSA returns because RBS's returns at end-2007 included all ABN AMRO assets in a single line under the '*aggregation plus*' approach, which did not separate banking book and trading book assets. RBS did not have a record of the split of ABN AMRO's assets as at that date. To estimate the split of assets, the Review Team compared the ratio of financial assets held at fair value through profit and loss in prior periods (as reported in published annual and interim accounts) to trading book assets reported in FSA returns for the same periods to mid-2007. The Review Team then took an average of these ratios and applied it to financial assets held at fair value through profit and loss in RBS's 2007 annual report and accounts to give an estimate of trading book assets for end-2007.

16 Note that derivative assets are not included within this figure for 2004 to 2007, but are included in the figure for 2008.

Graph 1.3: RBS's total very short-term wholesale funding gap split between sterling and non-sterling denominated funding[17]



Source: CSI reports and LRP reports.

10 Available figures for RBS's very short-term[18] wholesale funding gap[19] before the provision of ELA revealed two relevant points. First, the gap consisted, in particular, of non-sterling wholesale funding (which was predominantly US$), rather than sterling wholesale funding (see Graph 1.3). Second, the deterioration in RBS's very short-term wholesale funding gap became very severe relatively late in the development of the crisis (see Graph 1.4). It is only from July 2008 that there is clear quantitative evidence of a sharp, significant and sustained increase in that gap (though RBS had described and suffered challenging liquidity conditions, for example difficulties obtaining term funding, at earlier points in the crisis). In September 2007, at the time of the Northern Rock failure, RBS had no difficulty raising debt funds for the ABN AMRO acquisition from the market, and indeed believed at that time that it was enjoying a 'flight to quality'.

11 By 2007, the UK and global banking system had become hugely vulnerable to a wholesale liquidity run as banks had become more reliant on potentially volatile sources of funding, both wholesale unsecured and wholesale secured (via the repo market) funding, which was often sourced from the short-term markets. RBS was even more exposed than most and became still more so after the ABN AMRO acquisition.

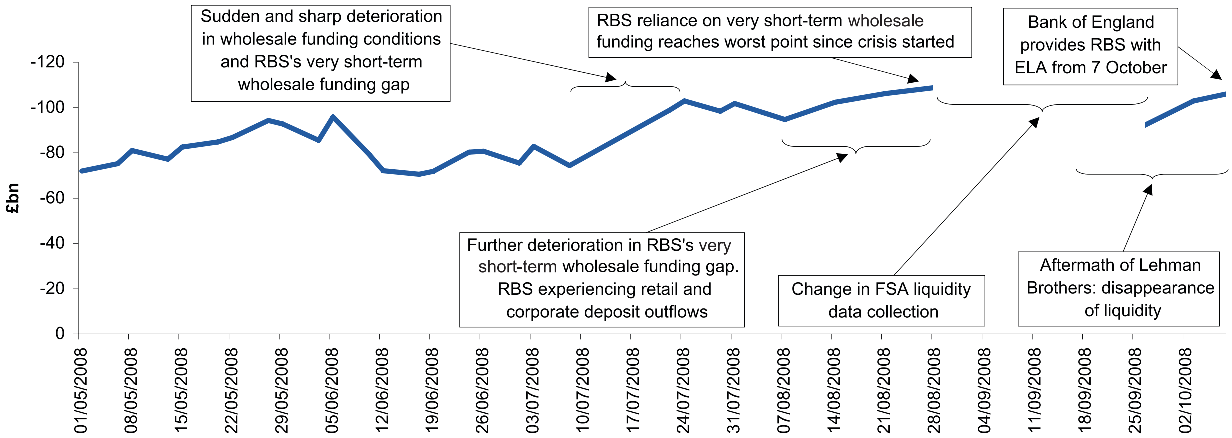
- Graph 1.5 shows how the loan books of UK banks were growing faster than their deposit bases, reflecting the increased use of wholesale funding to support traditional lending activities. By end-2006, this '*customer funding gap*' had widened to £500bn.

17 Wholesale funding gap data are taken from Current Status Indicator (CSI) reports (which included wholesale funding gaps in each major trading currency) and Liquidity Risk Profile (LRP) reports, which replaced them at end-August 2008, see Part 2, Section 1.2, paragraph 179. During the short transitional period, liquidity data were collected by the FSA from firms, including RBS, during regular telephone calls held at that time, see Part 2, Section 1.2, paragraphs 176 to 177. The Review Team was not able to present the sterling and non-sterling split from 1 September 2008 to 7 October 2008 as, although the LRP report template was able to capture liquidity data for major trading currencies, in practice, some firms, including RBS, did not complete these data. It is the Review Team's judgement that this did not undermine the FSA's monitoring and understanding of RBS's non-sterling liquidity position, see Part 2, Section 1.2, paragraph 183.

18 Very short-term funding is defined in this 'key factor' as wholesale funding falling due within five business days.

19 Wholesale funding is defined in this 'key factor' to include both unsecured and repurchase agreements (repo) funding from the wholesale markets. A repo is the sale of securities with an agreement to buy the securities back later; it is a form of short-term borrowing. Wholesale funding gap is defined in this 'key factor' as wholesale outflows less wholesale inflows on a contractual basis without taking collateral into account.

Graph 1.4: RBS's very short-term wholesale funding gap, May to December 2008[20]



Source: CSI reports and LRP reports.

- The associated risks created were neither adequately captured nor restrained by appropriate liquidity rules. While much effort in the decade before the crisis was devoted to a new capital regime (Basel II), there were no global quantitative liquidity rules nor was the need for them actively debated. In the UK meanwhile, liquidity regulation and supervision in relation to high impact firms was accorded a relatively low priority by the FSA. Insofar as the FSA was monitoring liquidity risks for firms such as RBS, it was through the Sterling Stock Regime (SSR), the quantitative requirements of which were inadequate fully to capture sterling wholesale funding risks, and which did not at all capture risks of funding in US$ or other non-sterling currencies. In 2003, the FSA recognised in a Discussion Paper on liquidity risk[21] that there were deficiencies in the existing SSR approach to monitoring bank liquidity, but in April 2004 decided not to follow up with a Consultation Paper on possible changes to liquidity regulation, in part because of the greater priority given to capital reform at that time. From then onwards, progress in liquidity reform was sought only via the track of international work, which has historically been slow. As with capital, so with liquidity: the FSA from autumn 2007 made significant improvements to its supervisory approach for liquidity, including actively redesigning its liquidity regime, and has subsequently been a global leader in developing new liquidity approaches. It also substantially increased its focus on RBS's liquidity position. But this proved to be too late to avert failure for RBS.

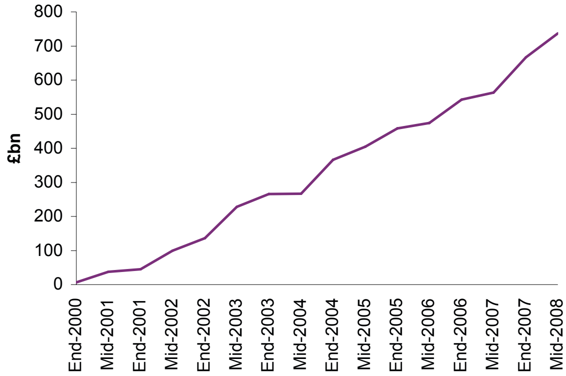
- Even in September 2007, before the acquisition of ABN AMRO, although one of RBS's large UK banking group peers had a bigger short-term[22] wholesale funding gap, RBS was more reliant on overnight funding than other firms in its peer group. RBS's concentration in the overnight markets is shown in Graph 1.6. This is discussed in more detail in Part 2, Section 1.2.1.

20 This graph depicts RBS's total sterling and non-sterling very short-term wholesale funding gap. Wholesale funding gap data are taken from CSI reports and LRP reports which replaced CSI reports from end-August 2008 (during the short transitional period, liquidity data were collected by the FSA from firms, including RBS, during regular telephone calls held at that time, see Part 2, Section 1.2, paragraphs 176 to 177).

21 FSA Discussion Paper (DP) 24, *Liquidity Risk in the Integrated Prudential Sourcebook: a quantitative framework*, October 2003.

22 Short-term wholesale funding is defined here as wholesale funding falling due within 25 business days.

Graph 1.5: Major UK banks' customer funding gap[23]

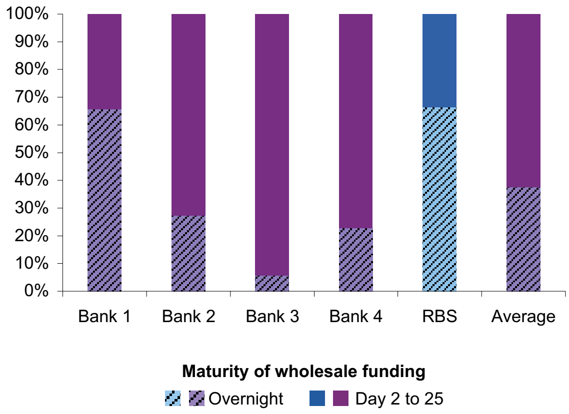


Source: Bank of England, Dealogic, ONS, published accounts and Bank of England calculations.

- The vulnerabilities created by RBS's reliance on short-term wholesale funding and by the system-wide deficiencies were moreover exacerbated by the ABN AMRO acquisition, which:
  - because it was primarily debt financed, of which the majority was short-term, resulted in a direct increase in RBS's reliance on short-term wholesale funding (in particular, the Review Team estimated that €12.3bn of the €22.6bn cash consideration had a maturity of one year or less);
  - by end-2007, had quadrupled RBS's committed liquidity facilities provided to own-sponsored asset-backed commercial paper (ABCP)[24] conduits which were a significant liquidity drain on RBS during the crisis period;
  - because of a reduction in lending limits provided by some market counterparties to the combined entity of RBS and ABN AMRO, reduced its borrowing capacity in those markets; and
  - because of ABN AMRO's large trading balance sheet, left RBS more exposed to any loss of confidence in funding markets, such as occurred in autumn 2008.
- RBS continued to have a vulnerable liquidity position compared to most of the large UK banks following the acquisition of ABN AMRO. At end-December 2007, its short-term[25] wholesale funding gap was the second largest in its peer group; its gap had increased by nearly 15% since September 2007. It remained more concentrated in the very short-term markets, and in particular the overnight markets, than most of its peers. See Graph 1.7. This is discussed in more detail in Part 2, Section 1.2.3.

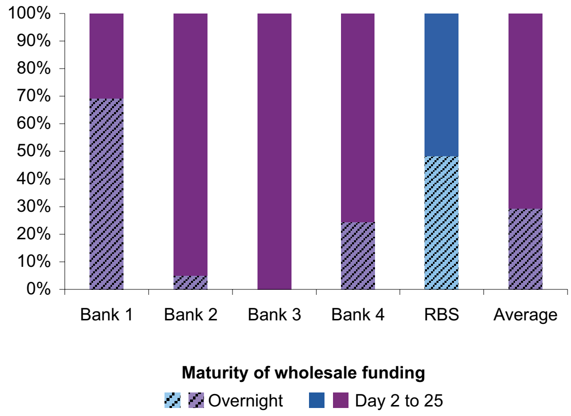
23 The customer funding gap is customer lending less customer funding, where 'customer' refers to all non-bank borrowers and depositors.
24 An ABCP conduit issues short-term commercial paper (CP) backed by a pool of assets. In order to ensure it can pay the CP as it falls due, the conduit has liquidity facilities provided by a bank or banks, as well as credit enhancement. See Appendix 2G.
25 Short-term wholesale funding is defined here as wholesale funding falling due within 25 business days.

Graph 1.6: Overnight wholesale funding as a proportion of the short-term wholesale funding gap at 11 September 2007[26]



Source: CSI reports.

Graph 1.7: Overnight wholesale funding as a proportion of the short-term wholesale funding gap at end-December 2007[27]



Source: CSI reports.

12 In the wake of the crisis, the international regulatory community has agreed new liquidity standards: alongside the capital standards detailed above, these liquidity standards were an essential element of the Basel III[28] package. For liquidity, the inadequacy of the prevailing regime can be illustrated by analysing how RBS's liquidity position would have appeared before its failure[29] under one of the new Basel III liquidity standards, the Liquidity Coverage Ratio (LCR).[30] This analysis shows that RBS would have had to increase by between £125bn and £166bn[31] its stock of high quality unencumbered liquid assets or, alternatively, reduce its reliance on short-term wholesale funding to comply with the standard, had the rules been in force at the time.[32]

3. Asset quality: concerns and uncertainties

13 The overall deficiencies of the capital and liquidity regimes described, combined with RBS's relatively risky position, even within the existing rules, made RBS highly vulnerable to a loss of market confidence. Losses incurred in credit trading and concerns about overall credit quality were important factors in driving that loss of confidence.

14 In 2008, credit trading losses comprised a significant element of the losses incurred, and amounted to £12.2bn. These losses are discussed under key factor 4. For that year, these losses exceeded the £7.1bn losses recognised due to impairment on loans and advances. In 2009, credit trading losses were a much smaller £4.1bn and more than offset by other trading profits, resulting in an overall positive

26 The peer group is the large UK banking groups. For the purposes of confidentiality, the anonymised titles are not used consistently in relation to individual peers in this graph, Graph 1.7, Part 2, Section 1.2, Graphs 2.3 and 2.5 and Part 2, Section 1.6, Graph 2.19. Short-term wholesale funding is defined here as wholesale funding falling due within 25 business days. For an explanation of CSI reports, see Part 2, Section 1.2, paragraphs 174 to 175.
27 See footnote to Graph 1.6.
28 The Basel III liquidity regime will be subject to an observation period to address unintended consequences. *Basel III: International framework for liquidity risk measurement, standards and monitoring*, Basel Committee, December 2010.
29 Analysis performed at end-August 2008 as this was the first month the FSA collected LRP reports which contained data which could be used to calculate the FSA's proxy of the Basel III Liquidity Coverage Ratio (LCR) for RBS.
30 The final calibration of the LCR is yet to be determined. The Review Team's estimate was, therefore, based on the interim calibration of this ratio, see Appendix 2E.
31 This is based on the Review Team's estimate of a proxy for RBS's LCR at end-August 2008 of between 18% and 32%. For further details on the assumptions used in this calculation, see Appendix 2E.
32 This analysis was necessarily conducted with the benefit of hindsight and, therefore, does not take into account behavioural effects that Basel III rules might have had, had these rules been in place at the time.

trading contribution of £3.9bn. Loan impairments, however, increased to £14.1bn in 2009, and were a further £9.1bn in 2010 (see Table 1.3 for a summary of RBS's income statement and Table 1.4 for its income or losses on trading activities from 2007 to 2010).

Table 1.3: Summary consolidated income statement of RBS, 2007 to 2010[33]

£m	2007	2008	2009	2010
Net interest income	12,668	18,675	16,504	14,209
Income/(loss) from trading activities	1,327	(8,477)	3,881	4,517
Other (net fees and commissions, net insurance premium, other)	17,120	15,670	18,305	13,142
Non-interest income	18,447	7,193	22,186	17,659
Total income (A)	**31,115**	**25,868**	**38,690**	**31,868**
Staff costs, premises and equipment, other administrative expenses, depreciation & amortisation	(14,435)	(21,452)	(21,115)	(18,218)
Write-down of goodwill and other intangible assets	0	(32,581)	(363)	(10)
Operating expenses (B)	**(14,435)**	**(54,033)**	**(21,478)**	**(18,228)**
Profit/(loss) before other operating charges and impairment (=A+B)	**16,680**	**(28,165)**	**17,212**	**13,640**
Insurance claims paid (net of reinsurers' share)	(4,652)	(4,430)	(4,857)	(4,783)
Impairment losses on loans and advances	(2,106)	(7,091)	(14,134)	(9,144)
Impairment losses on securities	(22)	(981)	(816)	(112)
Operating profit/(loss) before tax	**9,900**	**(40,667)**	**(2,595)**	**(399)**
Profit/(loss) for the year after tax and profit/(loss) from discontinued operations	**7,712**	**(34,373)**	**(2,323)**	**(1,666)**
Attributable to:				
RBS ordinary and B shareholders	7,303	(24,137)	(3,607)	(1,125)
ABN AMRO minority interests	10	(11,244)	(299)	(726)
Other owners (other minority interests and preference shareholders)	399	1,008	1,583	185

Table 1.4: Breakdown of income from trading activities, 2007 to 2010[34]

£m	2007	2008	2009	2010
Foreign exchange	1,050	1,994	2,465	1,491
Interest rate	1,466	1,454	3,875	1,862
Credit	(1,430)	(12,200)	(4,108)	41
Equities and commodities	241	275	1,649	1,123
Total losses on trading activities	**1,327**	**(8,477)**	**3,881**	**4,517**

33 2007, 2008, 2009 and 2010 RBS annual report and accounts.
34 2007, 2008, 2009 and 2010 RBS annual report and accounts.

15 This pattern over time, with first large trading losses and then later large loan impairments, was common to many banks during the crisis and reflects the following:

- Trading losses are recognised immediately under fair value accounting. As a result, major losses on credit securities are recognised even if the securities are not yet in actual default. Loan impairments, in contrast, are only taken on evidence of borrower delinquency or default.[35]
- The very fact of the banking crisis in 2008, in part precipitated by fair value losses on trading books, induced an economic recession which then in turn resulted in large loan losses.

16 In one sense, therefore, the big loan loss provisions of 2009 and 2010 were as much the result as the cause of RBS's (and other banks') failure. And even loan losses on this scale, since largely offset by other sources of income, would not have been sufficient entirely to erode RBS's apparent end-2007 capital resources.

17 The anticipation that large loan loss provisions might arise, and extreme uncertainty about the potential scale of those losses was, however, highly relevant to the collapse in confidence in RBS in autumn 2008. And while this confidence effect was general across the banking system, RBS was particularly affected because of market concerns that its loan portfolio might be of relatively poor quality. This perception of relatively poor loan quality (compared with some, but not all, other banks) was confirmed *post facto* by the scale of RBS's provisions in 2009 and 2010.

18 The perception at the time reflected market awareness that RBS's strategy had been driven by aggressive growth targets and that RBS had been a visibly aggressive competitor in a range of market segments (commercial real estate, leverage loans, syndicated loans, etc.) in which significant risks materialised. RBS grew rapidly during the Review Period, and while its organic balance sheet growth of 24% per annum between end-2004 and end-2007 was not exceptional, the acquisition of ABN AMRO meant that growth in total assets exceeded that of peers. Much of this growth was driven by the expansion of Global Banking and Markets (GBM), which subsequently recognised large loan impairments as well as losses on credit trading activities (which are discussed in the next key factor). But RBS also recognised large loan losses in other segments, especially on commercial property exposures, which were spread over a number of divisions. By end-2010, RBS's asset quality had deteriorated from having some of the lowest levels of impairment among its peers for 2007 to exhibiting asset quality below the average of its peers. Table 1.5 shows RBS's impairment losses by category for 2008, 2009 and 2010.

35 In accounting terms this is an '*incurred loss*'; following an impending change in accounting rules, this may in future become an '*expected loss*' leading to earlier recognition.

Table 1.5: RBS impairment losses by category, as a percentage of gross loans and advances as at end-2008, in 2008, 2009 and 2010[36]				
	Impairment losses on loans and advances			
£m	2008	2009	2010	Cumulative 2008-2010
Residential mortgages	(490)	(984)	(983)	(2,457)
Personal lending	(1,443)	(2,006)	(1,193)	(4,642)
Corporate – property	(1,398)	(3,995)	(5,029)	(10,422)
Corporate – other	(2,733)	(5,430)	(1,517)	(9,680)
Other	(1,047)	(1,726)	(422)	(3,195)
Total impairment losses	**(7,111)**	**(14,141)**	**(9,144)**	**(30,396)**

4. Losses in credit trading activities

19 The losses realised by RBS on credit trading – which amounted to £1.4bn in the 2007 accounts and to £12.2bn in the 2008 accounts – played a significant role in eroding already inadequate capital levels and in precipitating the confidence collapse.

20 These losses arose primarily from structured credit risks, related exposure to monoline bond insurers and leveraged finance. (The breakdown between these and other categories and the relative contribution to these losses of the original RBS businesses and of the businesses acquired from ABN AMRO is shown in Graph 1.8 and Table 1.6). A large proportion of these losses (the vast majority apart from the leveraged finance element) was related to the boom and bust in the US housing credit market, and in particular sub-prime credit, which occurred in the five years running up to 2007 to 2008. This boom entailed:

- A massive increase in the extension of mortgage credit to customers who could only pay back their loans if house prices continued to increase.
- The proliferation of complex structured credit instruments (e.g. collateralised debt obligations, or CDOs), which appeared to create safe tranches of highly rated securities out of portfolios of poor quality credits.
- The proliferation of related financial instruments, which included credit default swaps (CDSs), resecuritised CDOs ('CDOs squared'), synthetic CDOs representing a notional list of residential mortgage-backed securities (RMBSs) and/or CDOs, and even hybrid CDOs (a combination of cash and synthetic CDOs). This proliferation of instruments was accompanied by the creation of the Asset-Backed Securities Index (ABX) and other indices (which provided benchmarks for the performance of sub-prime mortgage-backed securities). These complex instruments increased the total amount of system-wide credit risk even beyond that arising from the actual extension of credit to sub-prime borrowers.

36 2008, 2009 and 2010 RBS annual report and accounts and data provided by RBS in September 2011. See also the notes to Table 2.6 in Part 2 Section 1.3.

21 In late 2006 and early 2007 it became apparent to a few market participants that the underlying credits on which this edifice was built (lending to US sub-prime borrowers) were rapidly turning bad. Initially, however, many market participants assumed (and were reassured by credit ratings) that the senior and super senior tranches of CDOs could remain high quality even if the underlying credits were turning bad. This turned out to be a delusion. RBS's response to the emerging problems reflected this delusion.[37] As reality dawned, the estimated mark-to-market value of different categories of exposure followed the pattern shown on Graph 1.9 and Graph 1.10, falling dramatically during 2007 and 2008.

Table 1.6: Extract of losses recognised by RBS in 2007 and 2008, split by assets originated by RBS and ABN AMRO

	2007			2008		
bn, £ (except where stated otherwise)	RBS	ABN AMRO	TOTAL	RBS	ABN AMRO	TOTAL
Statutory income statement[38]						
Impairment	(1.9)	(0.3)	(2.1)	(4.7)	(3.4)	(8.1)
	88%	12%	100%	58%	42%	100%
Profit/(loss) on trading activities[39]	1.1	€1.3	1.3	(5.6)	(€9.3)	(8.5)
GBM losses identified in published Business Review, on a pro forma basis						
Losses on credit market exposures in GBM strategic assets unit[40]	(2.1)	(1.1)	(3.2)	(5.5)	(2.3)	(7.8)
	67%	33%	100%	71%	29%	100%
Other trading asset write-downs in GBM[41]				(2.2)	(3.6)	(5.8)
				38%	62%	100%
Impairment losses[42]			(0.1)	(1.3)	(2.4)	(3.7)
				35%	65%	100%
Contribution[43]			3.7	(4.5)	(6.0)	(10.5)
				43%	57%	100%

37 The issues of whether better risk controls and reporting would have ensured a better response, and of who (as between different levels of management and the RBS Board) was and should have been aware of the positions and emerging problems, were considered in one of the FSA's Enforcement and Financial Crime Division's (Enforcement Division's) investigations (see Part 3, Section 1).

38 2008 RBS Group, RBS plc and ABN AMRO 2008 annual report and accounts. The columns for 2007 do not cast due to taking data directly from financial statements. Impairment losses for ABN AMRO for 2008 assumed to be the balance between those recognised by RBS Group and RBS plc.

39 It is not possible to reconcile the results for RBS and ABN AMRO businesses to the RBS group total due to inter-company balances, purchase price adjustments following the acquisition of ABN AMRO, the fact that ABN AMRO only contributed to RBS's results for a short period at the end of 2007 and asset transfers between ABN AMRO and RBS plc during 2008.

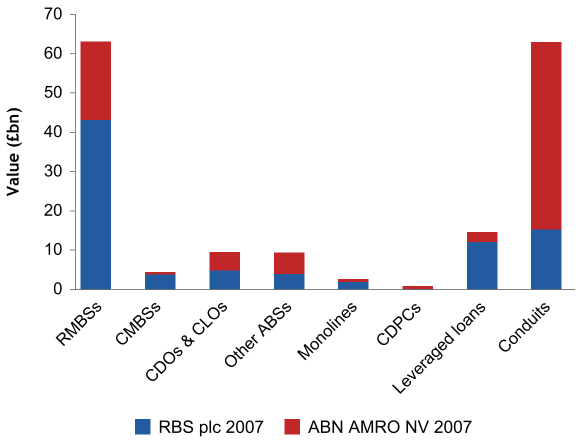
40 RBS Group Internal Audit Report, July 2008; RBS records and RBS Group and RBS plc 2008 annual report and accounts. CDS hedging assumed to reduce losses on credit market exposures in RBS rather than in ABN AMRO.

41 RBS 2008 annual report and accounts; and trading update, February 2009. Data provided by RBS in March 2011.

42 RBS 2008 annual report and accounts; and data provided by RBS in March 2011. Figure for 2007 is given on a pro forma basis, which assumes that ABN AMRO had been acquired and restructured in full as at 1 January 2007; hence it does not reconcile with the statutory impairment figure of £0.07bn for GBM in 2007.

43 2008 RBS annual report and accounts, page 51, and RBS records. The Review Team has not been able independently to reconcile the split of the 2008 GBM contribution between RBS and ABN AMRO.

Graph 1.8: RBS's net credit market exposures at end-2007 split between RBS plc and ABN AMRO[44]



Source: 2008 RBS Group, ABN AMRO and RBS plc annual accounts

22 The International Monetary Fund (IMF) estimated that potential write-downs of US$1,644bn would be taken by banks, insurers and other investors across the world on US credit securities between 2007 and 2010.[45] The eventual distribution of these losses (and of any offsetting gains from short positions) reflected:

- the relative success of different market participants in anticipating and responding to emerging evidence of deteriorating credit conditions; and
- the relative ability of the different market-makers and traders involved (the standalone investment banks, the trading arms of major commercial banks and independent asset managers) to offload positions to others once they realised that credit deterioration was occurring.

23 In this process of position-taking, hedging and distribution of products to often poorly informed end investors, RBS, while not alone among other major banks and investment banks, was among the less successful.[46] This reflected the following:

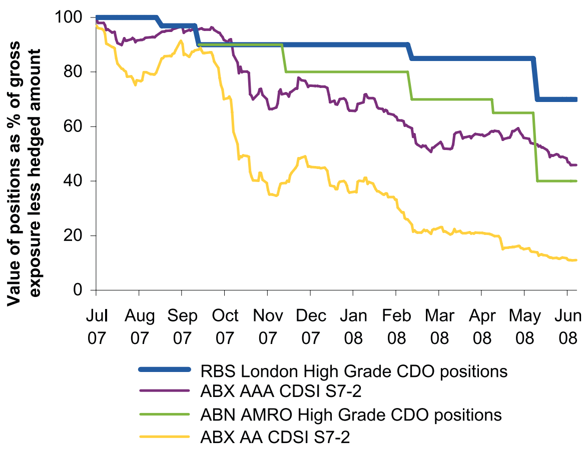
- RBS's decision in mid-2006 to expand its structured credit business aggressively, only shortly before the early signs of underlying credit deterioration emerged. This reflected a belief that the market undervalued RBS's share price and that a way to rectify this was to expand GBM rapidly.
- A failure to realise, until there were few hedging opportunities available, the limited extent to which the tranching inherent within the creation of CDOs

44 ABN AMRO exposures were assumed to be the balance between RBS plc and RBS Group exposures.
Net exposure for asset-backed securities (ABSs) = carrying value after taking account of hedge protection purchased from monolines and other counterparties but excludes the effect of counterparty Credit Valuation Adjustment (CVA).
Net exposure for monolines and Credit Derivative Product Companies (CDPCs) = gross exposure less CVA.
Net exposure for leveraged loans = drawn and undrawn balances.
Net exposure for conduits = maximum exposure to loss = total drawn and undrawn amount of liquidity commitments to conduits (excludes credit enhancements).
CLOs – Collateralised Loan Obligations.
CMBSs – Commercial Mortgage-Backed Securities.

45 *Global Financial Stability Report*, International Monetary Fund, April 2009, Table 1.3.

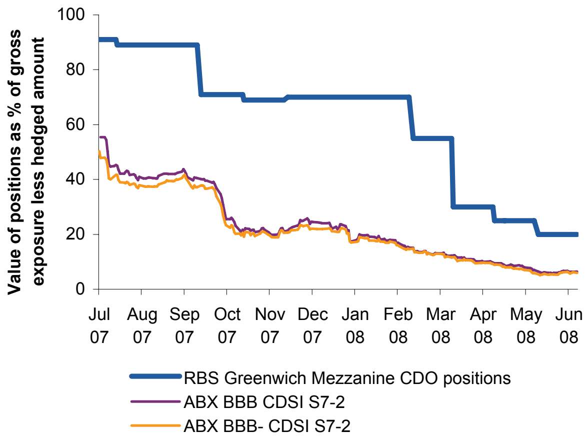
46 Michael Lewis's *The Big Short* provides an excellent description of the nature and chronology of this process.

Graph 1.9: 'Marks' of RBS high grade CDO positions compared to price of AAA and AA ABX indices, July 2007 to June 2008[47]



Source: RBS records and data from Markit Group Limited

Graph 1.10: 'Marks' of RBS mezzanine CDO positions compared to price of BBB and BBB- ABX indices, July 2007 to June 2008[48]



Source: RBS records and data from Markit Group Limited

would actually isolate the creditworthiness and value of senior tranches from deterioration in the credit quality of the underlying loans.[49]

- A less effective '*distribution capability*' than that enjoyed by some other major market-makers and traders, which meant that RBS was less able to distribute deteriorating credits to other investors, or to hedge out its positions by finding offsetting counterparties.[50]

24 Because of these deficiencies, RBS was, by summer 2007, left with significant positions from which escape without significant loss was impossible. Thereafter the open questions were simply:

- whether loss was best contained by sticking to positions or by closing them out at the cost of a crystallised loss;
- whether hedges at any price were actually available; and
- what were best estimates of losses incurred at any given date.

25 Assessments of losses gradually increased. RBS recognised £3.2bn of losses on credit market exposures[51] at end-2007, announced another £5.9bn of realised and forecast losses at the time of the rights issue in April 2008, and eventually realised £7.8bn losses on these assets by end-2008.

47 The graph shows the prices of ABX indices, which tracked the price of sub-prime mortgage-backed securities of various vintages, on the same scale as RBS's marks. Individual ABX indices were not perfectly correlated to individual firms' securities, but give an indication of price movements.

48 See notes to Graph 1.9 for further explanation of data.

49 This isolation was in effect impossible, given that the deterioration in credit quality applied to the great majority of the loans underlying the structured securities, and the deterioration was so great as to exceed the lower tranches.

50 For an account of how some other market participants responded to the changing market conditions, see *The Financial Crisis Inquiry Report*, the US Financial Crisis Inquiry Commission, January 2011; and *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*, Majority and Minority Staff Report, Permanent Subcommittee on Investigations, United States Senate, April 2011. In some cases an 'effective distribution capability' meant that firms distributed exposures to investors who had an inadequate understanding of the risks involved. In describing a distribution capability as 'effective' the FSA does not mean that it condones distributing exposures to investors with an inadequate understanding of the risks involved.

51 These assets were specifically identified by RBS around the time of the April 2008 rights issue and thereafter managed as legacy business within a 'strategic assets unit'.

26 The losses that RBS made on these credit market exposures were substantial. But, as shown in Table 1.4, in 2007, overall credit trading losses of £1.4bn (of which the credit market exposures were a part) were more than offset by £2.8bn of profit in other trading activities, and in 2008 partly offset by £3.7bn of other trading profits, resulting in a total trading book loss of £8.5bn. Seen against the capital resources apparently available at the beginning of 2008, this might have seemed very bad for shareholders but not necessarily a cause of bank failure. Its impact on market confidence was, however, much greater, because market estimates of potential losses incurred were surrounded by huge uncertainty.

5. ABN AMRO acquisition: 'the wrong price, the wrong way to pay, at the wrong time and the wrong deal'

27 The acquisition of ABN AMRO is frequently described as a €71.1bn deal, the largest takeover in banking history. But RBS's share of the deal was much smaller. Initially RBS hoped to pay €27.2bn for those parts of ABN AMRO it was most interested in, with Santander and Fortis buying other parts for a combined €43.9bn. And after the LaSalle business, which RBS had hoped to acquire, was sold to Bank of America, RBS's share of the deal in fact amounted to €16bn.

28 Seen in these terms, the acquisition, though certainly large, was not mammoth: it was considerably smaller than the apparently successful £23bn acquisition of NatWest in 2000. But the ABN AMRO acquisition was a key contributor to RBS's failure for four reasons:

- It greatly increased RBS's exposure to risky trading assets and, in particular, to those categories of asset – including structured credit and leveraged finance assets – and monoline exposures where large losses were incurred. As Table 1.6 shows, credit trading losses on assets acquired from ABN AMRO were a major contributor to total losses, and RBS's increased exposure to such losses made it more vulnerable to a confidence collapse deriving from uncertainty about how great the losses might be.

- In addition, the Board and management decision to finance the acquisition primarily with debt rather than equity, and for most of that debt to be short-term, both reduced an already low capital ratio and increased potential funding strains. RBS's total payment comprised €4.3bn in RBS shares and €22.6bn cash consideration to ABN AMRO investors. Of the €22.6bn, the majority was funded by debt of which €12.3bn had a term of one year or less.[52] The decision to finance a major acquisition primarily with debt, of which the majority was short-term, was a risky financing strategy. Although €10.9bn in cash was due to RBS following the sale of LaSalle in October 2007, these funds were retained in the Netherlands longer than RBS had anticipated. Therefore having raised funds from the short-term markets, RBS needed to extend the period of this funding. Some market counterparties also lowered the amount they were willing to lend the combined entity of RBS

52 The €12.3bn comprised €4.9bn senior funding with a term of one year or less and €7.4bn bridge funding. Given that the bridge funding was raised from the inter-bank market and had an average maturity of six months, the Review Team has assumed that none of it had a maturity of more than one year. RBS was not able to provide a breakdown of the bridge funding.

and ABN AMRO following the acquisition, which reduced RBS's borrowing capacity in those markets. Funding strains were further increased by the fact that ABN AMRO businesses which RBS acquired included large exposures to ABCP conduits. The acquisition more than quadrupled RBS's committed liquidity facilities to own-sponsored ABCP conduits. At end-June 2008, the liquidity drawn under the committed liquidity facilities and still outstanding (i.e. drawn but not yet repaid) totalled £8.6bn.[53]

- RBS did not anticipate the impact on its ability to meet its regulatory capital requirements if ABN AMRO was not to receive approval for its Basel II credit risk models. The resulting higher capital requirements placed additional strain on RBS's capital resources and contributed to RBS's apparent fall below individual capital guidance as at end-March 2008.
- The fact that its Board decided that RBS should act as the consortium leader for the ABN AMRO acquisition, which meant consolidating the whole of ABN AMRO onto its balance sheet before the transfer of assets to the other consortium partners, introduced vulnerabilities and uncertainties that were important to market confidence, even if *post facto* none of these vulnerabilities resulted in loss. Thus:
  - Since RBS was positioned as the lead organiser and consolidator of the consortium bid, *De Nederlandsche Bank*'s advice to the Dutch Minister of Finance for a declaration of no-objection required that RBS should be '*responsible for compliance with the supervisory regulations applicable to the ABN AMRO Group in all relevant jurisdictions*'.[54]
  - In the long term, this arrangement did not result in RBS facing any additional losses arising from the assets acquired by other consortium partners. The businesses acquired by Santander were transferred to it during 2008 (or, in the case of Antonveneta, sold separately on Santander's behalf). And while the end-2008 loss included a £14.5bn write-off relating to goodwill within the assets that Fortis was acquiring, this was offset by an equivalent reduction in the minority interest claim of Fortis. After the eventual transfer of ABN AMRO's Dutch retail business to the State of the Netherlands (in place of Fortis) in 2010, all the related losses actually fell on Fortis's shareholders (at this point, the Dutch taxpayer) rather than RBS's shareholders (primarily UK taxpayers).
  - This *post facto* result was not, however, apparent to the market in 2008. The consolidation of all of ABN AMRO into RBS accounts at end-2007 therefore introduced complexity and uncertainty into the analysis of RBS's capital and liquidity positions. And the fact that Fortis itself failed in October 2008, before the relevant assets were transferred, made it possible that under some circumstances RBS might have suffered loss.

29 Overall, therefore, the Board's decision to go ahead with the ABN AMRO acquisition on the basis of due diligence which was inadequate in scope and

53 Data provided by RBS to the Review Team in August 2011.
54 *De Nederlandsche Bank*, advice to the Dutch Minister of Finance for a declaration of no-objection application '*Consortium*', 17 September 2007.

depth[55], to finance it primarily with debt rather than equity, and for most of that to be short-term, greatly increased the risks and vulnerabilities facing RBS. Combined with the organic build-up of the structured credit portfolio (and related monoline exposures) described under key factor 3, it put RBS by 20 July 2007[56] in a position from which escape was very difficult if not impossible.

6. Systemic vulnerabilities and confidence collapse: failure of the banks in relatively worse positions

30 Several of the factors set out above were specific to RBS; others, such as inadequate levels of capital and reliance on short-term wholesale funding were, to different degrees, common to many individual banks. But it is important also to recognise that the banking system before the crisis period had become more vulnerable as a total system. This was because individual banks, themselves inadequately capitalised and reliant on short-term funds from the wholesale markets, were also linked together in a complex web of funding and derivative exposure relationships (through, for instance, the interbank market, the repo market and the CDS market). As a result, the failure of one bank had potential but highly uncertain consequences for others. The failure of regulators to understand this complex inter-connectedness and its consequences for systemic fragility was, along with inadequate capital and liquidity rules, central to the origins of the crisis.

31 These regulatory failures created the conditions for the deterioration in market confidence, which intensified from summer 2008 and became catastrophic after the failure of Lehman Brothers in September. The system-wide collapse of market confidence which followed was driven by extreme uncertainty about the creditworthiness of trading and interbank counterparties, and about the potential knock-on consequences of any one failure for others.

32 In that environment, banks which were perceived to be (and in many cases actually were) relatively poorly positioned – in capital, liquidity or asset quality – became subject to a self-fulfilling downward spiral of falling confidence, with funding sources closed. RBS, as a result of poor management decisions over the previous several years, was one such bank.

33 Over a three-week period following the bankruptcy of Lehman Brothers, during which a number of other financial institutions collapsed or came near to collapse, RBS's gradual liquidity run reached extreme proportions. On 7 October 2008, RBS's wholesale counterparties, as well as, to a lesser extent, retail depositors, were simply not prepared to meet its funding needs and RBS was left reliant on ELA from the Bank of England.

34 The precise reason for this loss of confidence in RBS and for the resulting liquidity run cannot be determined with certainty three years after the event. Some of the factors which, in objective terms, created vulnerability may not have been fully apparent to the market; and, conversely, the market may have been influenced by some concerns which, with hindsight, were less important. Analysis of the objective

55 The adequacy and appropriateness of the due diligence conducted in relation to the ABN AMRO acquisition was one of the issues covered by the Enforcement Division's investigations (see Part 3, Section 2); see also Part 2, Section 1.5.
56 The consortium's bid for ABN AMRO was published on 20 July 2007.

facts, of market commentary at the time, and of the recollections of market participants suggested, however, that:

- At least three factors, had they been apparent to the market, should logically have been drivers of significant concern:
  - despite the £12bn rights issue, it is clear with hindsight that RBS's true loss-absorbing capital (estimated on a Basel III basis) remained weak and below average for its peer group[57];
  - RBS's reliance on short-term[58] wholesale funding was one of the greatest in its peer group of the large UK banks and RBS remained more concentrated in the overnight wholesale funding markets than most of its peers (see Part 2, Section 1.6.3); and
  - losses that RBS incurred in H1 2008 signalled significant asset quality problems in both its trading book and banking book.
- Concerns actually expressed by market participants focused on:
  - the inadequate quality, and quantity of its capital resources even after the rights issue announced in April 2008, and whether RBS would be able to strengthen its capital position further; and
  - RBS's asset quality, including in relation to the assets arising from the acquisition of ABN AMRO, as well as the composition of its loan portfolio and the extent of further losses to come from its banking book.[59]
- The Review Team, however, found little direct evidence that market participants understood or focused in particular on RBS's poor liquidity metrics relative to other banks.

A reasonable conclusion may therefore be that liquidity problems were driven by underlying solvency concerns.

35 Following the initial signs of the crisis in summer 2007, the FSA began to make significant changes to its approach to the regulation and supervision of capital, liquidity and asset quality. This increasing focus continued and was in some ways accelerated between May and October 2008. But in retrospect the improvements proved to be too late to prevent the failure of RBS.

7. RBS's underlying management approach

36 Some of the causes of RBS's failure were systemic – common to many banks or the consequence of unstable features of the entire financial system. And a deficient global framework for bank capital regulation, together with an FSA supervisory approach which assigned a low priority to liquidity, created conditions in which some form of systemic crisis was more likely to occur. But, with hindsight, it is

57 The Basel III reforms are set out in *Basel III: A global regulatory framework for more resilient banks and banking systems*, Basel Committee, 16 December 2010.

58 Short-term wholesale funding is defined here as wholesale funding falling due within 25 business days.

59 Scepticism about RBS's accounting approach to structured credit and other losses in its end-2007 accounts (published 28 February 2008) may have contributed to market concerns about RBS's trading book assets. It is difficult to determine whether such concerns were fully overcome by the more aggressive write-downs forecast at the launch of the rights issue on 22 April 2008.

clear that decisions taken by the RBS Board and senior management placed RBS in a more vulnerable position than other banks when the financial crisis developed between 2007 and 2008.

37 Individual poor decisions can result from imperfect analysis and judgement in particular circumstances: many of the decisions which RBS made appear poor only with the benefit of hindsight. But a pattern of decisions that may reasonably be considered poor, whether at the time or with hindsight, suggest the probability of underlying deficiencies in a bank's management capabilities and style, its governance arrangements, checks and balances, and mechanisms for oversight and challenge, and in its culture, particularly its attitude to the balance between risk and growth.

38 It is difficult, from the evidence now available, to be certain how aspects of RBS's management, governance and culture affected the quality of its decision-making, but the Review Team's analysis prompts the following questions:

- Whether the Board's mode of operation, including challenge to the executive, was as effective as its composition and formal processes would suggest.
- Whether the CEO's management style discouraged robust and effective challenge.
- Whether RBS was overly focused on revenue, profit and earnings per share rather than on capital, liquidity and asset quality, and whether the Board designed a CEO remuneration package which made it rational to focus on the former.
- Whether RBS's Board received adequate information to consider the risks associated with strategy proposals, and whether it was sufficiently disciplined in questioning and challenging what was presented to it.
- Whether risk management information enabled the Board adequately to monitor and mitigate the aggregation of risks across the group, and whether it was sufficiently forward-looking to give early warning of emerging risks.

Questions raised by RBS's failure and addressed in this Report

39 The account of RBS's failure above raises important issues both about the effectiveness of the regulation and supervision of RBS, and about the quality of decisions made by RBS's management and Board decisions.

40 The issues relating to the quality of regulation and supervision include:

- Why were the regulations on capital and liquidity so inadequate? Why were the deficiencies not spotted and corrected, in the UK, US and other major jurisdictions?
- Did the FSA fail to supervise capital and liquidity effectively even within the context of these deficient rules, or did it effectively implement an inadequate set of rules?

- To the extent that RBS's failure derived from identifiable decisions specific to RBS (e.g. overly aggressive growth in structured credit and loan underwriting or the acquisition of ABN AMRO), was the FSA's supervision deficient in not challenging those decisions? Could it have done so within the supervisory rules and philosophy of the time? And if not, what does this imply for required approaches in future?

41 These issues are considered in Part 2 of this Report.

42 The key issues relating to the quality and effectiveness of RBS management and Board decision-making are:

- How far was RBS's failure the result of decisions, judgements and actions of RBS's management and Board which were specific to RBS, placing RBS in a more vulnerable position than other banks, and how far the result of factors common to all banks?

- To what extent were any poor decisions, judgements and actions deficient even given the information then available versus deficient only with the benefit of hindsight?

- Whether, and if so to what extent, poor culture and governance adversely affected management and Board decisions, or the relationship between management and the Board.

43 These issues are considered in Part 2 and also in Part 3, which records the conclusions reached by Enforcement Division on whether RBS's decision-making processes and management controls were so deficient as to justify enforcement action for breach of FSA rules and principles. The enforcement investigations focused on three specific areas:

- decisions and management control processes relating to the growth and risk management of the structured credit trading business;

- the decision to go ahead with the ABN AMRO acquisition on the basis of very limited due diligence; and

- whether investor communications, for instance through key investor circulars issued in relation to the ABN AMRO deal and the April 2008 rights issue, met required standards of accuracy and transparency.

Part 2

Lessons for the regulatory framework and supervision, and for the management of firms

Introduction

1 Part 2 of this Report analyses in detail the factors behind RBS's failure which were described in Part 1. It describes decisions made by RBS's management and Board which resulted in RBS failing amid the systemic crisis. It also describes the deficiencies in global regulation which made such a crisis more likely, and flaws in the FSA's supervisory approach which provided insufficient challenge to RBS. It sets out lessons learned for firms and for the FSA's regulation and supervision of high impact firms, describes reforms already implemented in response, and recommends further changes where necessary.

2 This Part of the Report reaches many judgements about the quality of RBS's decisions and underlying control systems and processes. As explained in the overall Introduction (paragraphs 14 to 18), these judgements are quite different in nature from those described in Part 3.

- In Part 3, we summarise a legal assessment of whether there were actions by individuals which breached FSA rules and/or displayed incompetence or a lack of integrity which could be subject to legal sanction.
- In Part 2, we make judgements about the relative importance of different factors and about the possible underlying drivers, in order to satisfy as best possible the legitimate public interest in understanding what occurred and why. All of these judgements are formed to some degree with the benefit of hindsight, since it is only with hindsight that we know the consequences of different actions. But the dependence on hindsight is less in relation to some issues than others: in some circumstances we reach a judgement that decisions could be considered poor even within the context of the time. The fact that some decisions are described as poor or mistaken (either in retrospect or at the time) in Part 2, however, carries no implication that RBS or any individual was guilty of any regulatory breach. The judgements reached in this Part are views expressed in an attempt to describe the causes of RBS's failure for the purposes of satisfying a legitimate public interest in understanding what occurred. They can quite reasonably be subject to public debate.

3 The structure of Part 2 mirrors the account of why RBS failed set out in Part 1:

- Section 1 analyses in detail the six key substantive drivers of RBS's failure:
  - RBS's capital position and the underlying regulatory framework;
  - RBS's liquidity position, and the regulatory framework and supervisory approach;
  - asset quality concerns and uncertainties;
  - losses in credit trading activities;
  - the ABN AMRO acquisition; and
  - the systemic vulnerabilities and confidence collapse.

- Section 2 analyses the seventh factor we identify as crucial – underlying deficiencies in RBS's management, governance and culture.
- Section 3 provides background information on the FSA's supervisory approach, resources and priorities during the Review Period, and identifies how the specific deficiencies in FSA's regulation and supervision described in Section 1 were rooted in an overall regulatory philosophy and approach which was flawed.

4 Included in summaries at the end of each relevant section are conclusions on what happened in RBS, and the lessons learned from the Review Team's assessment of the FSA's regulation and supervision of RBS in the Review Period.

5 There are a number of Appendices to Part 2:

- Appendix 2A summarises the lessons learned from the deficiencies in the FSA's approach, both those where changes have already been made and recommendations for further change.
- Appendix 2B addresses issues relating to the UK Listing Authority's oversight of investor communications by RBS.
- Appendix 2C provides a chronology of main events during the Review Period.
- Appendix 2D summarises the international prudential policy framework during, and the main changes in prudential policy since, the Review Period.
- Appendix 2E gives detail on the Report's estimates of Basel III measures for RBS.
- Appendix 2F outlines the FSA's policy on IRB model approvals in the Review Period.
- Appendix 2G gives details about the liquidity risk from RBS's exposure to asset-backed commercial paper conduits.
- Appendix 2H provides details of RBS's Board membership.
- Appendix 2I gives details of the FSA's organogram, Board and Executive Committee memberships.
- Appendix 2J gives some further detail on the approach and processes followed by the Review Team.

1 Factors contributing to RBS's failure, and the FSA's regulatory and supervisory response

1.1 RBS's capital position and the underlying regulatory framework

6 The immediate cause of RBS's failure in autumn 2008 was a liquidity run, with wholesale funding providers unwilling to roll over funding commitments. But the system-wide liquidity crisis had its roots in market uncertainty about the scale of losses that banks would suffer, and therefore about bank solvency. So concerns about RBS's capital adequacy (and about capital adequacy across the banking system) were crucial to RBS's failure.

7 According to the capital adequacy framework in place before the crisis, such concerns should have been misplaced. At end-2007, RBS had total capital resources of £68bn and a published total capital ratio of 11.2%. It announced a £12bn new equity raising in April 2008 and, of its £40.7bn operating loss in 2008, only £8.1bn directly reduced regulatory capital resources. At first sight, the firm's capital should have been adequate to absorb such losses.

8 In fact RBS's capital position created vulnerability, which is described in this section. There are five key points.

- The global regulatory capital framework in place before the crisis was, with hindsight, severely deficient, both in terms of the definition of capital resources and risk capture of trading book assets. These deficiencies are demonstrated by analysing how RBS's capital position would have appeared, had it been calculated on the new Basel III standards during the Review Period. The Review Team estimated that RBS would have had a common equity tier 1 ratio of 1.97% at end-2007. This compares to an absolute minimum, under the new standards, of 4.5% and a higher level of 9.5% which the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (Basel Committee) have now agreed that the largest systemically important banks (as RBS was at that time) should hold during normal times in order to operate without restrictions on dividends and other distributions.
- Even under the Basel I and II capital regimes, RBS was lightly capitalised relative to its peers and made considerable use of lower-quality forms of capital during the Review Period.
- The acquisition of ABN AMRO further weakened RBS's capital position, and significantly increased RBS's exposure to trading assets where the existing capital regime was most deficient.

- The FSA's regulation and supervision of RBS's capital position before the April 2008 rights issue could be described as an adequate application of a regime that proved to be fundamentally flawed.
- From late 2007 onwards, the FSA was active in developing and applying a more rigorous capital regime. In April 2008, pressed by the FSA to raise as much capital as possible, RBS announced a £12bn rights issue, which did, initially, reassure some market participants. In retrospect, however, neither the improvements in the FSA's capital regime nor RBS's rights issue were sufficient to change RBS's capital position fundamentally.

9 These points are set out in five sections (1.1.1 – 1.1.5).

1.1.1 The global regulatory capital framework

10 RBS was regulated for capital adequacy under the Basel I and Basel II standards, which were believed at the time to be appropriate, but in fact were severely deficient. As a result, RBS was operating with capital which fell well below what the FSA now believes is required, or what the market considered essential to ensure solvency and liquidity in autumn 2008.

The prevailing standards: Basel I and Basel II

11 The FSA's regulation of capital followed the internationally agreed Basel capital rules. These had been drawn up by the Basel Committee, which at that time comprised senior representatives of bank supervisory authorities from 13 countries.[1] The UK was represented by the FSA and the Bank of England. Therefore, the FSA had been a party to the design of both the Basel I and Basel II frameworks, the two sets of rules which (having been implemented in European legislation and subsequently in the UK via the FSA Handbook) established the capital requirements for banks, building societies and investment firms during the Review Period. A more detailed description of how the international policy framework was incorporated into FSA rules, the Basel I and Basel II regimes and changes in prudential standards since 2008 is provided in Appendix 2D.

12 Basel I assessed capital requirements for credit risk by weighting different categories of assets or off balance sheet exposures according to broad categories of relative riskiness. Firms were then required to hold capital resources equal to at least 8% of these risk-weighted assets (RWAs). A variety of capital instruments could be counted towards firms' capital resources requirements, up to certain limits (as described in Box 2.1 and shown in Table 2.2). The Basel I framework applied to RBS until 31 December 2007.

13 From 1 January 2008, RBS was required to calculate credit risk, counterparty credit risk and operational risk capital requirements according to rules derived from the Basel II framework. These aimed to increase the risk sensitivity of capital requirements and permitted (subject to regulatory approval) significant use of internal models based on firms' own estimates of key credit risk

1 *International Convergence of Capital Measurement and Capital Standards: A Revised Framework Comprehensive Version*, Basel Committee, June 2006. The Basel Committee has since expanded its membership to include other jurisdictions.

parameters. The overall minimum capital requirement remained unchanged at 8% of RWAs, as did the overall framework on quality of capital.

Box 2.1

Quality of capital resources

Under Basel I and Basel II, firms could meet the overall minimum total capital requirement of 8% of RWAs using a variety of capital instruments. Capital resources were structured into tiers, with tier 1 capital instruments being higher quality than those within tier 2 or tier 3. What came to be known as 'core tier 1' capital, which comprised mainly common equity (with some adjustments) and represented the highest-quality capital resources, formed a subset of tier 1 capital resources. The balance between the different tiers was subject to the following restrictions:

- Tier 2 capital resources should be no greater than tier 1 capital resources after deductions. As a result, tier 1 capital instruments had to be at least 4% of RWAs.
- Core tier 1 capital instruments should comprise at least 50% of tier 1 capital, with preference shares and innovative instruments comprising no more than 50% after deductions. In effect, this meant that, under Basel II, the minimum core tier 1 ratio was 2% of RWAs.

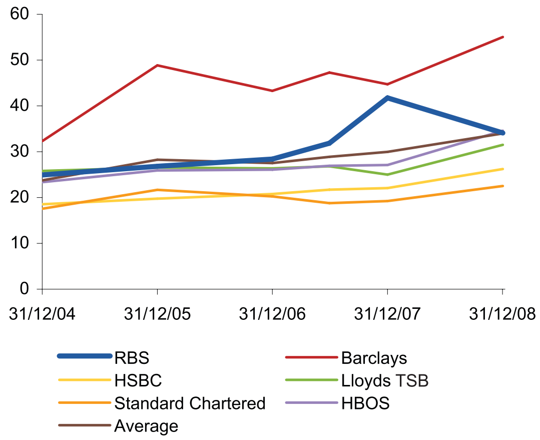
Under the Basel frameworks, tier 1 capital instruments are seen as 'going concern' capital: instruments that are able to absorb losses while a bank continues in operation (thus protecting creditors and avoiding the very serious loss of value typically associated with bank insolvency proceedings). Losses are taken first to equity (normally reducing retained earnings) and then by other capital instruments in order of seniority. Equity is immediately available to absorb losses at all times and thus is the highest quality and most common form of going concern capital. Other tier 1 instruments absorb losses (before failure) indirectly by coupon deferral or cancellation. By contrast, 'gone concern' capital (tiers 2 and 3) absorbs losses only after a bank has failed.

During the crisis, a range of capital instruments did not absorb losses under stress, nor while allowing firms to continue as a going concern. The approach for applying regulatory deductions to capital was also deficient. In reality, only common equity in excess of both regulatory minima and the minimum that the market would accept was immediately available to absorb losses on a going concern basis. Further information on the Basel I and Basel II frameworks and subsequent reforms is given in Appendix 2D.

14 The financial crisis revealed that the minimum total capital requirement of 8%, and in particular the fact that firms could meet this requirement using low quality forms of capital, was severely deficient. This was demonstrated, in the case of RBS, by the fact that the firm was unable to maintain market confidence in its ability to continue as a stand-alone, independent entity in autumn 2008, despite a £12bn rights issue in April of that year which exceeded the £8bn of losses recognised for 2008 that directly eroded capital resources. During the financial crisis, the market simply did not believe, on a forward-looking basis, that RBS had enough capital to cover the potential losses. Also, as discussed in paragraphs 31 to 36, much of RBS's total capital resources was non-core capital that did not absorb losses across the group, on a going concern basis, during the crisis.

15 There had been considerable growth in the relative size of the financial sector in the years leading up to the start of the market turbulence in 2007, with activities

Graph 2.1: Leverage for selected firms, 2004 to 2008 (leverage defined as total tangible assets divided by tier 1 capital)



Source: Published annual accounts.

within the banking system growing faster than services provided to the real economy. This was accompanied by an increase in leverage in the financial system, which amplified the vulnerability of the system, since it increased the impact of asset price falls on system capital adequacy.[2]

16 As in the financial system as a whole, RBS's leverage (calculated by dividing total tangible assets by published tier 1 capital resources) grew during the period, from 25 times at end-2004 to a peak of 42 times at end-2007. As shown in Graph 2.1, RBS's leverage grew particularly rapidly compared to its peers during 2007, when it saw significant balance sheet growth (particularly including the acquisition of ABN AMRO). During 2008, the firm's balance sheet continued to expand in absolute terms, but leverage fell due to an increase in tier 1 capital. As seen across the financial services sector, high leverage increased RBS's risk profile by amplifying the effect of changes in value of assets on its capital resources.

17 Subsequent reforms agreed as part of the new Basel III global standards will raise the quality of capital to ensure that banks are better able to absorb losses. This is discussed further in paragraph 21. A leverage ratio is also being introduced.[3]

18 Alongside the requirements for credit risk, the Basel I capital framework incorporated a market risk capital regime. This permitted (subject to regulatory approval) the use of value-at-risk (VaR) models to calculate firms' capital requirements for trading positions. VaR is the name given to a methodology that seeks to measure (for a given confidence level) the potential loss in value of an asset or portfolio over a defined period. It is based on the assumption that inferences about forward-looking risk can be drawn from the observation of past patterns of price movement.[4] Supervisory work conducted in relation to VaR models is discussed further in paragraphs 61 to 69.

2 *The Turner Review*, March 2009 and FSA Discussion Paper (DP) 09/2, *A regulatory response to the global banking crisis*, March 2009.

3 *The Basel Committee's response to the financial crisis: report to the G20*, Basel Committee, October 2010.

4 This technique, developed in the early 1990s, was not only accepted as standard across the industry, but adopted by regulators as the basis for calculating trading risk and required capital (being incorporated for instance within the European Capital Adequacy Directive). See *The Turner Review*, March 2009, Section 1.1 (iv).

19 Weaknesses in VaR had been apparent since its introduction into the market risk capital regime. To mitigate these, the Basel Committee set qualitative criteria for the regulatory recognition of models and a multiplication factor to account for potential weaknesses in the modelling process.[5] However, in retrospect, despite these mitigants, the very low risk weights assigned to certain trading book positions were inadequate to cover the potential losses in relation to such instruments.[6] *The Turner Review* noted other weaknesses in the regime, including: the use of short-term historical observation periods (which can result in procyclicality); the risk that short-term observation periods combined with an assumption of normal distribution can lead to a large underestimation of the probability of extreme loss events; and the fact that VaR-based models do not capture systemic risk.

20 RBS had a large trading book, in line with the scale of its trading activities, including significant positions involving credit risk. The risks in this trading book were capitalised according to the market risk regime. This led to a very small proportion of capital being held against certain positions, in comparison to the scale of losses subsequently realised (particularly on products with a credit risk component that became illiquid, for which the regime was particularly deficient). Therefore, it is clear with hindsight that the inadequate capitalisation of the trading book played an important role in the firm's failure.

RBS's pre-crisis capital under Basel III standards

21 To illustrate the deficiencies in the Basel II capital framework, the Review Team assessed how RBS's capital position would have appeared against the common equity tier 1 capital requirements incorporated in the Basel III standards.[7] A description of the main changes to the capital regime introduced by the Basel III standards, which have been developed in the wake of the financial crisis and which will be phased in between 2013 and 2019, is set out in Appendix 2D. Given that the Basel III regime was not in force during the Review Period, the Review Team made a number of assumptions in developing a proxy Basel III common equity tier 1 measure; these are set out in Appendix 2E. This analysis was necessarily conducted with the benefit of hindsight and does not take into account behavioural effects that Basel III rules might have had, had they been in place at the time.

22 The analysis showed that the firm's capital position would have appeared much weaker had these new standards been in force during the Review Period. The Review Team estimated that RBS's common equity tier 1 capital ratio at end-2007 would have been 1.97%, significantly below the new absolute minimum of 4.5%. This calculation is set out in Table 2.1. Moreover, this figure was heavily dependent on minority interests (the significance of which is discussed in Box 2.2).

5 *Overview of the Amendment to the Capital Accord to Incorporate Market Risks*, Basel Committee, January 2006 and *An internal model-based approach to market risk capital requirements*, Basel Committee, April 1995.

6 *The Turner Review*, March 2009 and FSA DP10/4, *The prudential regime for trading activities: A fundamental review*, August 2010.

7 The 'Basel III' reforms are set out in *Basel III: A global regulatory framework for more resilient banks and banking systems*, Basel Committee, 16 December 2010.

Table 2.1: Estimates of a proxy Basel III common equity tier 1 measure for RBS, as at end-2007[8]

	£bn
Gross core tier 1 capital[9] (net of prudential filters[10])	79.8
Of which: minority interest reported in core tier 1	(39.1)
Gross core tier 1 capital attributable to RBS shareholders (net of prudential filters)	**40.8**
Recognition of minority interest equity	35.1
Regulatory adjustments[11]:	
Deduction of excess minority interest equity attributable to third-party owners	(4.5)
Deduction of intangible assets	(52.5)
Deduction of material holdings[12]	(2.9)
Adjustments for prudential filters[13]	(0.6)
Net common equity tier 1 (including partial recognition of minority interests)	**15.4**
Net common equity tier 1 (excluding minority interests)	**6.5**
Basel I RWAs	609.0
Market risk and counterparty risk changes	155.6
Add securitisation exposures weighted 1250%	18.1
Basel III RWAs (Review Team estimate)	**782.6**
Common equity tier 1 attributable to RBS shareholders	**0.83%**
Basel III common equity tier 1 capital ratio (Review Team estimate)	**1.97%**

23 The Review Team also estimated that RBS would have been below the new Basel III 4.5% minimum common equity tier 1 ratio from at least end-2004 and therefore even further below the 9.5% level now believed to be appropriate for global systemically important banks such as RBS.[14] As at end-2007, the Review Team's estimates showed that RBS would have required an additional £18.0bn common equity tier 1 to meet the minimum level of 4.5%, or £56.0bn to reach 9.5% common equity tier 1.[15]

24 The Review Team's estimates of the Basel III common equity tier 1 position of RBS's peers as at end-2007 showed that RBS would not have been alone in being below the minimum of 4.5%. However, the ratio estimated for RBS was

8 These data were provided in the context of this Review and were supplemented with data obtained from other sources. Review Team analysis of FSA returns, FSA records and data provided by RBS in March to September 2011. Table does not cast due to rounding of figures.

9 Gross core tier 1 capital comprises ordinary shares and reserves attributable to RBS shareholders, plus minority interests, net of prudential filters.

10 'Prudential filters' are adjustments made to accounting values for prudential and financial stability purposes. See FSA DP09/2, *A regulatory response to the global banking crisis*, March 2009.

11 Only adjustments that were not zero at end-2007 are shown in the table.

12 The Review Team treated material holdings as significant investments in common stock, so an amount was allowed up to 10% of common equity tier 1 (including minority interests) after other deductions, in line with the Basel III framework.

13 Basel III requires the removal of prudential filters on unrealised gains and losses.

14 This level comprises the 4.5% minimum applicable to all banks, combined with a 2.5% capital conservation buffer within which firms are constrained in their ability to distribute capital resources (e.g. dividends) and a further requirement for an additional loss absorbency of 1% to 2.5% for global systemically important banks. This framework has been agreed by the FSB and the Basel Committee (*Policy Measures to Address Systemically Important Financial Institutions*, FSB, November 2011). In addition, the capital conservation buffer could be extended by national regulators to reflect cyclical conditions. These buffers are described in Appendix 2E.

15 Review Team analysis of FSA returns, FSA records and data provided by RBS in March to September 2011.

below the average of its peers (estimated as 5.70%) and was also the lowest of its peers.[16]

25 The Basel III regime also introduces into common equity tier 1 capital, a capital conservation buffer amounting to 2.5% of RWAs that can be further extended in certain circumstances.[17] The consequences of RBS's common equity tier 1 capital resources being below this buffer are explained in Appendix 2E. If the capital conservation buffer had been in place, RBS would not have been allowed to pay a dividend from end-2004 throughout the Review Period, including after its rights issue in April 2008.

1.1.2 RBS's capital position within the prevailing Basel I and Basel II regimes

26 Even within the deficient standards at the time, however, RBS was lightly capitalised relative to peers, both in terms of quantity and quality of capital.

RBS's capital strategy: quantity

27 RBS's strategy during most of the Review Period was to operate with '*efficient*' capital. When announcing a £1bn share buy-back in February 2006, the then CEO noted that '*we don't like carrying more capital than we need to. You've heard me before on the subject of building up war chests and carrying; that's not the way we would wish to operate at all*'.[18] This buy-back was broadly welcomed by investors for a variety of reasons: these included the benefit of increased cash returned in the year, and the reduced risk that the firm would use 'excess' capital resources to fund acquisitions. The firm justified it on the basis that its capital ratio was ahead of its target tier 1 ratio of 7% to 8%.[19]

28 This overall strategy, which continued until April 2008, was well known to market participants and observers.[20] In 2005, some investors commented that RBS's capital position was '*verging on the weak*', '*aggressive*' or '*stretched*', with a majority of those interviewed in an RBS investor perceptions survey considering that the position was '*probably too tight*'.[21] However, others took comfort from the firm's profitability[22] and an investor survey in 2006 found that a majority of interviewees were comfortable with RBS's approach to capital. Its strategy was also apparent to the FSA.

29 At end-2006 and end-2007 respectively, RBS published tier 1 capital ratios of 7.5% and 7.3% of RWAs, and total capital ratios of 11.7% and 11.2%. As

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16 Peers were Barclays, HBOS, HSBC, Lloyds TSB and Standard Chartered. Peer group average is calculated excluding RBS.
17 This buffer can be extended by national regulators to reflect cyclical conditions.
18 RBS 2005 earnings conference call, 28 February 2006. Similar remarks were made in 2005. Transcripts sourced from Thomson StreetEvents.
19 *RBS announces £1bn buyback*, FT, 1 March 2006: '*In the past, Sir Fred has pledged to return capital to shareholders when Tier 1 was in the 7-8 per cent range*'.
20 RBS records, June 2005 and December 2006 and Review Team meetings with institutional investors, June to August 2011. See also several reports by Standard & Poor's during the Review Period that noted '*capital is run relatively tightly*'; and *UK bank leverage to a credit cycle*, Lehman Brothers Equity Research, November 2007. RBS reassessed its capital strategy when announcing its £12bn rights issue in April 2008 (RBS announcements, April 2008 and Review Team meeting with the then RBS Group Finance Director, June 2011).
21 RBS records, June 2005.
22 Standard & Poor's Ratings Report (18 December 2006): '*Standard & Poors considers that RBSG's capitalisation is weaker than most global peers', but this is compensated to a large degree by its very strong ability to generate retained earnings*'. This was also noted in contemporaneous data provided by one institutional investor in June 2011.

shown in Graphs 1.1 and 1.2 in Part 1, RBS's published tier 1 ratios were at the lower end of its peer group range in 2005 to 2007 (before the firm's recapitalisations in April and October 2008). However, on a total capital basis, the firm appeared in the middle of its peer group.

30 RBS's capital ratios at end-2007 were further stretched by the acquisition of ABN AMRO, and the firm's subsequent public statements indicate a '*worst point*' core tier 1 ratio of 4% at 1 January 2008.[23] In line with its overall strategy for capital, the firm viewed the anticipated reduction in its capital ratios as an acceptable consequence of the acquisition.[24] In September 2007, the RBS Board acknowledged that its tier 1 capital ratio could '*reduce to a level lower than previously seen for a temporary period due to market conditions*'.[25] The firm's expressed intention was to rebuild capital by internal capital generation over a three-year period, during which the consortium would restructure ABN AMRO.[26]

RBS's capital strategy: quality

31 Alongside quantity, quality of capital is extremely important. The pre-crisis regime allowed excessive latitude to firms, and RBS made significant use of non-equity capital instruments to meet its capital requirements during the Review Period. These included preference shares, innovative tier 1 instruments and tier 2 capital instruments. During the market turmoil, these instruments did not absorb losses for systemic banks such as RBS.

32 Within tier 1 capital, the firm's own long-term target for the non-equity component of its tier 1 capital resources was 25% to 30%.[27] This was at the top of the range seen among its peer group[28]; therefore, RBS placed more reliance on non-core capital than most of its peers.

33 Although the acquisition of ABN AMRO was mainly debt-funded, some preference shares were issued to raise cash for the purchase. In September 2007 there was concern among RBS senior management about the level of non-core capital within RBS's tier 1 capital resources.[29] The firm's capital plan for 2008 showed that the level of preference shares was expected to remain above its internal target during the year and at around 40% in mid-2008.[30] This was also a concern of a few institutional investors during the Review Period.[31]

34 Tier 2 capital resources are a lower-quality form of capital, which are only able to absorb losses in liquidation (i.e. tier 2 cannot absorb losses while a firm remains a going concern), and as such their use is limited to a proportion of total capital resources. Within total capital resources, from 2005 to 2007 (and

23 2010 RBS annual results, 24 February 2011.
24 RBS records, June 2007 and Review Team meeting with RBS non-executive director, May 2011.
25 RBS records, September 2007.
26 RBS trading update, April 2008.
27 This meant that equity should comprise at least 70% of tier 1 capital, with preference shares and innovative instruments accounting for up to 30%.
28 Peers compared were Barclays, HBOS, HSBC, Lloyds TSB and Standard Chartered. Use of non-equity tier 1 (calculated as common equity divided by tier 1 capital before deductions, in the absence of specific disclosure of gearing ratios) ranged from 11% to 27% among the peer group, with the average being 19%). 2008 Barclays interim results, 2007 HBOS annual results presentation, 2008 HSBC annual report and accounts, 2007 Lloyds TSB annual report and accounts and 2007 Standard Chartered annual report and accounts.
29 RBS records, September 2007.
30 RBS records, February 2008.
31 Review Team meetings with institutional investors, June to August 2011.

before its recapitalisations in 2008), RBS used a significant proportion of tier 2 capital to meet its capital requirements.[32]

35 Before its recapitalisations in 2008, RBS's use of tier 2 capital resources was close to the limit of the amount permitted within total capital resources. RBS was also generally more aggressive in its use of tier 2 capital resources than its peers. This is illustrated in Table 2.2.

Table 2.2: tier 2 : tier 1 gearing at RBS and its peer group[33]

Gross tier 2 capital resources must not exceed tier 1 capital resources net of 100% deductions (i.e. tier 2 capital resources must be less than net tier 1 capital resources); the higher the percentage, the greater the reliance on tier 2 capital.

	end-2004	mid-2005	end-2005	mid-2006	end-2006	mid-2007	end-2007	mid-2008	end-2008
RBS	89.2%	96.0%	79.5%	91.6%	91.0%	86.5%	76.4%	54.8%	48.4%
Peer group average (excluding RBS)	65.9%	74.0%	75.5%	72.6%	68.5%	65.9%	69.0%	71.7%	68.7%

36 As discussed in paragraph 90, the market turbulence from late 2007 onwards led to an increased focus on the quality of capital. During the financial crisis, preference shares and innovative instruments did not, in general, absorb losses.[34] Similarly, since the financial crisis, tier 2 capital instruments have been regarded as of limited use for systemic banks in the absence of robust resolution mechanisms for such banks. The fact that such instruments were not permanent and had to be refinanced regularly also reduced their usefulness.[35]

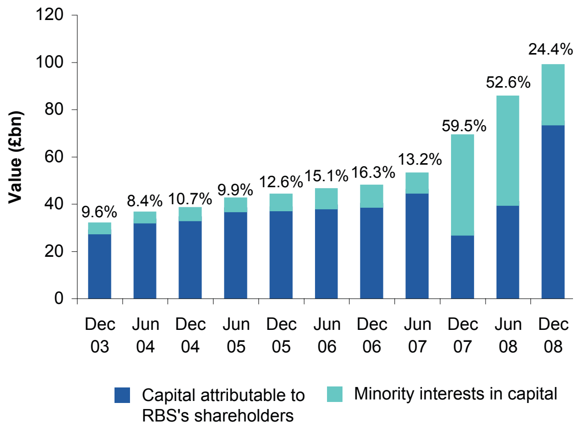
1.1.3 RBS's capital position after the acquisition of ABN AMRO

37 The acquisition of ABN AMRO had a significant effect on both the quantity and quality of RBS's capital resources, and significantly increased RBS's trading assets, which were, with hindsight, inadequately assessed by the prevailing capital regime.

38 As noted in paragraph 30, the acquisition of ABN AMRO weakened RBS's capital ratios and led to it operating below its own internal core tier 1 target of 5.25%. The following factors affected RBS's capital position immediately after the acquisition (these are also discussed in Section 1.5).

32 FSA returns.
33 FSA returns. Peers for this comparison are Barclays, HSBC, Lloyds TSB, Standard Chartered and HBOS.
34 FSA DP09/2, *A regulatory response to the global banking crisis*, March 2009.
35 In the absence of lock-in features, the mandatory repayment of tier 2 capital instruments weakens a firm's capital position, particularly in times of stress when the firm needs to preserve cash and may find it difficult to raise alternative capital. See FSA DP07/6, *Definition of Capital*, December 2007.

Graph 2.2: RBS's total capital resources (net of deductions), as reported in FSA returns, end-2003 to end-2008, showing separately the proportion of total capital resources attributable to minority interests[36]



Source: FSA returns.

- RBS's decision to fund the majority of its share of the acquisition with debt (most of which was short-term), rather than equity, led to an anticipated reduction in its core tier 1, tier 1 and total capital ratios.[37] RBS's capital position would not have been so adversely affected had it financed the acquisition with a greater proportion of equity. The structure of the funding raised by RBS is set out in detail in Section 1.5.

- This effect was amplified by the significant goodwill recognised following the acquisition. At end-2007, this goodwill was deducted from tier 1 capital resources and therefore (given that the acquisition had not been funded in full by tier 1 capital) acted to reduce RBS's tier 1 and total capital ratios.[38]

- The effect of the two factors above was to some extent mitigated by the capital contributed by RBS's consortium partners, Fortis and Santander. This led to RBS recognising significant minority interests in its capital resources for the duration of the restructuring process. As the investment of the consortium partners was in the form of equity, these minority interests supported RBS's core tier 1 position in particular. Box 2.2 explains how these minority interests arose and the consequences on the quality of RBS's capital of recognising significant minority interests at end-2007 and thereafter.

- The acquisition of ABN AMRO also resulted in a large increase in trading assets, especially credit trading assets, the capital regime for which was particularly deficient (see Section 1.1.1).

36 As discussed in Box 2.2, the transaction structure and the treatment of goodwill under the Basel I and II frameworks meant that the proportion of core capital accounted for by minority interest was even greater.

37 RBS records, June 2007. '*Core tier 1*' is not explicitly defined in the records but appears to be defined as equity tier 1 before deductions.

38 This effect persisted in mid-2008, but was less of an issue at end-2008, by which time most of the goodwill arising on the acquisition had been written down.

Box 2.2

Minority interests in capital resources

Accounting standards require a group to recognise minority interests in equity when it consolidates an entity that it does not fully own (i.e. where other shareholders have an interest in the entity being consolidated). The share of the entity owned by third parties constitutes 'minority interests'. Under Basel I and Basel II, banking groups are required to count minority interests towards their regulatory capital, including them in the relevant tier of capital at group level.

As the full amount of RWAs of the entity is also consolidated with group RWAs, the inclusion of minority interests in capital is consistent with providing a like-for-like view of risks and resources. However, this ignores the fact that, in the event that funds need to be transferred out of the entity to cover risks or losses in another part of the consolidated group, part of the transfer will leave thegroup and go to the third parties.[39] As a consequence, while minority interests do cover risks or losses in the relevant subsidiary, full inclusion overstates the amount of capital available to absorb risks throughout the group that consolidates the entity.

Although RBS's consolidated core tier 1 capital ratio fell as a result of the ABN AMRO acquisition, the absolute amount of core tier 1 capital after the acquisition was significantly boosted by the equity contributed by RBS's consortium partners. This was a result of the transaction structure, and the fact that the investment by the consortium in RFS Holdings (RFS, the specially created holding company, discussed further in Section 1.5) was in the form of ordinary shares. As the goodwill and other intangible assets arising on the transaction were deducted from total tier 1 capital resources rather than core tier 1 capital resources, there was no offsetting effect on core tier 1 stemming from the purchase. The different classes of shares issued by RFS to track each member's interest in the different parts of ABN AMRO further restricted the extent to which that capital would absorb losses across the RBS group.

Graph 2.2 shows how significant minority interests became as a component of total capital as a result of the ABN AMRO acquisition. Given that Fortis's and Santander's investment in RBS was in the form of common equity, at end-2007 minority interests played an even greater role in measures of core capital than the 60% that they contributed to RBS's total capital ratio, as shown in Graph 2.2.

Under the new Basel III capital standards, minority interests are given some recognition in group capital, but only to the extent that they cover the capital requirements of the entity to which they relate.[40] Any surplus above requirements attributable to third-party owners is considered not to be available to the rest of the group and is therefore excluded from group regulatory capital. However, there is no formal limit as a proportion of group capital within the Basel III rules. So, in principle, future situations could still arise under which a firm's common equity tier 1 is over-dependent on minority interests, which is not available to absorb losses elsewhere in the group.

1.1.4 FSA regulation and supervision of capital

39 Within the context of the global regulatory regime for capital described in Section 1.1.1, this section describes the FSA's supervisory approach to bank capital in general and the supervisory work conducted on RBS's capital position

39 For example, if a subsidiary with minority shareholders transfers resources by way of a dividend to the parent (controlling shareholder) to cover risks elsewhere in the group, some of that dividend must be paid to the minority shareholders and is not therefore available in full to the parent.

40 The Basel III reforms are set out in *Basel III: A global regulatory framework for more resilient banks and banking systems*, Basel Committee, 16 December 2010; minority interests are discussed in paragraphs 62-65. For this purpose, capital requirements are defined as the relevant minimum requirement for each tier of capital, plus the capital conservation buffer.

in particular. It describes the latter in considerable detail, since it is important to assess whether there were technical deficiencies in the FSA's application of global rules or of its defined supervisory approach. But an important conclusion is that, until the shift in the FSA's approach described in Section 1.1.5, much of the detailed activity was addressing issues that in retrospect did not focus sufficiently on the overall quality and quantity of capital (which, ultimately, was fundamental to RBS's failure).

- Large resources were devoted to implementing the Basel II framework. Various detailed issues (described in paragraphs 49 to 60) arose during this implementation. But in retrospect, Basel II introduced huge additional complexity to the capital regime for banks while failing to address the fundamental problem of severely deficient overall capital resources.
- As described in paragraphs 61 to 69, the FSA was engaged in review of RBS's VaR-based market risk models. But in retrospect there were more fundamental deficiencies of the whole market risk regime, which have subsequently been partly addressed by the Basel Committee and are now being considered in more detail by the Basel Committee's fundamental review of the trading book capital regime.

40 As a result, while the Review Team did not find important technical deficiencies in the application of capital regulations, these regulations still allowed RBS to operate with inadequate capital. The Review Team did not find any evidence of breaches of RBS's Pillar 1 minimum capital requirement during the Review Period and, in general, the supervisory practices applied to RBS were in compliance with the prevailing supervisory approach. However, just as the capital rules proved to be deficient (as noted in Section 1.1.1), so too did the overall supervisory approach.

FSA's supervisory approach: overview

41 The FSA's overall pre-crisis supervisory approach was inadequate, with in retrospect an overly reactive approach and insufficient data available to supervisors to assess prudential risks fully.

42 Aside from work setting individual capital ratios (ICR) or individual capital guidance (ICG), the prevailing FSA approach to supervising firms' capital adequacy under the Basel I framework was mainly reactive and driven by alerts and exception reporting generated by the central analysis of regulatory returns. No peer analysis was routinely performed on capital returns. And only during the later part of the Review Period did the FSA focus on the quality of capital.

43 In terms of reactive work conducted, the Supervision Team dealt with a number of issues relating to the firm's capital calculations that arose during the Review Period. There were substantive discussions with RBS on its capital planning before its share buy-back in 2006, and work was performed on the firm's intra-group exposure framework. Supervision also corresponded with the firm when capital instruments were issued, to confirm, for example, whether a particular instrument met the prevailing conditions to count as tier 1.[41]

41 FSA records, 2005 to 2007.

44 During the Review Period, where the FSA did consider prudential matters, this was focused on capital requirements and resources. The FSA's approach did not routinely consider balance sheet leverage. The Review Team did not see evidence that such a measure was considered in RBS's case. While the FSA's ARROW letter to RBS in 2007 reflected the inherent risks associated with the continued pace of growth in GBM, it did not raise concerns about the size, leverage or composition of RBS's balance sheet.

45 Four different FSA returns were used during the Review Period to collect data on capital adequacy, reflecting significant changes being made to the FSA's reporting systems, including in preparation for Basel II. These required different information to be provided at different points in time.[42]

46 During 2007, when the reporting systems and overall Basel framework were in transition, the FSA made an explicit decision to analyse only high-level data on capital by means of a key data sheet (FSA009).[43] August 2008 saw the introduction of GABRIEL[44], the FSA's online regulatory reporting system for the collection, validation and storage of regulatory data. RBS, in line with others, submitted its first consolidated capital adequacy return on this system for the period to end-June 2008.

47 The Review Team found data collected on the FSA's regulatory returns during the Review Period to be inadequate to assemble a complete, consistent and reliable picture of RBS's capital position. Consequently, RBS provided additional information to support the Review Team's analysis. While most issues related to the design of the returns, some related to RBS in particular. It was the Review Team's view that these issues are likely to have hampered the effectiveness of the FSA's supervision of RBS, but the Review Team did not consider that this was a factor in the firm's failure. For example, the following issues were found in analysing data from FSA returns submitted at the time.

- Data on use of innovative tier 1 capital instruments were not collected separately within FSA returns before 2008. In the case of RBS, these were reported within reserves.
- Data on minority interests within capital resources and prudential filters were collected differently by the FSA on different returns used across the Review Period.
- In the case of RBS and some other firms, share premium attaching to preference shares was reported within reserves before 2008. Preference shares did not form part of core tier 1 capital, so this would have inhibited the FSA's ability to assess firms' compliance with its rules on quality of capital

42 RBS reported consolidated capital data on the BSD3, FSA009, ER2 and FSA003 returns during the Review Period. From July 2008 (as discussed in paragraph 48), these were supplemented by enhanced data collection for certain major UK banks.

43 FSA Policy Statement (PS) 06/10 notes in paragraph 8.13: '*we appreciate that figures reported in* [the capital adequacy section of BSD3, the previous reporting form] *may need to be manipulated by firms to meet all the validation rules, and will result in incorrect figures for a firm's capital position. We will not be placing any reliance on this section of BSD3 during 2007. A firm's correct capital position will be monitored from the key data sheet*'.

44 'GABRIEL' stands for 'Gathering Better Regulatory Information Electronically'.

(the same would also have been true for innovative instruments included within reserves).[45]

- While the treatment of preference share premium in returns was clarified for regulatory returns submitted from 2008 onwards, the issue remained in RBS's mid-2008 returns. £2.1m was reported at the time, compared to £10.6bn in data submitted by the firm in the context of the Review.
- RBS's electronic end-June 2007 return was '*missing*' from FSA records for an extended period and was not discovered until April 2010.[46]

48 In July 2008, the FSA's ExCo agreed two enhanced monthly capital data collection forms for certain major banks. These included forward-looking capital projections. Both these monthly forms and the main regulatory reporting framework have since been updated (for example, to collect data on capital planning buffers for periods ending on or after 31 December 2010). During 2011, the FSA amended the enhanced monthly capital data collection to include information on Basel III capital measures (among other changes). It is also developing its regulatory reporting regime in light of the European legislation on regulatory reporting.[47]

Basel II

49 While overall there was much less focus on capital than was appropriate and than the FSA would now devote, considerable resources were devoted to one particular issue: implementing Basel II. Overall, the Review Team's investigation suggested that the FSA's interaction with RBS on Basel II was professional, with a focus on some important issues. However, in some specific instances, there may have been too great a willingness to respond to industry lobbying and, in retrospect, the whole Basel II framework failed to address the fundamental issues of quantity and quality of capital, which have now been addressed under Basel III.

Implementation of Basel II at RBS

50 As noted in paragraph 13, the Basel II framework applied to RBS from 1 January 2008. However, the FSA's work with RBS on its preparations for Basel II had begun much earlier, in 2002, when it took part in a thematic exercise to look at firms' preparations for the new regime. Preparations continued throughout the Review Period, employing significant FSA resources (including specialists alongside the Supervision Team), in line with the FSA's overall approach to Basel II implementation. There is some evidence that RBS's models were towards the weaker end of its peers. However, the principal weaknesses were in the design of

45 By way of comparison, RBS's published annual accounts showed that RBS issued billions of pounds of preference shares from 2005 to 2007, but the amount reported in FSA returns varied between £0.1m and £14m across the same period. FSA returns and 2005, 2006, 2007 and 2008 RBS annual report and accounts.

46 The missing return had been tagged with the wrong code. Review Team discussions with FSA specialists, January to March 2011. RBS's records note that the return was submitted on time (data provided by the firm to the Review Team in May and June 2011).

47 Common Reporting (COREP) is the term used to describe harmonised European reporting for credit institutions and some investment firms and will be mandated by the European Banking Authority as a standardised reporting framework from 31 December 2012. This implements requirements in Article 74 of the Capital Requirements Directive (CRD, as published November 2010). In July 2011, the European Commission published proposals to amend the CRD; these propose changing the implementation date to 1 January 2013.

the overall Basel II framework (as discussed in Section 1.1.1), rather than its implementation at RBS.

51 Before the start of the Review Period, some RBS senior management had been vocal in their concerns about the emerging Basel II policy framework.[48] Around January 2005, as RBS was implementing the new framework, Supervision believed that the attitudes of senior management at RBS might present challenges to the firm's Basel II preparations. In particular, Supervision was concerned that the firm might be unable to demonstrate that components of the internal ratings based (IRB) approach were truly employed for internal risk management purposes – i.e. it might be unable to pass the 'use test'.[49] Supervision considered that the position improved from 2006, and saw the new RBS Group Finance Director's views on the Basel II use test '*as an advantage*' in this regard.[50]

52 In 2005 and 2006, there was a series of specialist visits to RBS to assess particular models within the firm's IRB approach. RBS's formal IRB models application was submitted in Q4 2006 and considered by an FSA Decision Making Committee (DMC) in May 2007and June 2007.[51] The DMC explicitly considered high-priority issues that had to be resolved before model approval could be granted and had a procedure for dealing with subsequent weaknesses. More detail on the FSA's IRB model approval process is set out in Appendix 2F.

53 RBS's IRB models were approved, subject to conditions, at these DMCs in 2007. The final directions were sent to the firm on 19 December 2007 and the permission applied from 1 January 2008.

54 All RBS's peers were granted approval to move to an IRB approach over a similar timeframe and all had conditions attached at the point of approval, typically addressing model build, calibration and risk management issues. So RBS was not unusual in having conditions imposed on its use of internal credit risk models, either in terms of the number or nature of the conditions. Nevertheless, overall, RBS's models appeared towards the weaker end of the spectrum; in addition to issues raised in early 2008, when only partial approval was given (see paragraph 55), there were concerns during the initial approval process about stress-testing in relation to RBS's credit risk models, that were to be dealt with as part of Pillar 2 (see paragraphs 70 to 83).[52]

55 Following model approval in May and June 2007, specialist resource continued to monitor RBS's models during 2007 and in early 2008 and there was ongoing dialogue with the firm. Further visits in early 2008 raised serious concerns about the compliance of certain credit risk models to be used by RBS, as well

48 Review Team meeting with the former RBS Group Finance Director, August 2011.
49 The use test refers to the requirement that a bank operating on the IRB approach cannot use the underlying risk estimates only for the purposes of calculating regulatory capital. The estimates must also be used in other aspects of the business (such as planning or risk management). This aimed to reduce the incentives for firms using their own models to minimise capital requirements rather than produce accurate risk estimates, and to create incentives for firms to keep their models up to date. FSA records, January to February 2005.
50 Review Team meeting with the Supervision Team, February 2011.
51 FSA records, May and June 2007.
52 FSA records, June 2007.

as other ongoing modelling issues at the firm (such as weaknesses in model validation processes).[53]

56 This led to a further DMC on changes to RBS's master grading scale and corporates models in April 2008. By this time, it was also clear that the firm faced significant issues with its capital position (see Section 1.1.5). In a departure from normal FSA practice, the FSA's ExCo acted as the DMC on this occasion. The paper presented to ExCo noted that, despite still being subject to approval, RBS had partly incorporated the benefit from these model approvals into its capital plan.[54] ExCo granted only partial approval to the changes proposed (which provided some capital benefit to the firm by reducing RWAs), subject to further conditions.[55] The process of resolving issues with these models continued throughout 2008.

57 While firms were expected to ensure that they met all pre-implementation conditions before first use (which for RBS was 1 January 2008), the FSA gave itself until end-2008 to check these conditions had been satisfied. The Review Team believes that this decision represented a shortcoming in the FSA's approach to IRB models. There is evidence that the FSA followed up all of RBS's pre-implementation conditions (some of which became ongoing conditions).[56] Subsequent to the Review Period, the FSA has improved its processes for identifying and following up on all DMC conditions.

The UK banking industry's Basel II preparations more generally

58 The preparation for Basel II resulted in the UK authorities becoming focused on the capital position of the UK banking industry generally, and of RBS in particular. This, and other FSA work with RBS and other major banks on Basel II implementation, is described below.

- The impact of Basel II on major UK banks was considered by FSA senior management in November 2007 and by ExCo in December 2007.[57] The latter noted an expected 13% reduction in aggregate capital resources arising from the transition and that '*the drop in published capital ratios will potentially attract an adverse reaction*'. The minutes suggested that ExCo felt that firms should strengthen their capital positions over the following two years, but that the precise timetable would depend on individual firm circumstances.

- The Tripartite Standing Committee on Financial Stability also discussed UK banks' Basel II positions on 5 December 2007. Minutes of that discussion noted that '*some of the* [Basel II] *numbers are startling – for example, they show that RBS is very close to its minimum regulatory capital requirements*'. So it is clear that, by December 2007, the UK authorities were aware of capital strain in the UK banking system generally, and at RBS in particular.

53 FSA records, March to July 2008.
54 FSA records, April 2008.
55 FSA records, April 2008.
56 FSA records, August to September 2008.
57 FSA records, November and December 2007.

- In late 2007, amid regulatory concern that the capital ratios for the larger UK banks might be lower under Basel II than they had been under Basel I, there was nevertheless lobbying by the UK banking industry for modifications to the FSA's Basel II implementation to permit more favourable treatment for certain exposures. By way of example of this lobbying, RBS raised two issues: treatment of certain venture capital investments and the 'expected loss (EL) less provisions' deduction[58] with the Supervision Team on 7 December 2007. These issues (which were also raised by other firms) were discussed by ExCo, which considered that, '*subject to it being permissible under the directive, the more lenient treatment should be adopted*'. The FSA subsequently clarified the approach to be taken to the two issues in December 2007.[59] These changes affected all firms moving to an IRB approach. In RBS's case, the decision taken for the 'EL less provisions' deduction increased its core tier 1 capital resources for mid-2008 by £0.84bn.[60]

59 Despite the considerable resources devoted to implementing Basel II at the FSA, at RBS and across the banking sector more generally, the position that emerged at end-2007 showed that, even before it had come into effect, there were concerns that RBS's positions under the new regime would be very close to regulatory minima, with little room to absorb further stresses. The development of the firm's capital position from late 2007 and the FSA's supervision at that time is described in Section 1.1.5.

60 In the context of deteriorating market conditions and increasing losses on some asset classes, this had clear implications for market confidence. Also, as discussed in Section 1.1.1, the Basel II regime did not address the fundamental weaknesses in the Basel I framework, which permitted relatively low-quality capital to meet capital requirements. Furthermore, with hindsight, the greater use of models introduced additional complexity[61], such as valuation challenges, an increased focus on risk-weights (i.e. the denominator of the capital ratio) and further concern that these might be too low. In contrast, there was less consideration of capital quality and Basel II failed to address the fundamental problem of severely deficient overall capital resources.

The capital regimes for market risk and counterparty credit risk

61 There was a considerable amount of work conducted as part of the market risk capital regime. With hindsight it was too narrowly focused and was at the expense of looking at risk in other ways that were more important. These are being fundamentally addressed in Basel III.

62 As discussed in paragraph 18, the market risk capital regime within the Basel capital framework permitted the use of VaR models to calculate capital

58 Under the IRB formula for credit risk capital requirements within Basel II, the difference between expected losses (calculated by the firm's IRB models) and the accounting provisions on a given portfolio are deducted from capital. This is known as the 'EL less provisions' deduction. FSA records, December 2007.

59 In the case of venture capital, the FSA allowed firms to apply for a waiver to risk-weight their equity exposures in venture capital at 370% rather than deduct them, subject to certain conditions (Review Team discussions with FSA specialists, March 2007). On 'EL less provisions', the FSA wrote to the BBA on 21 December 2007 confirming a more favourable treatment. The Tripartite Standing Committee on Financial Stability was informed of the two changes in January 2008.

60 Data provided by RBS in March 2011.

61 FSA DP09/2, *A regulatory response to the global banking crisis*, March 2009.

resources requirements. For most of the Review Period, the FSA's supervision of market risk was mainly focused on the maintenance and monitoring of firms' VaR models and the associated approval and periodic review process, in line with the prevailing framework for market risk supervision. Neither the dedicated specialist resources nor the Supervision Team looked in detail at either the trading book inventory or risks that were not fully captured by VaR models, for example credit risk associated with particular instruments held in the trading book. In retrospect, this reliance on sophisticated models was one of the fundamental weaknesses of the overall market risk framework.

63 At the start of the Review Period, RBS had relatively wide VaR model permissions, including for asset-backed securities (ABS). Holding VaR model permission for this class was unusual. The Review Team understands that, at the time that RBS received its VaR model permission (i.e. pre-Basel II), firms applying for model permission did not have to comply with such strict requirements as those that applied for model permission after the Basel II rules, as set out in the BIPRU section of the FSA Handbook, came into force in 2007. RBS supplemented its permissions (with FSA approval) during the Review Period, for example adding permission for an intermediate approach to modelling commodities[62] in 2007 before its joint venture with Sempra.

64 The FSA's regular supervision work was based on information provided by the firm in CAD quarterly packs.[63] These were heavily focused on back-testing results from VaR models, where the actual profit or loss realised in trading activity was compared to the VaR estimate. Results were reviewed to assess the ongoing suitability of the VaR model. Other information contained in the pack included significant changes to methodology or pricing models, stress-testing reports and relevant reports from the firm's internal audit function.[64]

65 FSA market risk specialists did not regard RBS's CAD quarterly packs as revealing matters of particular importance in relation to market risk before August 2007, when they started showing significant back-testing exceptions. The size of the back-testing exceptions, rather than their number, appeared striking. On some occasions, for example, the profit or loss exceeded VaR by a factor of eight. A remediation programme was set up by the FSA to address the weaknesses shown by these exceptions but, due to ongoing difficulties in financial markets, this progressed slowly. RBS was eventually required to seek re-approval for its VaR model in 2008. A panel held to consider this in March 2009 set a number of remedial actions.[65]

66 The Basel II framework also introduced revised counterparty credit risk capital requirements, which applied to RBS from when it moved to Basel II on 1 January 2008. This change to the requirements was expected to cause stress to RBS's ratios in early 2008, in particular to the solo bank's 8%

62 This 'CAD 1' model approval was an intermediate step within the market risk capital regime between the standardised approach and full VaR ('CAD 2') model approval. 'CAD model permissions' can refer to both CAD 1 and VaR model permissions.
63 The references to 'CAD' refer to the Capital Adequacy Directive, which implemented the Basel market risk capital regime in European legislation. The content of the packs was determined by FSA specialists.
64 Review Team discussions with FSA specialists, February 2011.
65 FSA records, March 2009, and Review Team meeting with FSA specialists, January 2011.

minimum capital requirement.[66] As for other risks under the capital framework, use of internal models was permitted subject to regulatory approval, and RBS submitted an application to use an expected potential exposure (EPE) model in December 2007. The FSA reviewed RBS's application during the first half of 2008 and challenged the firm on several aspects, including on stress-testing (as mentioned in relation to IRB models in paragraph 54).[67] The FSA granted permission for RBS to use its EPE model in July 2008.

67 Although a focus by the FSA on capital models did give some more insight into RBS's portfolios and capital management than might otherwise have been the case, with hindsight this focus appears to have been too narrow and at the expense of examining risk in other ways. In 2007, the Supervision Team recognised that information from VaR models was not sufficient to understand the risks associated with RBS's trading activities and therefore needed to be supplemented with additional data, for example about inventory held within the trading book.[68] This is discussed further in Sections 1.4 and 1.6.

68 The Review Team's view was that Supervision met prevailing practices in relation to its focus on models and the associated model recognition processes in supervising market and counterparty credit risk. The main focus of supervisory attention during the Review Period was understandably on individual firms' implementation against the agreed Basel standard and not in reviewing whether the standard itself was appropriate. The Review Team also saw evidence of the FSA challenging RBS to improve its market risk models.

69 However, as noted in paragraph 19, with hindsight it is clear that there were fundamental weaknesses in the regulatory regime applied to market risk: RBS's own internal audit report stated that '*Losses were significantly in excess of those predicted by RBS VaR measures as the historic data used for VaR did not capture the market movements that were experienced*'.[69]

Pillar 2 and individual capital guidance

70 During most of the Review Period, the FSA's main tool to influence the level of capital held by firms was by setting ICRs or, from 2007 under Pillar 2 of the capital framework, individual capital guidance (ICG). Pillar 2 was one of the three supervisory pillars set out in the Basel II framework.[70]

71 On the one hand, in the context of the primarily rules-driven Pillar 1 capital framework, Pillar 2 was a new judgement-based tool which gave the supervisor the opportunity to increase individual bank capital levels significantly. On the other hand, the Pillar 2 framework could be seen as focused on certain risks not

66 FSA records, December 2007. 'Solo' capital requirements are set for individual entities within a group to ensure capital adequacy within specific entities as well as at the consolidated level. The Review Team did not find any evidence of breaches of the firm's 8% Pillar 1 minimum capital requirement during the Review Period.

67 For example, the RBS Chairman, Global Markets, was noted to have '*a very negative view of stress- testing and its usefulness*' and there was concern about '*the impact of his vociferous, negative views on how the Firm and in particular the businesses use stress-testing*'. FSA records, April 2008.

68 Review Team meeting with the Supervision Team, January 2011.

69 RBS Group Internal Audit report, July 2008.

70 These were written into European legislation through the CRD, and further developed in the Pillar 2 guidance issued by the Committee of European Banking Supervisors. Collectively Pillars 1, 2 and 3 form an overall framework for prudential supervision of banks, credit institutions and investment firms.

covered in Pillar 1 (such as interest rate risk in the banking book), rather than as a means to address any fundamental under-capitalisation arising from the overall level of minimum capital requirements under Pillar 1. Indeed, a key concern from the industry at the time was that the FSA would use Pillar 2 to reverse out anticipated reductions in capital arising from the new requirements. The FSA explicitly noted, '*We will not use* [a Pillar 2 review] *to claw back reductions resulting from the move to the Basel II framework for calculating Pillar 1 regulatory capital*'.[71] Therefore, it was a tool which, in practice, was not used to increase substantially overall capital levels in the banking sector, either in the case of RBS or more generally.

72 Although it is unlikely that greater use of Pillar 2 to increase capital requirements would have prevented RBS's failure, this illustrates a supervisory approach which did not fully utilise the tools available and therefore proved insufficiently tough and comprehensive. However, the Pillar 2 process was in development in 2007 and, considering this, the decisions taken were reasonable. The FSA's approach to influencing firms' capital levels changed more fundamentally in April 2008 when ExCo approved a core capital target for certain firms, including RBS.

73 Under Pillar 2 a firm must, among other things, regularly assess the amount of capital it considers adequate to cover all of the risks to which it is, or is likely to be, exposed, including those risks not covered or adequately captured by Pillar 1 (for example, interest rate risk in the banking book). A firm determines its level of capital through an internal capital adequacy assessment process (ICAAP). This then forms a key input into the FSA's supervisory review and evaluation process (SREP), which is performed by FSA specialists together with Supervision Teams. The output of the SREP is the setting of ICG for the firm, this being the amount of capital the FSA believes is adequate for a firm to hold given its risk profile, strategy and capital resources.[72]

74 It was the FSA's practice at the time to set ICG with reference to peers as well as on an absolute basis. Where an ICAAP was not of sufficient quality to set ICG, an interim ICG might be issued. Given that, in 2007, the ICAAP and SREP were new both to firms and the FSA, the approaches to both were, understandably, still being developed.

75 RBS prepared and submitted its first ICAAP to the FSA in early 2007, based on end-2006 numbers. A SREP for RBS was performed in summer 2007 alongside the ARROW assessment. As the firm was approaching the end of its 'regulatory period', the FSA decided to proceed with this assessment considering the firm as it was then, rather than to take account of the forthcoming potential acquisition of ABN AMRO.

76 RBS's ICAAP submission was deemed by the Supervision Team (a view subsequently validated by the ARROW Panel[73]) to be of insufficient quality to

71 *Our Pillar 2 assessment framework*, FSA, May 2007.
72 *Our Pillar 2 assessment framework*, FSA, May 2007.
73 As described in Part 2 Section 3, ARROW Panels were convened to discuss, challenge and agree the Supervision Teams' approach to a firm's ARROW at particular points in the process. SREP Panels were established to play the same role in relation to the SREP. During 2007, the ARROW and SREP were both overseen by the same Panel (in line with the FSA's approach to align the two assessments where possible), and so for simplicity the Panel is referred to simply as the 'ARROW Panel'. 'ARROW' is the FSA's firm risk assessment framework, and is described in more detail in Part 2 Section 3.

perform a SREP adequately or to set ICG.[74] Further work on the SREP was postponed due to prioritisation of resource in response to market events. In September 2007, instead of issuing final ICG, the ARROW Panel agreed with the Supervision Team's recommendation to set '*interim*' ICG while it worked with the firm to refine its ICAAP.[75] Final ICG was to be concluded for the firm within six months.[76]

77 The main weakness was the firm's use of a 96% confidence interval in its assessment of how much capital it should hold, rather than the '*standard*' 99.9%, and the discussions at the ARROW Panel focused mainly on this rather than on the Pillar 2 risks. The FSA had not mandated a specific confidence interval to be used in firms' ICAAPs, instead using a BBB credit rating as a reference point. Although firms at the time used a variety of confidence intervals in their ICAAP submissions, these were almost always in the range of 99.5% to 99.9%, in line with FSA guidance.[77] Therefore, the 96% used by RBS was a significant outlier[78] and the Supervision Team was concerned that the firm was underestimating the amount of capital that should be held. When, at the Supervision Team's request, the firm applied a 99.9% confidence interval in its ICAAP, this showed a significant increase in the firm's estimate of total capital required above the Pillar 1 capital requirement (an extra £3.1bn on top of RBS's initial estimate of £4bn).[79]

78 From peer analysis performed at the time, this total capital add-on of £7.1bn that would have been required by the FSA above the Pillar 1 requirement had ICG been set at this revised confidence level would have been significantly higher than those set for peers. A proposed ICG at this level would also have been a significant increase from the firm's existing Basel I capital requirements. In light of these two factors, the Supervision Team concluded that it was not proportionate to apply this quantum of ICG to the firm, noting that '*a significant departure*' from the Basel I capital figure '*takes some explaining as to why we so massively underestimated the capital impact of the risks facing the group under Basel I*'.[80]

79 RBS's interim ICG was set by the FSA by applying a fixed add-on of £1.7bn to cover pension risk and an additional 3% scalar to all other risks. This was higher than estimated in the firm's ICAAP, which had estimated a 7% increase over its Pillar 1 capital requirement.[81] The Supervision Team saw this as '*a suitable amount of conservatism incentivising the resolution of a number of key issues – most notably their use of a 96% confidence interval*'.[82] After interim ICG was issued to the firm, an RBS internal Risk Management update in

74 FSA records, August to September 2007.
75 FSA records, August 2007.
76 FSA records, September 2007.
77 The ICAAP should determine the adequacy of existing capital requirements for Pillar 1 as well as additional capital for Pillar 2 risks. To undertake the former a firm must use at least an equivalent confidence interval as that implied by Pillar 1, i.e. 99.5% to 99.9%. Although the FSA does not specify a confidence interval for the Pillar 2 risk assessment, it is reasonable that firms should calibrate in a similar way to that required under Pillar 1 (Review Team discussions with FSA specialists, March 2011).
78 FSA records, September to October 2007.
79 FSA records, August 2007.
80 FSA records, August 2007.
81 RBS's interim ICG, as set by the FSA, was expressed as 110% of Pillar 1 risks plus a fixed add-on of £1.7bn.
82 FSA records, August 2007.

October 2007 stated that its ICG was '*at the lower end of the range of market expectations for UK banks*'.[83]

80 The Review Team judged that the following decisions, on the basis that they were intended to be a temporary solution and that the FSA's Pillar 2 framework was in its infancy, were reasonable and in line with decisions taken in the SREPs of other firms:

- the ARROW Panel's decision to endorse the Supervision Team's recommendation to provide the firm only with interim ICG, in light of the view that the firm's ICAAP contained weaknesses and because of delay to completion of the SREP due to reasonable FSA resource prioritisation;
- the decision[84] to apply a conservative interim ICG to RBS to act as an incentive to improve its ICAAP; and
- the ARROW Panel's judgement to set a six-month deadline for full ICG to be concluded by the FSA.

81 The Review Team noted that full ICG was not in fact concluded for RBS within the timeframe set by the ARROW Panel. Given the increased focus on the quality of firms' capital and the priority in late 2007 and early 2008 of ensuring RBS had sufficient capital (discussed further in Section 1.1.5), this was de-prioritised (at the instigation, the Review Team understood, of FSA senior management) and subsequently overtaken by events.

82 In the Review Team's view, in this case there were acceptable reasons for deferring the setting of the ICG, including the high level of focus on the quality and quantity of RBS's capital leading up to the rights issue. However, it can take significant time to determine the various issues associated with a firm's ICAAP and there is a risk, in other circumstances, that the pace and progress of issuing ICG could be disproportionately disrupted. Just as there are risks associated with setting ICG before establishing what these are, equally there are risks associated with undue delay.

83 The SREP did present an opportunity for the FSA to set higher capital guidance for RBS, had the ARROW Panel decided to set the ICG based on the more '*standard*' 99.9% confidence interval. With hindsight, had the FSA used this tool in a tougher way, the increase in ICG of £3.1bn calculated using a 99.9% confidence level might have resulted in RBS raising new capital earlier. However, the Review Team does not consider that, given the scale of subsequent losses, this would have prevented the firm's failure.

1.1.5 Focus on capital in late 2007 and 2008

84 From late 2007 onwards, the FSA was increasingly developing more robust and appropriate approaches to capital and played a major role in ensuring the rights issue of April 2008 raised what was then perceived as sufficient capital to absorb potential losses. In retrospect, however, the improvements in FSA

83 RBS records, October 2007.
84 As recommended by the Supervision Team and agreed by the ARROW Panel.

practice and regulatory rules at that time were insufficient to ensure a fundamental change in RBS's already weak capital position. The rights issue also reflected RBS's awareness of these capital weaknesses, but this followed a period of time (in late 2007 and early 2008) which illustrated severe deficiencies in the firm's capital planning.

Evolution of RBS's capital position in late 2007 and early 2008

85 As noted in Section 1.1.2, RBS's capital position between 2005 and 2007 was relatively tight. However, the Review Team did not find any evidence of breaches of the firm's 8% Pillar 1 minimum capital requirement during the Review Period. As became clear from early 2008 onwards, this regulatory minimum was inadequate. In particular, in autumn 2008 it was insufficient to withstand the scale of losses suffered by the banking sector while maintaining market confidence in the solvency of the sector as a whole and of major financial institutions such as RBS.

86 The difficult market conditions in late 2007 and early 2008, combined with the transition from Basel I to Basel II, led Supervision to increase its focus on the capital position of RBS and other firms significantly, and to assess whether RBS's capital was of sufficient quality and quantity to meet its needs.

87 The adequacy of RBS's capital position was considered by the FSA Supervision Director, CEO and Chairman shortly before the ABN AMRO deal was concluded in October 2007 (discussed further in Section 1.5).[85] Briefings from the Supervision Team concluded that RBS would be able to deal with the impact of the acquisition from a capital perspective, bearing in mind the minimum capital requirements at that time.

88 In November 2007, FSA senior management discussed peer analysis of the anticipated effect of Basel II, alongside the capital impact of potential stresses (including the drawdown of conduit liquidity facilities and forward leveraged buy-out commitments). It noted with respect to RBS that '*there are a number of uncertainties (including the Basel II status of ABN AMRO), and detail on the Basel II impact will not be clear for some time*'. The paper's estimate of the Basel I capital position of the '*enlarged group*' (including ABN AMRO on a pro forma basis) as at September 2007 showed RBS well below its UK peers.[86]

89 In December 2007, RBS was added to the FSA's Watchlist[87] for capital risk and ExCo considered the impact of Basel II on major UK banks (as noted in paragraph 58). From February 2008, there were regular, senior-level FSA discussions on RBS's capital position and contact with the firm (both by the Supervision Team and FSA senior management) on steps needed to improve it.[88]

90 The FSA's focus on the capital position of the major UK banks, including RBS, increased significantly in late 2007 and early 2008. FSA senior management received several briefings on these issues and the Chairman and CEO met firms to

85 FSA records, September to October 2007.
86 FSA records, November 2007. The peers considered were Barclays, HBOS, HSBC and Lloyds TSB.
87 A tool within the FSA's risk framework to escalate risk issues in firms to FSA executives and to provide subsequent updates on their resolution. Details of the Watchlist are shared with Tripartite authorities.
88 FSA records, February to April 2008, and Review Team meeting with the FSA CEO, February 2011.

discuss capital issues.[89] At this time, supervisory focus also rapidly moved away from Basel II measures of total capital to alternative measures of capital strength, in particular placing emphasis on higher-quality '*core capital*'.[90] In April 2008, the FSA's ExCo discussed the capital of major UK banks and supported the implementation of a core capital target of 5% (pre-stress) to underpin firms' ICG.[91] As with the Basel 8% Pillar 1 minimum requirement, firms calculated this ratio without taking into account the effect of particular stresses on their capital position. Nonetheless, the FSA did explicitly consider stresses on firm's capital positions in late 2007 and early 2008. This represented a further development from the supervisory approach seen earlier in the Review Period.

91 At that time, it was the FSA's view that a core capital target of 5% (for firms to achieve by end-2008), combined with improved liquidity provided by the Bank of England Special Liquidity Scheme, should be sufficient for systemic banks to weather the crisis and retain the confidence of the market. The move by the FSA to focus on core capital mirrored market moves to consider alternative measures of capital strength.[92]

92 From an already weak point at end-2007, RBS's capital position worsened during early 2008. RBS notified Supervision on 3 April 2008 that it was likely to have fallen below its ICG at end-March 2008, based on provisional figures which indicated a total capital ratio of 9.01% against an ICG of 9.10%.[93] This was escalated to the FSA CEO immediately, and prompted a Threshold Conditions analysis to be considered by ExCo.[94] The firm's capital position further deteriorated to 8.72% on 10 April 2008.[95] The firm was judged still to meet Threshold Condition 4 (the requirement to have adequate resources), taking into account the fact that the Pillar 1 minimum of 8% did not appear to have been breached and that the firm now planned to raise significant capital through a rights issue.

93 On 9 April, the FSA CEO met the RBS CEO to discuss the end-March 2008 figures. During this meeting, the RBS CEO noted '*he was not sure about the exact ratio numbers, but recognised that the position was likely to be a breach* [of ICG] *in March and very tight for April*'. The FSA CEO said that the FSA '*would need a written commitment from the Group that they would be pursuing a rights issue*'.[96]

89 FSA records, February to April 2008 and Review Team meeting with the then FSA Chairman, February 2011.
90 This was defined as ordinary shares, plus reserves (after GENPRU 'filters'), less deductions previously made 100% from tier 1 (investment in own shares, intangibles and unrealised net losses on Available For Sale equities), less tier 1 share of 50/50 deductions (securitisation exposures, expected loss amounts gross of any tax adjustment and material non-insurance holdings).
91 FSA records, April 2008. The 5% core capital target was in effect the fore-runner of the benchmarks used for the October 2008 recapitalisation and subsequently. Note that this is different to the firm's internal long-term core tier 1 capital target of 5.25% referred to in paragraph 38. The Review Team was unable to ascertain when the FSA's 5% target was formally communicated to RBS, although believed it to have been discussed with the firm's CEO on 17 April 2008.
92 See, for example, *A Regulator Blinks*, Citi, 6 March 2008.
93 FSA records, April 2008.
94 FSA records, April 2008 and Review Team discussions with the Supervision Team, March 2011. RBS's apparent falling below ICG was not reported to the FSA Board in April 2008; this was consistent with the Board's overall approach in relation to detailed firm-specific issues. The FSA Board did receive updates on RBS's general capital position in February and March 2008 (along with capital positions of other major UK banks) and was notified that the FSA CEO had met RBS in April 2008.
95 This was primarily due to unplanned RWA growth. FSA records, April 2008.
96 FSA records, April 2008.

94 Thereafter, during April, there was frequent contact between FSA and RBS senior executives in relation to its capital position and the need to improve it, building up to the announcement on 22 April 2008 of a £12bn rights issue and a reassessment of the firm's overall capital strategy.[97] The FSA pushed the firm to raise as much capital as possible and more than the firm originally proposed.[98] The rights issue restored the total capital ratio to 13.2%[99], and was initially perceived as sufficient to ensure adequate capitalisation.

RBS's capital planning in early 2008

95 The rapid deterioration in RBS's capital ratios and the apparent fall below ICG was indicative of weaknesses in RBS's capital planning in late 2007 and early 2008. For example, a Board capital planning document in March 2008 still anticipated an end-March total capital ratio of over 11%[100] and on 28 February 2008 the firm still maintained that there were no plans for '*inorganic capital raising*'.[101] The following factors were identified as immediate contributors to the fall in RBS's capital ratios in early 2008[102]:

- The firm had planned to issue £2.3bn of tier 2 capital instruments in March 2008, but did not due to difficult market conditions.
- The disposal of Antonveneta (part of ABN AMRO) was delayed, having previously been expected in Q1 2008.[103]
- Anticipated FSA approval for certain credit risk models under the IRB approach, which would have reduced RWAs by £62bn, did not transpire in Q1 2008, although RBS had assumed these reductions in its capital planning.[104]
- The firm experienced difficult trading conditions and significant write-downs on structured credit and leveraged finance in particular. Market conditions had deteriorated further in late March 2008 after the collapse of Bear Stearns.
- ABN AMRO withdrew its application to move to an IRB approach and had not made contingency preparations to move to the Basel II Standardised Approach (for more detail, see Section 1.5).[105]

96 A number of those interviewed by the Review Team commented that the firm appeared to have been late in realising and responding to the gravity of the market situation in early 2008. It was the Review Team's judgement that, had RBS reacted more promptly to the worsening market conditions, including in

97 RBS rights issue announcement, 22 April 2008; and Review Team meeting with the then RBS Group Finance Director, June 2011.
98 FSA records, April 2008 and Review Team meetings with the FSA Supervision Director and CEO, January and March 2011.
99 2008 RBS interim results.
100 RBS records, March 2008. This document does begin to consider asset disposals. It appears that the failure to reflect any concerns that RBS might fall below its group ICG was caused by weaknesses in RBS's systems and controls.
101 Comment made by RBS CEO on RBS full year 2007 analysts' call, 28 February 2008. Transcripts sourced from Thomson StreetEvents.
102 FSA records, April 2008.
103 Although these proceeds would in time be transferred to Santander, RBS was required to consolidate ABN AMRO for regulatory purposes until the respective business units were transferred to the relevant consortium members. Therefore, RWAs and the associated capital resources relating to Antonveneta were included within the RBS group until the point at which the business was transferred to Santander.
104 RBS did subsequently receive partial approval for these changes in April 2008 (see paragraph 56).
105 FSA discussions with RBS, December to February 2008 and RBS records, April 2008.

respect of the factors listed above, the sharp fall in its capital ratios could have been mitigated. In April 2008, an FSA paper considering risks affecting ten major UK deposit-takers, highlighted '*poor capital planning and forecasting*' as an issue for RBS.[106]

97 Although, on 10 April 2008 (on the basis of provisional numbers), RBS's capital position was reported as being below ICG to the RBS Chairman's Committee[107], RBS subsequently finalised its period-end capital calculation and concluded that it had not fallen below ICG. An internal audit report commissioned by the firm's Chairman '*to understand the background to, and lessons learned from, the events that led to significant write-downs in RBS sub-prime, leveraged finance and other credit market activities*' concluded that '*there was no actual breach of the* [FSA's ICG] *ratio at that time* [4 April 2008] *or subsequently*'.[108] The same view was expressed in the Deloitte working capital statement from end-April 2008 and by RBS and its then senior management in the context of the Review.[109] The FSA's view in 2008 was that RBS's capital position did fall below its ICG.[110] The UK Listing Authority's consideration of this issue in the context of the rights issue is set out in Appendix 2B.

98 The Review Team noted that RBS appeared uncertain of its capital position at critical times during the Review Period. This included after end-March 2008. The Review Team remained unclear about when a final capital position for end-Q1 2008 was settled by the firm. The then RBS Group Finance Director told the Review Team that balance sheet data were not available until three weeks after the month end.[111] So, at best, compliance was only established on a retrospective basis. This undermined the ability of the firm to demonstrate compliance with regulatory Pillar 1 requirements and its ICG.[112] This was an especially serious failing for a firm which had chosen to operate with limited capital headroom, giving it a very low margin for error (although the Review Team did not consider this uncertainty in April 2008 to have been a crucial factor in RBS's subsequent failure).

99 During April 2008 or thereafter, the Supervision Team did not definitively establish the firm's final end-March 2008 capital position, although this was an action arising from a meeting between the FSA CEO and RBS CEO on 9 April.[113] Given the vulnerabilities in the firm's capital planning at this time, the Review Team considered this to be a considerable weakness in the approach taken. The Supervision Team told the Review Team that the following factors were relevant.

106 FSA records, April 2008. The same risk was not noted against the other firms considered in that paper.

107 RBS records, April 2008. This document refers to the figures as '*estimates*'.

108 RBS Group Internal Audit report, July 2008.

109 Review Team meetings with RBS senior management and non-executive directors, June to July 2011.

110 This is reflected in FSA records (April 2008) and in the Review Team's discussion with FSA staff (February to July 2011). As noted in paragraph 99, the Supervision Team did not definitively establish the firm's final end-March capital position at the time of the rights issue, and the Review Team did not see evidence of RBS providing the FSA with a final capital position at that time.

111 Review Team meeting with the then RBS Group Finance Director, June 2011.

112 Within the FSA's Handbook, GENPRU 2.1.9R requires that a firm must at all times monitor whether it is complying with the Pillar 1 rules. GENPRU 2.1.10 provides guidance that, although a firm does not necessarily need to measure the precise capital position on a daily basis, it must be able to demonstrate the adequacy of its capital resources at any particular time if asked to do so by the FSA.

113 Review Team meeting with the Supervision Team, March 2011 and FSA records, April 2008.

- The reported potential fall below ICG was in relation to the RBS group ICG. At that time regulatory reporting only captured group consolidated capital positions on a six-monthly basis (as at end-December and end-June).
- Given the rights issue, the firm moved back above its ICG minimum level, and the Supervision Team was then focused on other priorities.
- RBS's capital reporting was poor at that time (in part due to the recent acquisition of ABN AMRO and the introduction of Basel II).

100 Transcripts of analysts' calls around the same time evidenced imprecision from RBS senior management on how its capital position had been affected by the ABN AMRO takeover. For example, the then RBS Group Finance Director responded to a question on the firm's capital position. The analyst asked what was RBS's core equity tier 1 position on a proportional basis: '*it's a number, you can work it out … It does begin with a four and it does begin with a seven, I think would be as much as we would like to say at this point*'.[114] Some institutional investors also commented that it was difficult, in meetings with the RBS CEO, to gather detailed information on the firm's capital position and strategy.[115]

101 It should be noted, however, that RBS was not alone in being relatively slow to respond to market participants' requests for greater transparency. For example, the Financial Stability Forum commented in April 2008 that '*weaknesses in public disclosures by financial institutions have damaged market confidence during the turmoil*'.[116]

102 The Review Team considered that during the second quarter of 2008, Supervision addressed the key priority which was to ensure that the firm was adequately capitalised albeit that, at the time, supervisory resources were limited (see Section 3). The £12bn rights issue and associated revised capital targets and plan appeared to have mitigated the immediate risk to the firm's capital position.

103 With hindsight and as discussed in this section and in Section 1.6, this turned out to be insufficient to shield RBS from collapsing market confidence and radical increases in the perception of capital levels required to deal with uncertainty later in 2008.

RBS's capital position after the rights issue

104 RBS successfully completed its £12bn rights issue in June 2008.[117] This rights issue was one of the largest of its kind and its value exceeded all the tangible losses suffered by RBS in 2008. It also represented a change in capital strategy at RBS: alongside the rights issue, the firm announced increased target capital

114 Full year 2007 RBS analysts' call, 28 February 2008. Transcripts sourced from Thomson StreetEvents. The Review Team also heard, in a meeting with an RBS executive director in May 2011, that there was some reluctance from RBS senior executives to disclose capital ratios at that time.

115 Review Team analysis of information provided by institutional investors, July 2011. For instance, one contemporaneous meeting note recorded: '6% *'seemed like the right number wrt* [sic] *core tier 1' – NOT very scientific!!*'.

116 *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience,* Financial Stability Forum, 7 April 2008.

117 *Result of the Rights Issue*, RBS, 9 June 2008.

ratios and an asset disposal programme to increase its tier 1 capital ratio to in excess of 8% by end-2008.[118]

105 The firm's total capital and tier 1 capital ratios improved: at end-June 2008, the firm's published total capital ratio had increased to 13.2% (from 11.2% at end-2007). This was the second highest in its peer group (as shown in Graph 1.1 in Part 1) and was well in excess of the 8% Pillar 1 minimum capital requirement. Similarly, RBS's published tier 1 ratio was 9.1% at end-June 2008 (from 7.3% at end-2007), the highest in its peer group, as shown in Graph 1.2 of Part 1.

106 However, market participants had mixed responses when the rights issue was announced in April 2008. Some queried RBS's motivations, including whether it had decided to do the rights issue at the request of the FSA (RBS senior management told analysts that this was not the case). Rating agencies welcomed the rights issue as a means to absorb losses and rebuild RBS's capital position, but remained cautious in their assessment of RBS due to: the challenges it faced in integrating ABN AMRO in difficult market conditions; weaker performance in GBM; and the magnitude of write downs on its credit market exposures. Fitch downgraded RBS and Moody's put the firm on review for a possible downgrade on the same day as the announcement of the rights issue.[119] Many institutional investors that the Review Team spoke to expressed frustration at the swift change from RBS's assertions earlier in 2008 that it did not need to approach the market for fresh capital.[120] As discussed in more detail in Section 1.6.4, the rights issue did not succeed in shielding RBS from market participants' concerns about the adequacy of its capital later in 2008.

107 With hindsight, RBS's quality of capital remained weaker than average amongst its peers despite this capital raising. By way of illustration, when considered against the capital regime incorporated in the Basel III standards (as discussed in paragraph 21), the Review Team estimated that RBS's common equity tier 1 ratio would have been 2.79% at end-June 2008, compared to an average of 3.97% for RBS's peers.[121]

108 The plan announced by RBS in April 2008 to rebuild its capital position also anticipated the firm making significant disposals during 2008. In the months that followed, RBS did not achieve all the expected disposals (such as its insurance business) at its target price.[122] This, combined with the fact that the rights issue did not fully address underlying weaknesses in RBS's core capital position, meant that RBS did not have sufficient quality capital to absorb further losses later in 2008 while maintaining confidence in the firm's solvency. This was against a backdrop of increasing market uncertainty and market expectations that firms should hold more and better quality capital. The subsequent developments in the financial markets in late 2008 are set out in Section 1.6.

118 *£12 Billion Rights Issue: Update on Credit Market Exposures, Disposals, Capital, Trading Conditions and Outlook*, RBS, 22 April 2008.
119 Analysts' conference with RBS senior management, 22 April 2008 (transcripts sourced from Thomson StreetEvents) and research reports from Standard & Poor's, Moody's and Fitch, April 2008.
120 Review Team analysis of information provided by institutional investors, July 2011.
121 Review Team analysis of data provided by RBS in March to September 2011, FSA returns, FSA records and published annual accounts. Peers: Barclays, HBOS, HSBC, Lloyds TSB and Standard Chartered.
122 Review Team analysis of press articles, May to October 2008.

Conclusions on what happened in RBS

- There were significant weaknesses in RBS's capital position during the Review Period, both in terms of the quantity and quality of capital held. The firm's strategy during the Review Period was to operate with 'efficient', rather than conservative, levels of capital.
- There were significant shortcomings in RBS's regulatory capital calculations and planning, which became apparent during Q1 2008. These shortcomings undermined the firm's ability to demonstrate compliance with the FSA's requirements and were especially serious given that the firm had chosen to operate with a low margin for error.
- The Review Team did not find any evidence of breaches of the firm's 8% Pillar 1 minimum capital requirement during the Review Period.
- RBS's leverage increased rapidly in the latter part of the Review Period.
- RBS was inappropriately expecting capital reductions arising from FSA model approval in advance of that approval being granted.

Conclusions on the global regulatory framework and the FSA's supervision

- The Basel capital frameworks in force during the Review Period were inadequate, allowing firms to operate with capital resources which were insufficient to maintain market confidence in the face of potential losses in autumn 2008.
- The inadequacies of these regimes can be illustrated by estimating what RBS's capital position would have been according to the new Basel III standards. The Review Team estimated that, on a Basel III basis, RBS's common equity tier 1 ratio at end-2007 would have been 1.97%. This compares with the 9.5% ratio which, under Basel III, the most systemically important banks will have to hold during normal times to be free of additional constraints on distributions. If the Basel III capital conservation buffer had been in place before the crisis, RBS would not have been allowed to pay a dividend during the Review Period.
- With hindsight, there were severe deficiencies in the globally agreed market risk capital regime.
- Until late 2007 and early 2008, the prevailing FSA approach to supervising firms' capital adequacy was mainly reactive. Nor was routine consideration of firms' leverage part of that approach. Thereafter, the FSA's focus on the capital position of the major UK banks, including RBS, increased significantly. This included the implementation of a 5% core capital target in April 2008 to underpin firms' ICG.
- Preparation for implementation of the Basel II capital framework was a key priority for the FSA's prudential supervision work with RBS in the Review Period.
- Overall, in respect of the supervision of RBS's market and credit risk models, the Supervision Team followed the prevailing practices. With hindsight, the Review Team concluded that there were weaknesses with those practices.
- The Supervision Team and ARROW Panel made reasonable judgements about the SREP and setting of ICG, which followed the prevailing practices. With hindsight, the Review Team concluded that there were weaknesses with those practices, which were in development during the Review Period.

- The Review Team found the FSA's regulatory returns to be inadequate to assemble a complete, consistent and reliable picture of the firm's capital position during the Review Period.
- While there were some weaknesses in the supervision of the firm's capital position during the Review Period, the Review Team considered that, from the second quarter of 2008, Supervision addressed the key priority which was to ensure that the firm was adequately capitalised, albeit that, at the time, supervisory resources were limited.

Lessons already identified where actions have been taken

- Recent reforms to the prudential framework will, once implemented, significantly increase the quality and quantity of capital that firms must hold. In the meantime, the FSA has increased its focus on core capital and introduced capital benchmarks of 8% tier 1 and 4% core capital after stress.
- A fundamental review of the market risk capital regime (including reliance on VaR measures) was required. This was recommended by the Turner Review, and is being undertaken by the Basel Committee. In the meantime, the Basel Committee has agreed a package of measures, including stressed VaR and enhancements to the capture of credit risk within the trading book, which is being implemented in the European Union. These changes have resulted in increases of capital requirements of at least three to four times for some categories of trading book assets.
- Weaknesses in the FSA's processing and analysis of regulatory returns were previously noted in *The Northern Rock Report*. Subsequently a new returns system has been introduced by the FSA.

Recommendations for further change

- With the moves towards Basel III underway, the FSA has in train the introduction of a leverage requirement. To supplement this, it should review its current supervisory arrangements to ensure that sufficient focus is given to leverage as well as risk-based capital ratios.
- In order to avoid a situation in future where a firm's capital resources are over-dependent on minority interests, the FSA should consider quantitative monitoring of firms' dependence on minority interests as part of ongoing supervision.
- The FSA should review firms' practice in calculating their regulatory capital position in order to ensure compliance with FSA rules. This would enable the FSA to form a view on the extent, if any, to which it is acceptable for firms to rely on estimates prior to the final figures becoming available, and the appropriate frequency and timeliness of the calculations.
- Where shortcomings on the part of the firm lead to a delay in the FSA reviewing and setting capital guidance for a firm, the FSA should consider whether additional conservatism is appropriate when setting interim guidance.

1.2 RBS's liquidity position, the FSA's regulatory framework and supervisory approach

109 A loss of confidence in a bank, arising, for example, because of concerns about solvency, usually results in liquidity problems, as wholesale counterparties may become unwilling to lend to it and retail and corporate depositors may withdraw their funds. Adequate liquidity helps a bank survive long enough for a perceived lack of confidence to correct itself or for the bank to implement changes to boost confidence in its credit-worthiness. If genuine solvency issues exist, adequate liquidity gives the bank more time to try to improve its position sufficiently to restore confidence in it.

110 During the widespread collapse in market confidence in August through to October 2008, any firm perceived to be relatively poorly positioned became subject to falling confidence, with funding on ever more stringent terms and, eventually, denied. RBS was one such bank.

111 As described in Section 1.6, in the last few months before RBS's failure, it struggled to obtain anything but very short-term funding (which was predominantly overnight) from wholesale counterparties due to market concerns over its solvency. Then, on 7 October 2008, RBS's wholesale counterparties, as well as to a lesser extent retail and corporate depositors, were simply not prepared fully to meet its funding needs. RBS was, therefore, left reliant on Emergency Liquidity Assistance (ELA) from the Bank of England.[123]

112 By the time the crisis period started, RBS was significantly more reliant on short-term wholesale funding[124] than most of its peers. This reflected the following:

- Over 2005 to 2007, RBS had developed a risky liquidity position that was extensively reliant on wholesale funding and, in particular, on access to the short-term wholesale markets. This is detailed in Section 1.2.1.
- The acquisition of ABN AMRO in October 2007 exacerbated RBS's vulnerable liquidity position (see Section 1.2.2).
- RBS's very short-term[125] wholesale funding gap[126], which consisted in particular of US$ funds, and predominantly unsecured funds, continued to grow following the acquisition of ABN AMRO.
- Both before and after the acquisition of ABN AMRO, RBS was more dependent than most of its peers on the overnight wholesale markets. As

123 From April 2008, RBS also, like other banks and building societies, accessed liquidity from the Bank of England under its Special Liquidity Scheme (SLS). When it became operational on 13 October 2008, RBS, like other institutions, also accessed liquidity under the Credit Guarantee Scheme (CGS) announced by the UK government. For further information on the SLS, see the Bank of England website; www.bankofengland.co.uk/markets/sls/index.htm. For further information on the CGS, see the UK Debt Management Office website; www.dmo.gov.uk/index.aspx?page=CGS/CGS_about.

124 Wholesale funding as defined in this section includes both unsecured and repurchase agreements (repo) funding from the wholesale markets. A repo is the sale of securities with an agreement to buy the securities back later; it is a form of short-term borrowing.

125 Very short-term wholesale funding is defined here as wholesale funding falling due within five business days.

126 The wholesale funding gap is defined in this section as wholesale outflows less wholesale inflows on a contractual basis without taking collateral into account.

market uncertainty escalated over the crisis period, it was difficult for RBS then to lengthen the maturity of its wholesale funding (see Section 1.2.3).

113 The FSA's regulation and supervision of liquidity developed in three phases:

- Before the crisis period, both the FSA's regulatory and supervisory frameworks for liquidity were deficient (see Section 1.2.4):
  – the domestic quantitative liquidity regime in place for banks such as RBS before the crisis period, the Sterling Stock Regime (SSR), was seriously flawed; and
  – the FSA's supervisory approach placed only limited emphasis on the supervision of liquidity risks in relation to banks in general, including RBS.
- During the Review Period, from late 2007, in response to the crisis:
  – the FSA made significant improvements to its supervisory approach to liquidity risk (and began considering the shape of a future liquidity regulatory regime); and
  – the Supervision Team, Supervision and FSA senior management substantially increased its focus on RBS's liquidity position.

  But these actions proved to be too late to prevent the failure of RBS. These developments are dealt with in Section 1.2.5.
- Following the crisis, and in response to lessons learned, the FSA made fundamental reforms to its regulatory and supervisory frameworks for liquidity, including introducing a new domestic liquidity regime; and it has played a major role in arguing for and designing a new global liquidity regime (see Section 1.2.6).

1.2.1 2005 to 2007: RBS's increasing reliance on short-term wholesale funding

114 In the period prior to the onset of the crisis, UK banks in general significantly increased their reliance on wholesale, and often within that short-term, funding. Within this overall context, RBS at end-2005 seemed to be broadly in line with peers; but by mid-2007, even before the acquisition of ABN AMRO, it had in several key respects become more vulnerable.[127] The acquisition of ABN AMRO made this situation worse.

115 RBS, like other major UK banks, increased its reliance on wholesale funding to fund not only wholesale assets but traditional lending activities.[128] As noted in *The Turner Review*[129], UK banks expanded their loan books more rapidly than their retail deposit bases, placing increasing reliance on wholesale funding. When there was a major shock in the wholesale markets, such as that following

127 In a meeting with the Review Team, the then RBS Group Finance Director stated that RBS's use of wholesale funding made it more vulnerable (than other firms), Review Team meeting with the then RBS Group Finance Director, June 2011.
128 Paragraph 116 and FSA records, February 2006.
129 *The Turner Review: a regulatory response to the global banking crisis*, p32, March 2009.

the collapse of Lehman Brothers in September 2008, RBS and other firms had difficulty in accessing a major source of their funding.

116 The sector's growing reliance on funding sourced from the wholesale markets is illustrated by the widening customer funding gap from 2000 to 2008, shown in Part 1 Graph 1.5. It was also highlighted in a paper prepared by the Bank of England and considered by the Tripartite Standing Committee on Financial Stability in October 2006. The paper considered the impact of wide-ranging disruption to the wholesale markets. It noted that:

'*the major UK banks' reliance on wholesale funding sources has increased markedly over recent years. At end-2005, wholesale funding accounted for 29% of total liabilities compared to 22% at end-2000*'.

And that:

'*a significant proportion of the increase in wholesale funding has been associated with a corresponding increase in wholesale assets … However, … part of the wholesale funding is increasingly being used to fund traditional lending activities*'.[130]

117 According to the paper, RBS's wholesale funding accounted for approximately 25% of its total liabilities at end-2005; this was a smaller proportion than for most of the peer group of large UK banks. The paper stated, however, that nearly all of RBS's wholesale funding was in the (interbank) unsecured markets and it concluded that the unsecured markets were more vulnerable than the secured markets as they were more likely to close during periods of market stress. The paper also noted that the majority of RBS's wholesale funding had a maturity of three months or less. It concluded that, overall, RBS was mid-placed (amongst the peer group determined for the paper) in terms of funding vulnerability.[131]

118 By end-June 2007, RBS had clearly developed a more risky liquidity profile than many of the large UK banks. Analysis performed by FSA specialists in February 2008, for example, showed that, at end-June 2007, the proportion of RBS's wholesale funding[132] that was short-term[133] was greater than that of all but one of these peers; and that, on an absolute basis, RBS made the greatest use of short-term wholesale funding.[134]

119 RBS was, therefore, exposed to greater liquidity risk and was more vulnerable than most of those peers to even short periods of market stress. A reliance on short-term wholesale funding requires frequent roll-over of existing funding arrangements with counterparties or ample sources of new funding. Stressed market conditions are characterised by, amongst other things, a lack of willing counterparties and only selective roll-overs of existing wholesale funding.

130 FSA records, October 2006.
131 FSA records, October 2006.
132 In this analysis wholesale funding is considered gross rather than in terms of the wholesale funding gap.
133 Short-term wholesale funding is defined in this analysis as wholesale funding falling due within 30 days (as data not available in shorter maturity bands).
134 FSA records, February 2008.

120 RBS's reliance on wholesale funding, and within that its concentration in the short-term markets, was able to build up because, as noted in a RBS Group Internal Audit report 2008, '*there is no absolute cap on the reliance on market funding, although there were ratio based guidelines in place, which require action by GALCO*[135] *if the ratios breached agreed levels*'.[136] Although there was also no absolute cap on RBS's use of short-term funding[137], RBS told the FSA in July 2007[138] that it monitored its reliance on short-term funding against red, amber and green indicators to help prevent it become too dependent on this type of funding.[139]

121 With regard to RBS's liquidity management framework, together with an absence of absolute limits on its use of wholesale funding, as well as short-term wholesale funding, the Review Team noted that the RBS Group Internal Audit report 2008 stated that '*the internal transfer pricing obtained by businesses did not fully reflect the liquidity costs to the Group*'. The result, according to that audit report, was that RBS may have been able to hold assets which might otherwise have been subject to more business model challenge and deemed less economic.[140]

122 From early August 2007, conditions in credit markets deteriorated. The extent of the disruption to wholesale funding markets, including the securitisation markets, which followed was generally not foreseen by commentators. It was the crystallisation of a low probability, high impact event.[141] From the early stages of the crisis period, there was limited unsecured funding (except of very short maturity) available in the markets; later in the crisis period, the disruption spread to the secured markets.[142]

123 On 14 September 2007, Northern Rock received ELA from the Bank of England and suffered a subsequent run on deposits. This was caused not by immediately evident solvency or credit quality problems, but by the drying-up of the market for both securitised credit assets and wholesale funding availability.[143]

124 By this time in September 2007, although one of RBS's large UK banking group peers had a bigger short-term[144] wholesale funding gap, RBS was more

135 RBS Group Assets and Liabilities Committee (GALCO).

136 RBS Group Internal Audit report, July 2008; Review Team meeting with the then RBS Group Finance Director, June 2011; also FSA records, October 2007.

137 However, the Sterling Stock Regime (SSR) required an SSR bank (RBS was an SSR bank) to set an internal limit for its maximum sterling wholesale net outflow over the next five business days which would have provided a cap with regard to sterling short-term wholesale funding, IPRU Bank, Section 4.3.2 paragraph 7. For the purposes of the RBS Group Internal Audit report, RBS defined short-term funding to be funding falling due within one year, RBS Group Internal Audit report, July 2008.

138 During a meeting with RBS for the FSA's 2007 supervisory review and evaluation process (SREP) of RBS's individual capital adequacy assessment process (ICAAP), FSA records, July 2007.

139 FSA records from February 2006 reported that RBS's reliance on short-term wholesale funding was at 'red' status against its internal red, amber, green guidelines, FSA records, February 2006; also FSA records, November 2007.

140 RBS Group Internal Audit report, July 2008.

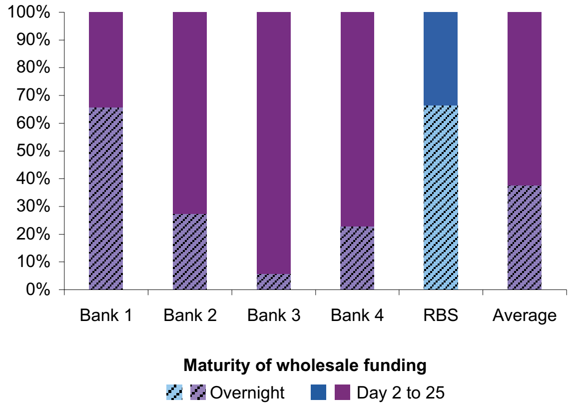
141 The FSA's Internal Audit report, *The supervision of Northern Rock: a lessons learned review* (*The NR Report*), Executive Summary, paragraph 3, March 2008.

142 *The Turner Review*, Box 1B, March 2009.

143 *The Turner Review*, p35, March 2009.

144 This conclusion was based on analysis of the absolute size of RBS's and its peers' short-term wholesale funding gaps. At this date, RBS also had the second largest short-term wholesale funding gap relative to liabilities within that peer group. These data are taken from Current Status Indicator (CSI) reports, see paragraph 174 to 175. Short-term wholesale funding is defined here as wholesale funding falling due within 25 business days. FSA records, September 2007.

Graph 2.3: Overnight wholesale funding as a proportion of the short-term wholesale funding gap at 11 September 2007[145]



reliant on overnight funding, than other firms in its peer group.[146] RBS's concentration in the overnight markets is shown in Graph 2.3.

125 As shown in Graph 2.4, for RBS, the majority of its very short-term[147] wholesale funding gap was, increasingly, non-sterling denominated and that non-sterling component was predominantly US$. Overall, RBS's US$ overnight and US$ very short-term wholesale funding gaps were the second largest of its peer group of large UK banks.[148] As discussed in paragraphs 153 and 154, RBS's use of US$ (and other non-sterling) funding was neither captured nor restricted by the quantitative requirements of the prevailing liquidity regime.

126 From the evidence seen by the Review Team, RBS was not initially concerned by its dependence on overnight and short-term sources of wholesale funding. In September and October 2007, for example, the Supervision Team considered that RBS's concentration in the overnight markets was in order to benefit from the pricing advantage between overnight funding and funding maturing in three or six months.[149] RBS believed it was benefiting from a 'flight to quality' effect at that time and that the liquidity risk associated with being dependent on an ability to roll over or source new short-term funding was mitigated effectively by its ability to access funding, as a large, reliable and top tier name.[150] This belief subsequently proved mistaken, as detailed in Section 1.6.

145 The peer group is the large UK banking groups. For the purposes of confidentiality, the anonymised titles are not listed consistently in relation to individual peers in this graph, Graph 2.5, Section 1.6, Graph 2.19 and Part 1, Graph 1.6 and 1.7. Short-term wholesale funding is defined here as wholesale funding falling due within 25 business days. Data are taken from CSI reports. For an explanation of CSI reports, see paragraphs 174 to 175. Analysis as at 11 September 2007 as the Review Team considered it relevant to show this analysis prior to RBS's acquisition of ABN AMRO (the acquisition of ABN AMRO completed on 17 October 2007 and CSI reports were collected by the FSA from 11 September 2007). FSA records, September 2007.

146 This conclusion was based on analysis of RBS's and its peers' overnight wholesale funding gaps: on an absolute basis; relative to liabilities; and as a proportion of their short-term wholesale funding gaps. These data are taken from CSI reports. FSA records, September 2007.

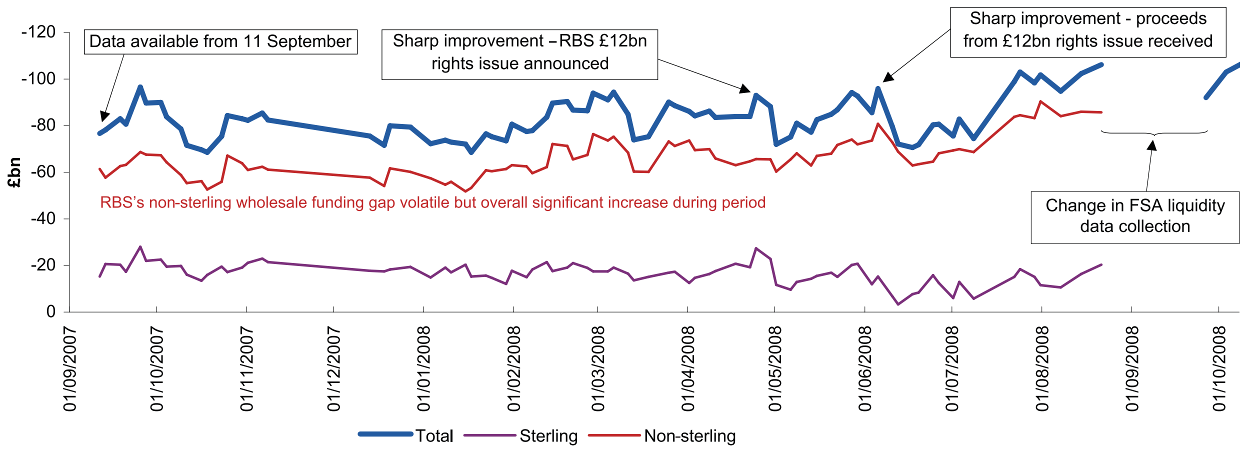
147 Very short-term wholesale funding is defined here as wholesale funding falling due within five business days.

148 Based on the period September 2007 to August 2008. Wholesale funding gap data are taken from CSI reports. At end-August 2008, the FSA replaced CSI reports with Liquidity Risk Profile (LRP) reports and data by currency were not available from these reports for RBS and the large UK banks for the remainder of the Review Period, see paragraphs 179 to 183. FSA records, September 2007 to August 2008.

149 FSA records also stated that RBS (and other firms) were not willing to pay for longer term funding at that time. FSA records, October 2007.

150 FSA records, September to December 2007.

Graph 2.4: RBS's very short-term wholesale funding gap split between sterling and non-sterling denominated funding[151]



127 RBS Group Assets and Liabilities Committee (GALCO) papers indicated that around the start of October 2007, the Supervision Team challenged the firm on its reliance on very short-term[152] wholesale funding as the Supervision Team considered RBS was out of line with its peers. RBS responded by confirming its '*comfort with the Group's liquidity policy and limits*' and stated that based on its analysis, its '*dependence on short-term market* [funding] *is consistent with that of our peer group*'.[153]

128 The Review Team noted that the Group's liquidity policy was approved by RBS GALCO but not by the RBS Board as the Board had delegated authority to GALCO to approve it.[154] This may have reflected a collective lack of appreciation by RBS senior management and the RBS Board of the potential significance of the firm's liquidity risk (see Section 2, paragraph 616 to 617).

1.2.2 The impact of the ABN AMRO acquisition on RBS's liquidity position

129 The acquisition of ABN AMRO in October 2007 exacerbated RBS's vulnerable liquidity position in several ways.

130 RBS funded the acquisition primarily with debt rather than equity. RBS's total payment for ABN AMRO comprised €4.3bn in RBS shares and €22.6bn cash consideration. The majority of the €22.6bn cash consideration was funded by

151 Very short-term wholesale funding defined here as wholesale funding falling due within five business days. Wholesale funding gap data are taken from CSI reports (which included wholesale funding gaps in each major trading currency) and LRP reports which replaced them from August 2008. During the short transitional period, liquidity data were collected by the FSA from firms, including RBS, during regular telephone calls held at that time. The Review Team was not able to present the sterling and non-sterling split from 1 September 2008 to 7 October 2008 as, although the LRP report template was able to capture liquidity data for major trading currencies, in practice, some firms, including RBS, did not complete these data. See paragraphs 182 to 183. FSA records, September 2007 to October 2008 and July 2011.
152 Very short-term wholesale funding defined here as wholesale funding falling due within five business days.
153 RBS records, October 2007.
154 RBS records, December 2006. The Review Team was also told by the then RBS Group Finance Director that the Group Liquidity Policy was approved at GALCO but not by the RBS Board, Review Team meeting with the then RBS Group Finance Director, June 2011; also Review Team meeting with a then RBS Non-Executive Director (NED), July 2011.

debt, of which €12.3bn[155] had a term of one year or less. It is the Review Team's judgement that the decision to finance a major acquisition primarily with debt, and for most of that debt to be short-term[156], to be a risky financing strategy. Although the cash consideration received for the sale of LaSalle to the Bank of America was €10.9bn, and this accrued fully to RBS, those funds were retained in the Netherlands longer than RBS had initially expected.[157] As a consequence, having raised €12.3bn from the short-term markets in anticipation that it would be paid down promptly through the receipt of cash proceeds from the sale of LaSalle, RBS had to extend the period for which this funding was outstanding.

131 The acquisition also meant that, by end-2007, RBS's committed liquidity facilities to own-sponsored[158] asset-backed commercial paper (ABCP) conduits had quadrupled, along with, therefore, its off balance sheet liquidity risk.[159]

132 It is the Review Team's understanding that RBS had provided by end-2007 a total of £15.2bn of committed liquidity facilities to own-sponsored ABCP conduits that pre-dated its acquisition of ABN AMRO, and an additional £48.3bn to ABN AMRO own-sponsored ABCP conduits arising from the acquisition.[160] In the event that an ABCP conduit experienced difficulties rolling over its commercial paper (CP) in the wholesale markets, it could draw down against the committed liquidity facilities to repay the maturing CP. Alternatively, the sponsor of the conduit could purchase CP issued by the conduit. Either approach would likely have an impact on the liquidity position of the provider of the facility. Investors in the CP of ABCP conduits usually would have been aware who the sponsor was, therefore the probability of a conduit needing to draw on the committed liquidity facilities provided by RBS would likely have been correlated to RBS's financial position.

133 At end-June 2008, the liquidity drawn by own-sponsored conduits under the committed liquidity facilities and still outstanding (i.e. had been drawn but not yet repaid) was £8.6bn. The highest drawn balance for each of RBS's and ABN AMRO's own-sponsored conduits peaked at different points during the six months between January and June 2008. In total, the maximum drawn balances reached by these conduits was £10.2bn (of which £8.5bn related to ABN AMRO own-sponsored conduits).[161] These data demonstrate that RBS's and ABN AMRO's own-sponsored ABCP conduits suffered significant liquidity problems during 2008. The Review Team noted that these data did not include instances where RBS bought CP as a means to provide funding to these conduits. Therefore, the liquidity provided may have been greater than indicated

155 The €12.3bn comprised €4.9bn senior funding with a term of one year or less plus €7.4bn bridge funding. Given that the bridge funding was raised from the interbank market and had an average maturity of six months, the Review Team assumed that none of this bridge funding had a maturity of more than one year. RBS records, September 2007. RBS was not able to provide further breakdown of this bridge financing.

156 In the context of the financing raised by RBS for the ABN AMRO acquisition, short-term is defined as funding falling due in one year or less.

157 In June 2007, RBS expected the proceeds of the LaSalle sale (which was completed in October 2007) to be repatriated within three months. However, repatriation was delayed during 2008 and subsequent FSA records suggested that the proceeds were eventually absorbed by losses made by ABN AMRO in the Netherlands, rather than being transferred to RBS in the UK, FSA records, February 2008 and March 2011.

158 The Review Team was not able to estimate comparable figures for third-party asset-backed commercial paper (ABCP) conduits as RBS could not provide the required information.

159 Data provided by RBS to the Review Team in August 2011.

160 Data provided by RBS to the Review Team in August 2011.

161 Data provided by RBS to the Review Team in August 2011.

here. The Review Team considered that the liquidity provided to RBS's and ABN AMRO's own-sponsored conduits represented a significant liquidity drain on RBS. Appendix 2G provides further details about ABCP conduits.

134 In addition to this, some market counterparties reduced the amount they were willing to lend the combined entity of RBS and ABN AMRO which reduced RBS's borrowing capacity in those markets. By way of an illustration, while before the acquisition a counterparty might have had a lending limit of £500m to RBS and £500m to ABN AMRO, its limit for the combined entity might be less than £1bn. The Review Team saw evidence that indicated RBS senior management had not considered this risk in advance of the acquisition of ABN AMRO.[162]

135 The Review Team was not able to quantify the impact of the acquisition of ABN AMRO on the combined entity's use of wholesale funding and its wholesale funding gap during the Review Period.[163] RBS GALCO minutes from June 2008 noted '*the Group's increased reliance* [on short-term funding] *as a result of the ABN AMRO acquisition with the result that it now has a greater reliance on the short-term markets than many of its peers*'.[164]

1.2.3 Further deterioration in RBS's liquidity position following the acquisition of ABN AMRO

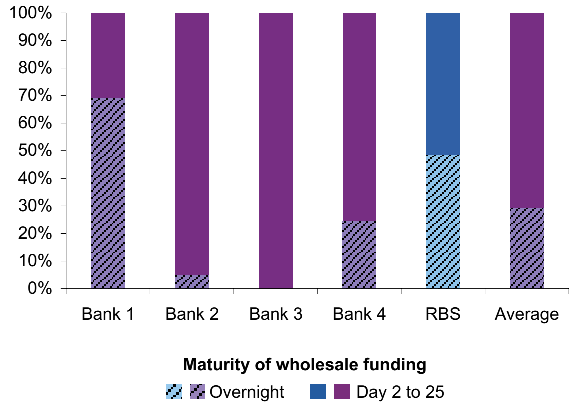
136 In November 2007, the maturity of RBS's wholesale funding reduced further, and the Review Team saw evidence of concern at RBS about this. The shortening of maturities was the result of further liquidity strain in the markets during which the availability of term funding had reduced.[165]

137 In a meeting with FSA liquidity specialists that month, the RBS Global Head of Money Markets acknowledged that the maturity of the firm's funding had '*shortened*'. The minutes of that meeting recorded that the RBS Group Treasurer commented that RBS's funding position was at the short end of the curve for a firm of RBS's size but that he did not accept that RBS was an outlier. The RBS Group Chief Finance Officer '*was not comfortable with the 1-5 day position*'.[166] [167]

138 RBS GALCO papers in November 2007 recorded that '*market liquidity conditions have deteriorated materially over the last week, underpinned by depositor/investor nervousness on the back of a number of recent large bank loss announcements*'. In these minutes, and the November Group Treasury Report to RBS Group Executive Management Committee, it was also highlighted that '*the lack of availability of*

162 RBS records, November 2007; FSA records, November 2007; Review Team meeting with the then RBS Global Markets Chairman, June 2011.
163 The liquidity data collected at that time (the CSI reports) from RBS did not include ABN AMRO. ABN AMRO had a high impact EEA branch in the UK. Under the Banking Consolidation Directive, the FSA was responsible for branch liquidity, conduct of business, and financial crime as host state regulator. However, there was a Global Liquidity Concession (GLC) in place which meant that the day-to-day supervision of branch liquidity was transferred back to the home state regulator, *De Nederlandsche Bank* (DNB). Under the IPRU Bank section of the FSA Handbook, there was provision for the FSA to obtain branch liquidity data even if there was a GLC, however, this was not routinely requested by the FSA at that time. The FSA also had a legal right under Article 42 to request group wide liquidity data if it considered it necessary to facilitate the supervision and monitoring of ABN AMRO's UK branch. Consistent with prevailing practice, the Supervision Team of ABN AMRO did not request any information of this nature from ABN AMRO or DNB, aside from routine annual confirmations to maintain the GLC. FSA records, April and May 2011; also Review Team meeting with DNB, June 2011.
164 RBS records, June 2008; also Review Team meeting with the then RBS Group Finance Director, June 2011.
165 FSA records, November 2007.
166 The '*1 to 5 day position*' refers to the wholesale funding gap for wholesale funding falling due within five business days.
167 FSA records, November 2007.

Graph 2.5: Overnight wholesale funding as a proportion of the short-term wholesale funding gap at end-December 2007[168]



funding materially beyond very short-term maturities or over the year end', together with the reduced capacity of the combined RBS and ABN AMRO entity to borrow in the wholesale markets (see paragraph 134), had put '*increasing pressure on the Group's short-term liquidity ratios*'.[169]

139 RBS continued to have a vulnerable liquidity position compared to most of the large UK banks following the acquisition of ABN AMRO. At end-December 2007, its short-term[170] wholesale funding gap was the second largest in its peer group[171]; its gap had increased by nearly 15% since September 2007.[172]

140 It remained more concentrated in the very short-term markets, and in particular the overnight markets than most of its peers (see Graph 2.5).[173]

141 By this time RBS was increasingly aware of the vulnerability created by its reliance on short-term wholesale funding and sought to improve its liquidity position, but the limited availability of longer term funding made this difficult.[174] This reflected the reality that it is extremely difficult to unwind over-reliance on short-term funds once there is a decline in market confidence. During November and December 2007, RBS began to implement changes to its liquidity management and took steps to try to improve its liquidity position, for example it:

- established '*more and improved*' liquidity management information (MI) and more frequent meetings of GALCO[175];

168 See footnote to Graph 2.3.
169 RBS records, November 2007.
170 Short-term wholesale funding is defined here as wholesale funding falling due within 25 business days.
171 This conclusion was based on analysis of RBS's and its peers' short-term wholesale funding gaps on an absolute basis. At this date, RBS had the largest short-term wholesale funding gap relative to liabilities within that peer group.
172 Based on analysis of CSI reports, FSA records, December 2007.
173 This conclusion was based on analysis of RBS's and its peers' very short-term and overnight wholesale funding gaps on: an absolute basis; relative to their liabilities; and as a proportion of their short-term wholesale funding gaps. Very short-term wholesale funding is defined here as wholesale funding falling due within five business days.
174 FSA records, November and December 2007; RBS records, November 2007; also Review Team meeting with the then RBS Group Finance Director, June 2011.
175 FSA records, November 2007. Further, from early 2008 and in the run-up to the rights issue, RBS closely monitored the liquidity of the Group, see Part 3 paragraph 282; also Review Team meeting with a then RBS NED, July 2011.

- created a new weekly GALCO sub-committee to focus only on liquidity, with reporting to the RBS Group Board and Executive Committee[176];
- took steps to protect and increase its deposit base in order to manage the growing pressure on its short-term wholesale funding position[177]; and
- increased its liquidity buffer.[178]

142 Liquidity strains continued in various markets throughout Q1 2008, with worries about the liquidity of major institutions.[179] Information collected by the FSA from firms at that time characterised wholesale funding conditions as '*difficult*', with a deterioration in sentiment and conditions; funding continued to be concentrated at the short end as there was limited term funding available.[180]

143 The Review Team saw evidence that, by end-March 2008, RBS approved further measures to try to improve the liquidity position of the Group and, specifically, its Global Banking and Markets (GBM) division. These measures included commitments:

- to reduce GBM's balance sheet and short-term funding requirements by £40bn by end-April 2008, with further reductions proposed across RBS/ABN AMRO balance sheets[181];
- to increase term debt issuance[182];
- for RBS Group Treasury to develop a proposal for consideration at RBS GALCO to build a centrally held liquid assets portfolio[183]; and
- to implement tighter limits for management of Group liquidity.[184]

RBS also acknowledged concern about the size of GBM's reliance on unsecured wholesale funding and that more needed to be done to reduce it.[185]

144 These commitments, and the steps described in paragraph 141, which were all made in response to the onset of the crisis period, would have been more effective if they had been implemented prior to the crisis.

145 On 14 March 2008, the Federal Reserve Bank of New York stepped in to prevent the collapse of Bear Stearns following significant deterioration in its liquidity position.[186] On 18 March, HBOS's share price fell 17% amid rumours of funding difficulties.[187] In a call with the FSA on 19 March to discuss wholesale funding conditions, RBS stated that from a funding perspective '*it had been one of the worst days seen*'.[188]

176 FSA records, December 2007.
177 RBS records, November 2007, FSA records, November and December 2007.
178 FSA records, November 2007; also Review Team meeting with the then RBS Group Finance Director, June 2011. RBS also took action to increase its liquidity buffer in October, FSA records, October 2007.
179 *The Turner Review*, Box 1B, March 2009.
180 FSA records (Bank of England questionnaires), January 2008 to March 2008. For further details on the Bank of England questionnaires, see paragraph 178.
181 RBS records, March 2008.
182 RBS records, January 2008.
183 RBS records, January 2008.
184 RBS records, March 2008.
185 RBS records, March 2008.
186 Bear Stearns was acquired by JPMorganChase on 17 March 2008.
187 *FSA concludes HBOS rumours investigation,* FSA, 1 August 2008.
188 FSA records, March 2008.

146 Following the announcement of RBS's £12bn rights issue on 22 April 2008, there was some improvement in RBS's liquidity position. As shown in Graph 2.4, RBS's very short-term[189] wholesale funding gap reduced but then increased to close on 5 June 2008 at its largest level since the start of the crisis period. Following closure of the rights issue on 6 June 2008, RBS's very short-term wholesale funding gap then decreased again[190] and there were indications that funding conditions in the wholesale markets had become slightly easier.[191] But there continued to be a shortage of longer-term funding available. See Section 1.6 paragraph 470 to 478.

147 Data collected by the FSA from July 2008 showed that the majority of RBS's very short-term wholesale funding gap continued to consist of unsecured funding; its reliance on unsecured wholesale funding was the second greatest amongst the large UK banking groups.[192] This would have further hindered RBS's attempts to lengthen the maturity of its wholesale funding at that time as, during periods of market strain, unsecured funding, if available at all, is usually only available at short maturities.

148 As described in more detail in Section 1.6, in late July 2008 market conditions and RBS's reliance on very short-term wholesale funding sharply and significantly increased.

1.2.4 The FSA's regulation and supervision of liquidity before the crisis period: assigned a relative low priority

149 Before the start of the crisis period, the liquidity regime in place was severely flawed, and the supervision of liquidity risk was assigned a relative low priority by the FSA, very largely limited to checking formal adherence to the requirements of the regulations. In 2003, the FSA recognised in a Discussion Paper (DP) on liquidity risk[193] that there were deficiencies in the existing liquidity regime, the Sterling Stock Regime (SSR), and included ideas for the reform of the quantitative regime. In April 2004, however, the FSA decided not to follow up with a Consultation Paper on possible changes to liquidity regulation, in part because of the greater priority given to capital reform at that time.[194] As noted in *The Northern Rock Report*, prior to the onset of the crisis period '*insufficient weight was given by the FSA to liquidity risks in firms*' and '*the priority given to making progress with the implementation of the Basel capital reforms affected the attention given to liquidity*'.[195]

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189 Very short-term wholesale funding is defined in paragraphs 146 to 148 as wholesale funding falling due within five business days.

190 The cash from the rights issue was received by RBS in June 2008 but the Review Team was not able to determine the extent to which the proceeds were used to pay down existing wholesale funding, although evidence indicated that RBS proposed to use £2bn of the proceeds for this purpose, RBS records, June 2008.

191 FSA records, August 2008.

192 Based on the size of RBS's unsecured very short-term wholesale funding gap compared to peers. Data on RBS's and its large UK banking group peers' wholesale funding gaps split into secured and unsecured wholesale funding only available in later CSI reports and in LRP reports. Therefore the Review Team was only able to determine the size of RBS's and its peers' unsecured wholesale funding gaps from these reports from end-July 2008 (RBS reported split from May 2008 on CSI reports, but other peers in the peer group did not. End-July 2008 is first reporting date from which RBS and its peers all reported this split), FSA records, May to October 2008.

193 FSA Discussion Paper (DP) 24, *Liquidity Risk in the Integrated Prudential Sourcebook: a quantitative framework*, October 2003.

194 FSA records, April 2004.

195 *The NR Report*, Section 3.2 paragraphs 2-3, March 2008.

150 From the beginning of 2005 to early 2007[196], '*domestic moves towards liquidity reform were de-prioritised*' and '*the low prioritisation reflected the house view on the risk*'.[197] Progress in liquidity reform was sought only via the track of international work, which has historically been slow. [198]

151 This approach to the regulation and supervision of liquidity risk presumably reflected the long period since any liquidity crisis and the dominant belief that the widening and deepening of funding markets made it easier than before for banks to access liquidity. It also reflected the general failure of the FSA, market participants and other policy makers to act on a low probability, albeit high impact, scenario in which a large retail bank would not be able to fund itself.

Liquidity regulation before the crisis period

152 The existing FSA regulatory regime for liquidity for large retail banks such as RBS during the Review Period was the SSR. This was originally implemented in 1996. The basic requirement of the regime sought to ensure that, for its sterling business, a bank had enough unencumbered highly liquid eligible sterling assets to cover a sterling wholesale net outflow[199] and a 5% retail outflow for the first week (five business days) of a liquidity crisis, without recourse to the market for renewed wholesale funding. The liquidity of the SSR banks was measured by the Sterling Stock Liquidity Ratio (SLR).[200]

153 The SSR was designed for major UK retail banks, not UK banks with a significant dependence on wholesale funding. Several years before the crisis period, the FSA had acknowledged a number of limitations with the SSR (for example in the October 2003 DP on liquidity risk). The limitations were also set out in 2007 in the FSA DP07/7, *Review of the Liquidity Requirements for Banks and Building Societies,* which formed part of the FSA's efforts to improve financial stability in response to market conditions. The limitations acknowledged included that the SSR:

- did not protect against longer liquidity stresses due to it only capturing wholesale flows out to a five day period;
- did not capture non-sterling flows;
- excluded off balance sheet contingent liabilities; and

196 When the FSA had begun its review of liquidity standards for deposit-takers, see FSA DP07/7, *Review of the Liquidity Requirements for Banks and Building Societies*, December 2007. This work had commenced in early 2007 in parallel with an international review of banking liquidity by the Basel Committee on Banking Supervision (Basel Committee) and a further review at EU level run by the Committee of European Banking Supervisors. Prior to Basel III (see paragraph 205), there had been no globally agreed liquidity standard.

197 *The NR Report*, Section 3.2 paragraphs 3-4, March 2008.

198 *The NR Report*, Section 3.2 paragraph 3, March 2008; also FSA records, November 2004 and April 2005.

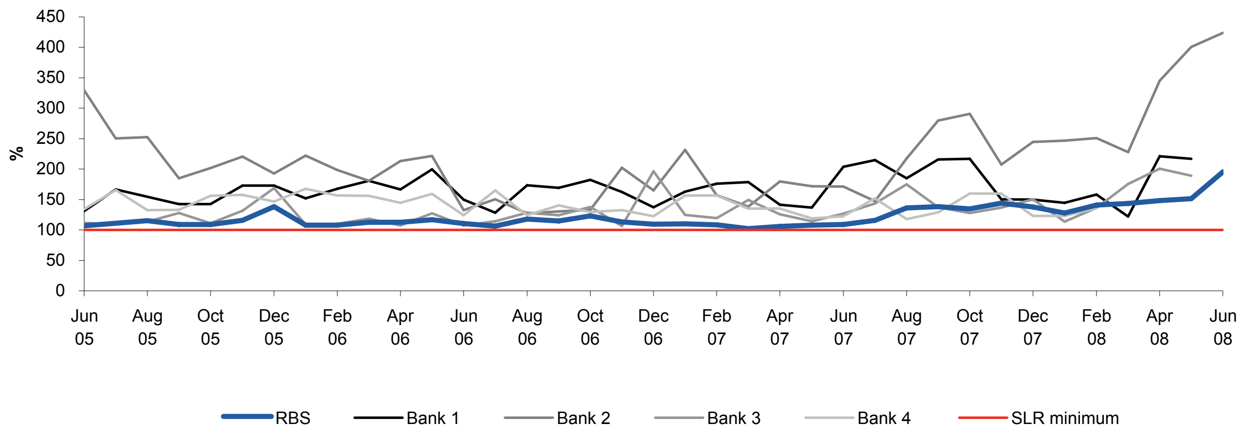
199 Here the wholesale net outflow is obtained by subtracting wholesale sterling assets maturing over the next five business days from wholesale sterling liabilities falling due over the same period.

200 SSR banks were required to work to a Sterling Stock Liquidity Ratio (SLR) and the minimum ratio was 100%. The SLR was calculated as:

$$\frac{\text{Stock of sterling liquid assets}}{\text{(Wholesale sterling net outflow over the next five business days – allowable sterling certificates of deposit held) + 5\% sterling retail deposits falling due in the next five business days}} \times 100$$

IPRU, Section 4, paragraph 3.

Graph 2.6: Sterling Stock Liquidity Ratios of RBS and peers[201]



- assumed only 5% of retail deposits would be withdrawn over the five day period. (The experience of Northern Rock indicated that this may not be a true reflection of possible retail behaviour over a five day period). [202]

154 Therefore, the requirements of the SSR were inadequate to regulate RBS's liquidity risk. They served neither to capture nor to limit the firm's dependence on non-sterling denominated wholesale funding[203] nor did they capture off balance sheet liquidity risk, for example as a result of committed liquidity facilities to ABCP conduits. They also provided no framework to regulate RBS's use of wholesale funding of other maturities, i.e. funding maturing after five days.

155 While RBS had a lower SLR than most of the large UK banks, regulatory returns submitted at the time showed that it met the minimum SLR of 100% throughout the Review Period, with an increase in the ratio, and therefore a reported improvement in RBS's sterling liquidity position, in 2007 and 2008 despite this being a period of increasing liquidity strains (see Graph 2.6).

156 However, over the period March 2006 to July 2007, RBS, as a result of internal error, materially overstated its SLR.[204] In early July 2007, the RBS Group Treasurer reported to the GALCO that Group Treasury had, on 6 July 2007, identified and informed the Group Treasurer of errors in the reporting of the SLR since March 2006 which had led to overstatement of RBS's SLR. This was then reported to both the FSA and Bank of England on 9 July. The restatement of RBS's SLR with the correct figures showed that RBS was below the minimum SLR during the period 21 April 2006 to 5 July 2007. RBS's SLR in fact averaged 69% during this period, well below the minimum 100%. However, the Supervision Team was informed by the firm that the mis-reporting did not impact RBS's overall liquidity position[205]; the incident resulted in non-sterling liquidity being reported in error as sterling liquidity. The Review Team saw evidence that indicated that RBS had returned to meet the minimum SLR by

201 FSA returns, June 2005 to June 2008. Data for RBS include mis-reporting errrors, see paragraph 156.
202 FSA DP07/7, *Review of the Liquidity Requirements for Banks and Building Societies*, paragraph 5.3, December 2007.
203 However, the FSA Handbook suggested that supervisors consider monitoring the risk arising from the foreign currency business of SSR banks, see paragraph 169.
204 FSA records, August 2007.
205 RBS records, July 2007; FSA records, July 2007.

17 July 2007.[206] See paragraphs 166 to 168 for more detail of the Supervision Team's response to this incident.

157 FSA regulated firms were also required to comply with Chapter 11 of the Senior Management Arrangements, Systems and Controls (SYSC) sourcebook, referred to as SYSC 11, which provided the minimum standards for systems and controls in respect of liquidity risk.[207] The majority of SYSC 11 was guidance, the appropriateness of which firms were required to assess according to the scale, nature and complexity of their activities. Firms were required to have policies and procedures for the monitoring and measurement of their liquidity position. Firms were also required to have contingency funding plans (CFP) in place to deal with liquidity crises and to perform liquidity stress-testing. The FSA has now replaced the rules and guidance previously set out in SYSC 11 to strengthen the application of the high level qualitative standards in line with the Basel Committee on Banking Supervision's (Basel Committee) *Principles for Sound Liquidity Risk Management and Supervision* published in September 2008.[208] However, qualitative standards alone are not sufficient to ensure effective regulation of liquidity risk and rules-based quantitative requirements are also necessary. The FSA's new quantitative standards for liquidity are discussed in paragraphs 201 and 202.

158 Since the crisis period, new international standards for liquidity, as well as for capital, have been published: the Basel III standards. A description of the main changes to the liquidity regime introduced by the Basel III standards is set out in paragraphs 205 to 209 and Appendix 2D.

159 The deficiencies in the FSA's liquidity regime in place before the crisis can, therefore, be demonstrated by analysing how RBS's liquidity position would have appeared at end-August 2008[209], had it been calculated on one of the two new Basel III liquidity standards, the Liquidity Coverage Ratio (LCR).[210]

160 Given that the Basel III regime was not in force during the Review Period, the Review Team made a number of assumptions in developing a proxy Basel III LCR for RBS; these are set out in Appendix 2E.[211] This analysis was necessarily conducted with the benefit of hindsight and therefore does not take into account behavioural effects that Basel III rules may have had, had these rules been in place at the time. The analysis showed that if the new Basel III LCR standard had been in force during the Review Period:

206 FSA records, July 2007.
207 New qualitative rules and guidance for liquidity risk – that is material relating to the systems and controls that firms should have to manage their liquidity risk – took effect in the FSA Handbook in December 2004. This material included requirements to carry out stress-testing in relation to liquidity risk and it also required a firm to have a contingency funding plan. The specific material on liquidity risk systems and controls was set out, on implementation, in PRU 5.1, and subsequently in SYSC 11.
208 SYSC 11 was replaced with BIPRU 12.3 and 12.4 with effect from December 2009. FSA Policy Statement (PS) 09/16, *Strengthening Liquidity Standards*, December 2008.
209 End-August 2008 is the first month the FSA collected LRP reports which contain data that can be used to calculate a proxy Basel III Liquidity Coverage Ratio (LCR) for RBS.
210 As with the Basel III capital standards, the Basel III minimum liquidity standards (the LCR and the Net Stable Funding Ratio (NSFR)) were published in December 2010. Both will be subject to an observation period and will include a review clause to address any unintended consequences. Banks have until 2015 to meet the LCR standard and until 2018 to meet the NSFR standard. The LCR was developed to ensure that firms hold sufficient high-quality liquid assets to survive a significant liquidity stress scenario lasting for one month.
211 The final calibration of the LCR is yet to be determined. The Review Team's estimate was, therefore, based on the interim calibration of this ratio.

- to comply with the standard at end-August 2008, RBS would have had to increase by between £125bn and £166bn its stock of high-quality unencumbered liquid assets or, alternatively, reduce its reliance on short-term wholesale funding[212]; and
- while it is not possible to determine whether this would have prevented the firm's failure, it would have allowed RBS longer to withstand the widespread collapse in market confidence in August through to October 2008 (see Section 1.6).

Since then, RBS has made steady and significant progress towards meeting the new Basel III LCR standard.

The FSA's supervision of liquidity before the crisis period

161 Not only was the regulatory framework for liquidity deficient, so too was the FSA's supervisory approach. It relied on reactive response to central monitoring against rules, and it reflected the low prioritisation assigned to liquidity issues. This approach was clearly mistaken, but it reflected a dominant belief that liquidity problems would not arise unless a bank was perceived to have a solvency problem, not least because the widening and deepening of funding markets made it easier than before for banks to access liquidity. It also reflected the general failure of the FSA, market participants and other policy-makers to act on a low probability, albeit high impact, scenario in which a major bank would not be able to fund itself.

162 Supervision of liquidity against the SSR was therefore in effect done on a reactive basis rather than being seen as an ongoing priority for supervisors. Section 3.1.1 outlines how this approach to the supervision of liquidity was consistent with the FSA's pre-crisis philosophy and general approach to supervision.

163 Prior to and during the Review Period, under a service level agreement with Supervision, the FSA Contact, Revenue and Information Management (CRIM) Department was responsible for 'baseline monitoring', covering analysis of regulatory returns submitted by firms, including the liquidity returns relating to compliance with the SSR. The results of this monitoring were reported to supervisors on an exceptions basis, and breaches and other indicators of risk were for Supervision to follow up on. Once the new GABRIEL[213] system was introduced in August 2008, returns were sent direct to Supervision. Current Status Indicator (CSI) reports, which were liquidity reports submitted by firms to the FSA from September 2007 as part of the FSA's response to the crisis period, were also sent to Supervision and to FSA senior management (see paragraphs 173 to 175).[214]

164 The Supervision Team commented to the Review Team that analysis of liquidity returns was not a focus of its supervision during the Review Period due, in part, to the limitations of SLR. This was consistent with the findings of *The Northern Rock Report* which stated that '*the analysis by supervisors of regulatory returns,*

212 This is based on the Review Team's estimate that, had the Basel III LCR been in place at the time, RBS would have had a LCR of between 18% and 32% at end–August 2008, compared with a requirement of 100%.
213 GABRIEL (Gathering Better Regulatory Information Electronically) is the FSA's online regulatory reporting system for the collection, validation and storage of regulatory data.
214 FSA records, November 2007 to August 2008.

including for liquidity, was consciously de-prioritised…The de-prioritisation was partly in anticipation of a computer system, which was to provide automated analysis, but which was not, in the event, introduced. Second, it was due to a lack of resource. Third, due to competing priorities and individuals' workload capacity during the period of the review, supervisors' available time on prudential matters was spent primarily on Basel [II]' (see Section 1.1, paragraphs 49 to 60).[215]

165 The Supervision Team informed the Review Team that it did recall receiving notifications from CRIM with key ratios highlighted. The Supervision Team also explained that it had not been aware of RBS's comparative SLR status at that time, as peer analysis was not produced by CRIM or others.

166 With regard to RBS's mis-reporting of its SLR discussed in paragraph 156, having been notified of the issue on 9 July 2007, the Supervision Team escalated the issue to the FSA Supervision Director that same day and to the FSA Firms and Markets Committee later in July.[216] It also shared information on the incident with FSA banking sector and liquidity specialist colleagues.[217] The Review Team saw evidence that the Supervision Team then followed up the matter with RBS on two occasions in July, and received and reviewed a copy of the RBS Group Internal Audit (GIA) report on the incident. Following this, the Supervision Team accepted the firm's assurance that its overall (sterling and non-sterling) liquidity position was not impacted by the mis-reporting; the incident resulted in non-sterling liquidity being reported in error as sterling liquidity.[218]

167 In August 2007, the Supervision Team also wrote to the RBS Group Treasurer to remind him of the FSA's expectations concerning the accuracy of regulatory reporting and to understand how RBS intended to take forward RBS GIA's recommendations to address the weaknesses in its internal process which had allowed the mis-reporting of the SLR to occur.[219] The Review Team did not find evidence that a response to this letter was provided by RBS to the Supervision Team but it is the Review Team's understanding that a response was probably received.[220]

168 The Review Team did not find evidence to determine when RBS fully addressed the weaknesses in its internal process and controls that led to the mis-reporting; however, the Review Team saw evidence which indicated that RBS had returned to meet the minimum SLR by 17 July 2007. In a meeting with the FSA on 17 July, RBS commented that '*the sterling stock figure is now within the limit*'.[221]

169 Because of the limitations of the SSR, supervisory judgement needed to be exercised in its application.[222] For example, guidance in the FSA Handbook suggested that supervisors consider monitoring the risk arising from the foreign currency business of SSR banks using either the main alternative, the mismatch framework, or firms' own MI.[223] Supervision did not incorporate this guidance into its supervision of

215 *The NR Report*, Section 1.3, paragraph 6, March 2008.
216 FSA records, July 2007.
217 FSA records, July 2007.
218 RBS records, July 2007; FSA records, July and August 2007.
219 FSA records, August 2007.
220 FSA records, June 2011.
221 FSA records, July 2007.
222 *The NR Report*, Section 3.3, paragraph 11, March 2008.
223 IPRU, Section 1.2 paragraphs 3 and 3(a); FSA records, May 2011.

liquidity risk for RBS, and other firms, during most of the Review Period.[224] As RBS had a significant reliance on non-sterling denominated wholesale funding (see paragraph 125), the Review Team considered this a weakness in Supervision's approach to RBS's liquidity risk.

170 In terms of the other areas of liquidity supervision, in the Review Team's opinion, the Supervision Team did not adequately assess RBS's compliance with the relevant requirements of SYSC 11, although aspects of SYSC 11 (including stress-testing and CFPs) were discussed with RBS at a high level during meetings in February 2006 and July 2007.[225] As noted in *The Northern Rock Report*, given the limitations recognised at the time in the quantitative requirements of the prevailing SSR for liquidity (see paragraphs 153 to 154), there was an additional need for effective monitoring of compliance with the qualitative aspects of liquidity risks for SSR banks.[226]

171 With regard to reliance on wholesale funding more generally, the FSA did not routinely monitor individual firms' growing use of wholesale, rather than retail, funding although as discussed earlier in this section, the Review Team saw evidence that the Tripartite authorities recognised the growing reliance on wholesale markets in general by major banks and building societies (see paragraphs 116 to 117). The Supervision Team provided limited challenge to RBS regarding its funding structure, consistent with the relative low priority accorded to liquidity by the FSA during the Review Period. The Review Team saw evidence that, during the Review Period, the FSA discussed wholesale funding dependence with two of RBS's peers.[227] This may have been because both firms were identified as more risky than RBS in the October 2006 paper to the Tripartite Standing Committee on Financial Stability, *Major UK Banks' Wholesale Funding Vulnerabilities*.

1.2.5 The FSA's monitoring and supervision of liquidity in late 2007 and 2008: improvements and increasing focus

172 After the onset of the crisis period, in summer 2007, there was a step change in the FSA's focus on liquidity risk. Liquidity monitoring mechanisms were significantly enhanced; the Supervision Team, Supervision and FSA senior management devoted far greater attention to liquidity issues at RBS; and the FSA Chairman raised concerns about the feasibility of addressing liquidity issues on a firm-by-firm basis without wider changes to policies relating to public authority liquidity support. This increased focus, however, proved to be too late to prevent RBS's failure, of which inadequate liquidity was the immediate contributory cause.

224 The Review Team noted that upon the introduction of CSI reports on 11 September 2007 (in response to the start of the crisis), data on RBS's non-sterling funding were collected by Supervision. See paragraphs 173 to 175.
225 FSA records, February 2006 and July 2007. The meeting in July 2007 was held as part of the FSA's 2007 SREP on RBS's ICAAP.
226 *The NR Report*, Section 3.3, paragraph 13, March 2008.
227 FSA records, October 2006.

Improvements in the FSA's liquidity monitoring mechanisms

173 In response to the crisis, the FSA supplemented the SSR with ad hoc reporting requirements to enhance the data available to it to monitor liquidity risk in firms. The two key reports relevant to the Review Period were:

- Current Status Indicator (CSI) data collected through CSI reports: September 2007 – August 2008; and
- Liquidity Risk Profile (LRP) data collected through LRP reports: September 2008 – June 2010.

These are described in more detail below.

174 From September 2007 until August 2008, the FSA collected CSI reports twice-weekly from RBS and other major banks and building societies. The data from these were used as an interim monitoring tool for liquidity risk, including to assess the impact of stress scenarios, such as the potential drawdowns of liquidity by own-sponsored and third-party ABCP conduits.

175 The CSI report submitted by firms used the same definition of wholesale assets and liabilities as the SSR. Key differences from the SSR included that the CSI report recorded both sterling and non-sterling wholesale flows, and wholesale flows from unsecured and repo/reverse repo arrangements were also captured. Using these data, the wholesale funding gap by maturity band could be determined. The CSI report included daily wholesale flows out to a 25 business day period, rather than just the five business day period of the SLR. The CSI report was later extended to record wholesale flows out to a three-month period[228], and then again to a 12-month period.[229] Later CSI reports also requested information on the level of unencumbered assets.

176 The quantitative data in the CSI reports (and later the LRP reports) were complemented with qualitative and quantitative data on market and funding conditions and liquidity positions submitted by firms, either via Bank of England questionnaires (see paragraph 178) or telephone calls with the FSA.[230]

177 The frequency of these calls to RBS and other firms depended on the market environment. Summaries of calls held were circulated by email to the relevant Supervision Teams (who also participated in the calls) and Supervision. At key points, these were also escalated to FSA senior management, including the Chairman and CEO, as well as to the Bank of England and HM Treasury.[231] The content of the calls was also discussed at FSA Market Conditions Committee meetings.[232] The FSA also participated in discussions with RBS and

228 RBS's CSI reports indicated that data out to a three-month period were collected from RBS from 18 October 2007. Wholesale funding flows over 25 business days were not broken down into daily flows but grouped in a 26 day to three month maturity band. FSA records, October 2007.

229 RBS's CSI reports indicated that data out to a 12-month period were collected from RBS from 27 May 2008. Wholesale funding flows over 25 business days were not broken down into daily flows but recorded in the following maturity bands: 26 business days to three months; three to six months; and six to 12 months. FSA records, May 2008.

230 The Review Team understood from individuals met as part of the Review that these calls commenced in about Q3/Q4 2007, following the failure of Northern Rock in September 2007. However, the Review Team saw evidence that these calls were held with RBS only from 3 December 2007, FSA records, December 2007.

231 FSA records, for example, September and October 2008.

232 These meetings were held daily, FSA records, August 2007 to October 2008.

the Federal Reserve Bank of New York about RBS's significant US$ wholesale funding gap.[233]

178 From October 2007, the Bank of England sent, via the FSA, weekly questionnaires to RBS and other major banks. The data submitted were collated by the FSA and used both by it and the Bank of England to monitor funding conditions. This was a survey on market conditions, maturities achieved, types (repo, other secured, unsecured) and cost of funding.

179 At end-August 2008, LRP reports were rolled out to certain banks and building societies to replace CSI reports; during the short transitional period, information on firms', such as RBS's, liquidity positions, including their overnight wholesale funding gaps, was received by the FSA during the regular telephone calls to those firms. The data collected in the LRP reports were significantly more comprehensive and granular than in the CSI report. As with the CSI report, the LRP report was not a formally required regulatory return. Nor was it used to set regulatory limits. Firms completed both the CSI and LRP reports on a 'best efforts' basis. The FSA accepted that firms might have some difficulties in extracting the required information in the precise format requested within the time frame set for completion. Where particular data items were very burdensome, firms were expected to complete these items to the best of their ability based on available information. Therefore, the Review Team cannot assure that the data quality was in line with what is expected by the FSA of a regulatory return.

180 The LRP report captured wholesale and retail outflows, off balance sheet positions that could contribute to liquidity risk, as well as margin and downgrade related risks. It initially captured flows up to five years, analysing them into daily or other maturity bands. It was later extended to include funding flows over five years.

181 The LRP report was designed to signal to supervisors any breach of a series of key indicators of liquidity that might increase a firm's likelihood of running into liquidity problems.[234] Some of these indicators were: loss of retail and wholesale funding; increased concentration of wholesale funding by counterparty, maturity, product or currency; unexpected outflows from commitments, contingent liabilities or derivatives; and a marked drop in a firm's pool of liquid assets.

182 Completing the expanded liquidity data in the CSI and then LRP reports may have required significant manual extraction and aggregation by firms at a time when they were already stretched due to market conditions. FSA expectations were that firms would complete a LRP report for each of the major currencies that it was active in (prior to this firms submitted liquidity data by major currency in the CSI reports). In practice this was not done by all firms, including RBS[235], reflecting the 'best efforts' basis for completion of these reports. The LRP report template also requested firms to present liquidity data on a day-by-day

233 Review Team meeting with Supervision liquidity specialist, January 2011. In order to support the provision of Emergency Liquidity Assistance to RBS from 7 October 2008, the Bank of England entered into US$ swap facilities with the Federal Reserve Bank of New York, Bank of England News Release, Federal Reserve Bank Swap Line Disclosure, 1 December 2010.

234 *New Liquidity Reporting Requirements,* FSA, 24 July 2008.

235 FSA records, September to October 2008.

basis but again, some firms did not complete this information, although RBS did. Some firms faced considerable system and resource challenges to submit an LRP report for each major trading currency at this time and to present liquidity data on a day-by-day basis. Therefore, there were examples of poor data quality when CSI and LRP reports were first introduced.

183 As a result, the FSA did not receive details from the LRP reports of RBS's non-sterling wholesale funding in September and October 2008. The Review Team considered that this did not undermine the FSA's monitoring and understanding of RBS's deteriorating liquidity position.[236]

Increasing supervisory focus on RBS's liquidity position

184 From the onset of the crisis period, the Supervision Team, Supervision and FSA senior management increased their focus on RBS's liquidity risk. However, they did not identify the full scale of RBS's immediate vulnerability as this only became apparent after the collapse of Lehman Brothers in September 2008.

185 Section 1.5.4 assesses the FSA's supervisory approach in relation to the acquisition of ABN AMRO which completed on 17 Octover 2007. In summary, the Review Team concluded that the FSA's overall supervisory approach was an inadequate response to the major risks inherent in the acquisition of ABN AMRO and that the analysis performed by the FSA, for example in relation to liquidity risk arising from the acquisition, was limited. Supervisory attention, under FSA senior management direction, should have been more proactively engaged from the time in April 2007 that the FSA was informed of the consortium's[237] intention to make a bid for ABN AMRO, with particular focus on testing in detail the potential capital and liquidity implications for RBS. Supervisory practice has since been rectified accordingly.

186 In September 2007, the Supervision Team wrote two briefing memos for the FSA Chairman and CEO on the potential impact of the current market conditions on RBS's liquidity (and capital) position, with a focus on ABCP conduits if it acquired ABN AMRO[238]; it further briefed the FSA Managing Director of Retail Markets in October. It is clear that, at that time, the Supervision Team was aware of the risk to RBS's liquidity position from ABN AMRO's significant ABCP conduits business.[239]

187 In these memos, the Supervision Team concluded that RBS could acquire and fund the acquisition of ABN AMRO in all but the most severe market conditions, (defined as conditions in which the firm would not be able to raise capital over a considerable period of time or access funding via the money markets).[240] One memo noted that RBS believed it could, if need be, find

236 Data in relation to RBS's non-sterling wholesale funding were received from and discussed with RBS during regular telephone calls at that time (see paragraphs 176 to 177).
237 A consortium of banks made up of RBS, Santander and Fortis acquired ABN AMRO.
238 FSA records, September 2007.
239 FSA records, October 2007.
240 FSA records, October 2007.

additional funding to meet commitments being taken on balance sheet, for example in relation to ABCP conduits.[241 242]

188 In one of the memos referred to above, the Supervision Team recognised RBS's vulnerability in the event that it could not fund its significant overnight wholesale funding position and understood that in the event of a severe scenario, for example where RBS could not access the wholesale markets, it would quickly run into liquidity problems. The Supervision Team and FSA senior management, however, considered this scenario '*very unlikely*'.[243] This reflected the fact that although the wholesale markets had recently dried up for second tier banks, contributing to the failure of Northern Rock in September 2007[244], few considered that this would spread to the so-called top tier banks. This judgement was reinforced at the time by the fact that RBS:

- by end-September, had successfully raised €17.3bn of senior and bridge financing to fund the acquisition of ABN AMRO (see Section 1.5, Table 2.12);
- continued to fund its significant overnight wholesale funding gap; and
- considered that it was benefiting from a 'flight to quality' effect (see paragraph 126).

189 Also in that memo, the Supervision Team stated that it had '*challenged RBS senior management to provide further information that demonstrates the Group has considered and discussed the risks of this strategy* [i.e. its reliance on short-term wholesale funding] *at an appropriate level*'.[245] RBS's reliance on overnight wholesale funding was also raised in an October 2007 FSA Market Conditions Committee meeting.[246]

190 On 19 November 2007 there was an FSA specialists' liquidity visit to RBS. During this visit, the firm acknowledged that the maturity of its wholesale funding had further shortened (see paragraph 137) and its liquidity profile and strategy, procedures and processes, largest depositors/lenders, and funding maturities were discussed.[247] RBS raised the following key issues:

- funding conditions had become tough again following a period of stability, and it did not expect an improvement until the second quarter of 2008;
- it was concerned with its funding position and confirmed that in the event that the maturity profile of its funding shortened further, it had contingency plans in place; and
- it was concerned with wholesale, not retail, funding outflows.

241 FSA records, September 2007.
242 Aside from the analysis performed on the impact of the acquisition on RBS's exposure to ABCP conduits described above, there was limited supervision of RBS's or (from the time it was acquired by RBS) ABN AMRO's ABCP conduit business. This was consistent with the limited attention given by the FSA to structured finance at the time (see Section 1.4). For example, when providing feedback to the industry in May 2007, following a thematic review of ABCP conduits during 2006 and 2007, the FSA agreed that ABCP conduits were a low priority in relation to other topics that the Securitisation Standing Group was considering at that time, FSA records, May 2007.
243 FSA records, October 2007.
244 *The Turner Review*, Box 1B, March 2009.
245 FSA records, October 2007; also RBS records, October 2007.
246 FSA records, October 2007.
247 FSA records, November 2007.

191 Later on 19 November 2007, the Supervision Head of Department asked the FSA specialist team to '*go back as a matter of urgency*', to request a range of further information from RBS. For example, RBS was asked to project its liquidity position under certain scenarios.[248]

192 On 26 November 2007, FSA specialists held another meeting with RBS, designed to obtain a quick but detailed view of the liquidity situation facing firms at that time. RBS gave an update on the market situation, its liquidity position and its largest lenders/depositors, and the FSA specialist team followed up on the further information requests referred to above. As part of this, RBS presented the projections of its liquidity position assuming certain scenarios. The specialist team's conclusions from this meeting were that RBS was '*responding well to the current situation*' and that its liquidity position appeared manageable provided there was no market shock.[249]

193 A few days after this meeting, a Bank of England update on RBS's liquidity position, which it shared with the FSA at the time, noted that RBS's significant use of overnight wholesale funding made it '*particularly vulnerable to any rapid change in market sentiment*'. [250]

194 The Supervision Team had added RBS to the FSA's Watchlist[251] in November 2007 due to concerns over the integration risk associated with RBS's lead role within the consortium which acquired ABN AMRO. In December 2007, the Watchlist commentary was expanded to include the impact of market conditions on the firm's liquidity and capital positions (for more detail of the decision to place the firm on the FSA's Watchlist, see Section 3, paragraph 702).

195 As mentioned above, RBS's significant reliance on short-term, in particular overnight, wholesale funding was recognised by the Supervision Team, Supervision, as well as by FSA senior management[252], but it was also recognised that this dependence could not be addressed quickly, particularly given the market conditions. The agreed supervisory approach for RBS was gradually to improve its liquidity position as the firm was attempting to do as market conditions allowed (see paragraphs 141 to 143).

Wider liquidity policy matters

196 From September 2007, the FSA, and in particular the FSA Chairman, stressed the significance of deteriorating liquidity conditions, and raised issues relating to overall policies on public liquidity support. These issues were discussed in detail at the September 2007 meeting of the FSA Board and the FSA Chairman made the other Tripartite authorities aware of his concerns.

197 By November 2007, the FSA executive management and Chairman had become concerned that market conditions for liquidity had worsened significantly, as demonstrated by many widespread indications that firms, including RBS, were

248 FSA records, November 2007.
249 FSA records, November 2007.
250 FSA records, November 2007.
251 Further details of the FSA's Watchlist are provided on the FSA's website www.fsa.gov.uk/pubs/other/watchlist.pdf and in *The NR Report*, Section 5.4, paragraph 32, March 2008.
252 FSA records, November 2007.

finding term liquidity increasingly difficult to find. In making the other Tripartite authorities aware of his concerns, the FSA Chairman noted that, although the FSA would continue to exert all the pressure it could to encourage prudent action by institutions which were at risk, it could not, through individual institution-specific actions, be expected to succeed in preventing a further incident. This opinion reflected the reality that, although it would have been highly desirable before the onset of the crisis for the FSA to have applied more rigorous liquidity regulations and placed greater focus on the supervision of liquidity, once liquidity strains had developed, it was difficult for any bank facing those strains rapidly to correct its position. This was because the funding actions required to improve a bank's liquidity position, even if feasible amid difficult market conditions, could themselves trigger market confidence concerns. It is recognised, however, that the appropriate response to this dilemma might have been significant increases in bank capital, addressing fundamental solvency concerns, rather than, or in addition to, public authority liquidity support.

198 While the Review Team acknowledged the step change in FSA senior management's, Supervision's and the Supervision Team's focus on RBS's liquidity risk over the crisis period, overall the Review Team concluded that this increased focus on liquidity proved to be too late to ensure an improvement in RBS's liquidity position sufficient to avert its failure in October 2008. This is discussed in more detail in Section 1.6.

1.2.6 Fundamental reforms to the regulation and supervision of liquidity

199 *The Northern Rock Report* highlighted the need for greater prioritisation of liquidity and reiterated the limitations of the SSR. Further, *The Turner Review* stated that '*liquidity regulation and supervision should be recognised as of equal importance to capital regulation. More intense and dedicated supervision of individual banks' liquidity positions should be introduced, including the use of stress tests defined by regulators and covering system-wide risks*'.[253]

200 In response, the FSA has introduced a radically changed liquidity regime, enforced via a more intensive supervisory framework for liquidity, and has played a major role in the development of the Basel III liquidity standards, the first globally agreed liquidity standards.

The FSA's new post-crisis liquidity regime

201 In October 2009, the FSA published Policy Statement 09/16, *Strengthening Liquidity Standards*[254], which set out its new liquidity regime, with qualitative requirements coming into effect on 1 December 2009 and quantitative requirements and reporting being introduced from June 2010 onwards. Implementation of the new regime met the key Supervisory Enhancement Programme (SEP) deliverables arising from *The Northern Rock Report*. The FSA's new liquidity returns were also consulted on and introduced from 1 June 2010.

253 *The Turner Review*, Introduction, March 2009.
254 FSA PS09/16, *Strengthening Liquidity Standards*, October 2009.

202 Key elements of the new regime are:

- over-arching principles of self-sufficiency and adequacy of liquidity resources;
- enhanced systems and control requirements, which implement the Basel Committee's updated *Principles for Sound Liquidity Risk Management and Supervision* (September 2008)[255];
- updated quantitative requirements (Individual Liquidity Adequacy Standards (ILAS)), coupled with a narrow definition of liquid assets;
- a new modifications regime for branches and subsidiaries; and
- granular and frequent reporting requirements.

203 The FSA has also invested considerably in its in-house systems and analytical capabilities to ensure that it can make effective use of the data, including performance of peer group analyses and firm-specific and market-wide scenario stress-testing.[256] Applying these analyses allows the FSA to track firms' liquidity risk profiles, including for example the composition of a firm's funding; off balance sheet liquidity commitments; a firm's funding sources; and maturity mismatches. The tools also allow Supervision Teams and FSA specialist teams to identify potential issues quickly, through the use of key risk indicators, metrics and ratios, together with trend analysis, triggers and limits. These are designed to prompt Supervision Teams to request FSA specialist support and/or to take action with firms when appropriate.[257]

204 For further detail on how the regime (both domestically and internationally) has addressed lessons learned from the crisis period, see Appendix 2D.

Basel III: future standards for liquidity

205 In December 2009, the Basel Committee issued for consultation a package of proposals to strengthen global liquidity and capital regulations with the goal of promoting a more resilient banking sector. The Basel III rules were published in December 2010 and introduced two new liquidity standards: the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR).[258]

206 The LCR will be introduced on 1 January 2015. It is a Pillar 1 minimum standard. In addition, there are areas of implementation where national supervisors are required to exercise their own judgement, for example through Pillar 2; this may lead to higher requirements. The NSFR will move to a minimum standard by 1 January 2018.

207 The LCR is intended to promote short-term resilience of a bank's liquidity risk profile by ensuring that it has an adequate level of unencumbered high-quality liquid assets that can be converted into cash to meet its liquidity needs for a 30 calendar day time horizon under a significantly severe liquidity stress scenario.

255 *Principles for Sound Liquidity Risk Management and Supervision*, Basel Committee, September 2008.
256 This builds on the tools developed to analyse LRP reports.
257 FSA PS09/16, *Strengthening Liquidity Standards*, paragraphs 10.11 to 10.14, October 2009.
258 *Basel III: International Framework for liquidity risk measurement, standards and monitoring*, Basel Committee, December 2010.

208 The NSFR was designed to promote structural changes in the funding profiles of firms, helping to move away from reliance on short-term funding toward more stable, longer-term sources. In particular, the NSFR is set up to help ensure that long-term assets are funded with at least a minimum amount of stable liabilities and has a greater focus on off balance sheet items.

209 Both the LCR and the NSFR, once fully implemented, will require banks to meet higher liquidity standards than existed before the start of the crisis period. As discussed in paragraphs 159 to 160, if RBS had had to meet the LCR standard at end-August 2008, it would have had to increase by between £125bn and £166bn its stock of high-quality unencumbered liquid assets or, alternatively, reduce its reliance on short-term wholesale funding to comply with the standard.

210 In addition to the new standards for liquidity, Basel III also outlines metrics to be used as monitoring tools. In using these metrics, supervisors should take action when potential liquidity difficulties are signalled. Examples of actions are set out in the Basel Committee's *Principles for Sound Liquidity Risk Management and Supervision*.[259]

211 In December 2010, the Basel Committee released results of its comprehensive Quantitative Impact Study (QIS) for Basel III.[260] This assessed the impact as at end-2009 of standards announced in 2009, including the Basel III liquidity and capital proposals. 263 banks from 23 Committee member jurisdictions participated, including 94 Group 1 banks.[261] The average LCR for Group 1 banks calculated through this QIS exercise (which included RBS) was 83%. This was below the proposed minimum requirement of 100% and the overall results indicated that a number of banks had significant progress still to make to meet Basel III liquidity standards.

212 Meeting new liquidity standards inevitably takes time. It is impossible for institutional banks to rapidly unwind excess volumes of short-term funding and if regulators required banks to meet new standards immediately, this could drive a significant and harmful reduction in the quantity and term of credit supply to the real economy.

Conclusions on what happened in RBS

- In the years preceding the start of the crisis period, RBS, as with peers, had an increasing reliance on wholesale funding. This made RBS and other firms particularly vulnerable to any shock to wholesale market confidence, such as that which followed the collapse of Lehman Brothers on 15 September 2008.

- Relative to the other large UK banks, RBS had one of the greatest dependencies on short-term wholesale markets, and within that the very short-term, and in particular overnight, markets. This made it more vulnerable than most of its peers to even short periods of market stress.

259 *Principles for Sound Liquidity Risk Management and Supervision*, Basel Committee, September 2008.
260 *Results of the Quantitative Impact Study*, Basel Committee, December 2010.
261 Group 1 banks are those that have tier 1 capital in excess of €3bn, are well diversified and are internationally active. RBS is a Group 1 bank.

- The majority of RBS's very short-term wholesale funding gap (and within that its overnight wholesale funding gap) consisted of US$ funds and predominantly unsecured funds.
- Even within the (inadequate) regulatory regime for liquidity, the Sterling Stock Regime (SSR), RBS had a lower Sterling Stock Liquidity Ratio (SLR), the main quantitative measure for liquidity under that regime, than most of its large UK banking group peers.
- The acquisition of ABN AMRO increased RBS's liquidity risk.
- During the crisis period and the liquidity strain that went with it, it was difficult for RBS to reduce the vulnerability of its liquidity position, for example through lengthening the maturity of its wholesale funding.

Conclusions on the FSA's regulation and supervision

- The regime being applied to liquidity, the Sterling Stock Regime (SSR), was inadequate and, within that, there were significant shortcomings in the main quantitative measure for liquidity – the Sterling Stock Liquidity Ratio (SLR). For example, it neither captured nor restricted the reliance on non-sterling wholesale funding of a firm such as RBS.
- Due to this limitation, guidance in the FSA Handbook suggested that supervisors consider monitoring the risk arising from the foreign currency business of SSR banks. However, Supervision did not incorporate this guidance into its supervision of liquidity risk for RBS, and other firms, despite RBS's significant reliance on non-sterling funding. The Review Team considered this was one example of weakness in Supervision's approach to RBS's liquidity risk. Therefore, RBS's use of non-sterling wholesale funding grew unchecked by the FSA.
- Until mid-2007, the attention paid by the Supervision Team, Supervision and FSA senior management to RBS's liquidity risk was limited. This reflected the prevailing standards, which were inadequate, and the relative low priority accorded to liquidity by the FSA at that time which was a major FSA policy mistake.
- After the onset of the crisis period, there was a step change in FSA senior management's Supervision's and the Supervision Team's focus on liquidity risk, but this proved to be too late to make a difference in the case of RBS.
- Due to the operational challenges faced by firms in completing the liquidity risk profile (LRP) report, the FSA did not receive full details of RBS's non-sterling wholesale funding in September and October 2008. The Review Team considered that this did not undermine the FSA's monitoring and understanding of RBS's deteriorating liquidity position.

Lessons already identified where actions have been taken

- The liquidity regime in place throughout the Review Period was inadequate and needed to be improved. The regime has subsequently been the subject of major policy and supervisory work domestically, for example through the introduction of the FSA's new liquidity regime, and internationally in the Basel III Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) standards.

Recommendations for further change

- When changes are proposed to quantitative and qualitative data reporting by firms, the Review Team recommends that, where necessary, the relevant FSA policy and risk specialists should introduce appropriate controls to ensure that there is a transitional period in which both the existing and new reporting requirements run in parallel to ensure required data continue to be collected.

1.3 Asset quality: concerns and uncertainties

213 Section 1.1 discussed RBS's capital adequacy. This proved inadequate to reassure the market in autumn 2008 that the firm would remain solvent in the face of uncertainty about the scale of losses that banks might face. Between 2007 and 2010, RBS made net accounting losses of £30.7bn. This reflected £50.0bn of income net of tax and other expenses, offset by three main categories of loss.[262]

- £17.7bn on credit trading, arising from assets acquired both as a result of organic growth and as part of the ABN AMRO acquisition. These losses are discussed in Section 1.4.
- Goodwill write-offs of £30.5bn, of which £22.0bn resulted from the acquisition of ABN AMRO. These, together with other adverse consequences of that acquisition, are discussed in Section 1.5.
- Losses of £32.5bn on loans and advances in RBS's banking book, across a wide range of sectors and geographies. This section focuses on this category of loss.

214 The full extent and composition of these losses was not known in autumn 2008, but uncertainties about the potential for further losses affected market perceptions of RBS. These uncertainties, when combined with perceived weaknesses in other areas, contributed to the collapse in confidence in RBS at that time. Amid the general market crisis in autumn 2008, any bank which was perceived as relatively risky on a combination of measures was vulnerable to failure.

215 The key points made in this section are:

- Between end-2004 and end-2008, RBS's balance sheet grew four times, as a result of rapid organic growth and the ABN AMRO acquisition. In a period of rapid credit growth in many markets, however, RBS's fast organic growth did not make it a clear outlier amongst its peers.
- While the £40.7bn operating loss declared for 2008 was dominated by a goodwill write-off and by losses on credit trading activities, impairment provisions on loans and advances of £32.5bn between 2007 and 2010

262 2007, 2008, 2009 and 2010 RBS annual report and accounts. RBS made a statutory profit of £7.7bn after tax for 2007, but was loss-making in each of the following years (recognising losses of £34.4bn in 2008, £2.3bn in 2009 and £1.7bn in 2010). Total losses due to credit trading, goodwill impairment and impairment on loans and advances over this period amounted to £80.6bn, as shown in Table 2.5.

were the dominant factor which eroded RBS's capital base.[263] These impairment losses compared with £17.7bn net losses incurred in relation credit trading activities.

- With hindsight, RBS's losses incurred as a percentage of loans and advances, while high, did not make RBS a clear outlier compared to its peers. Furthermore, the precise scale and distribution of losses that would follow was not known by market participants in autumn 2008.
- Nonetheless, analysis of market perceptions at the time suggested that market concerns about RBS's overall asset quality, as well as specifically about its potential losses in credit trading activities, played a role in making RBS one of the banks which suffered from a withdrawal of funding in autumn 2008.
- The FSA's general approach to supervision involved limited fundamental analysis of balance sheet composition or asset quality. While the Supervision Team did identify growing commercial property exposures as a concern in 2005, there was, with hindsight, a failure to follow through with supervisory action that might have reduced RBS's vulnerabilities in this area.

1.3.1 Overall balance sheet growth and composition

216 This section describes the overall growth and composition of RBS's balance sheet, to place in context the analysis of each of the categories of loss considered in Sections 1.3, 1.4 and 1.5.

217 Between end-2004 and end-2008, RBS's total assets grew from £588bn to £2,402bn. As Section 1.1 described, this growth was accompanied by inadequate capital support and by greatly increased leverage.

218 RBS's significant growth in total assets resulted from the combination of rapid organic growth and the acquisition of ABN AMRO. Between end-2004 and end-2007, excluding the impact of the ABN AMRO acquisition, total assets grew at an annualised rate of 24%. As shown in Table 2.3, there was particularly rapid growth in derivatives (which increased by more than ten times during the period), but also significant growth in loans and advances.[264]

263 2007, 2008, 2009 and 2010 RBS annual report and accounts.
264 The value of derivatives changes in response to a change in an underlying variable (such as an interest rate, security price or index), and therefore changes in the value of derivative contracts do not necessarily reflect underlying activity and trading volumes.

Table 2.3: Growth of asset classes at RBS, end-2004 to end-2007, excluding the effect of ABN AMRO at end-2007[265]

£bn	end-2004	end-2005	end-2006	end-2007[266]	% annualised growth
Cash, Treasury and other eligible bills	10.4	10.3	11.6	27.0	37%
Debt securities and equities held at fair value[267]	98.6	130.3	140.8	174.9	21%
Derivatives	17.8	95.7	116.7	247.2	140%
Loans and advances to banks	61.1	70.6	82.6	97.8	17%
Loans and advances to customers	347.3	417.2	466.9	530.2	15%
Other	53.0	52.8	52.9	45.9	-5%
TOTAL ASSETS	**588.1**	**776.8**	**871.4**	**1,122.9**	**24%**

219 This reflected RBS's expansion across a wide range of business sectors (as shown in Table 2.4). Assets held within Global Banking Markets (GBM) grew significantly during the Review Period, by an average of 34% per annum between end-2004 and end-2007. This growth rate included derivative assets, which were concentrated in GBM and which grew particularly rapidly, constituting over half of the growth in GBM's assets during this period.[268] GBM represented approximately 57%, 62% and 70% of the total assets of the firm in the years 2006, 2007 and 2008 respectively.[269]

220 RBS also grew in other sectors, with Ulster Bank being a significant contributor (growing at an annualised rate of 26%). In its 2005 results, RBS highlighted strong growth in corporate markets, 31% growth in mortgages at Ulster Bank and growth in its UK motor and European insurance businesses.[270] Just before the Review Period, the firm acquired Charter One in line with its strategy to expand its US operations; similarly RBS's investment in Bank of China in 2005 formed an important component of its ambitions to extend its franchise in Asia. The acquisition of ABN AMRO accelerated growth in GBM and in Asia, via ABN AMRO's retail presence in the region.[271] RBS's growth objectives tended to focus on revenue, rather than considering the overall size of the balance sheet.[272]

265 2005, 2006 and 2007 RBS annual report and accounts. Table does not cast errors due to rounding of figures taken from annual report and accounts. Note that end-2004 figures measure derivatives on a different basis to those of subsequent periods due to changes in accounting standards.
266 The total growth in assets due to the acquisition of ABN AMRO was £774bn, out of total assets of £1,901bn. Figures for individual asset classes have been estimated using data in 2007 RBS and ABN AMRO annual report and accounts. The estimates made give the increase in total assets due to ABN AMRO as £777bn – suggesting an error of around 0.4%.
267 Includes assets held for trading and as available for sale.
268 2005 and 2007 RBS annual report and accounts, supplemented with data from RBS, November 2011.
269 2007 and 2008 RBS annual report and accounts.
270 RBS 2005 annual results presentation, 28 February 2006.
271 When RBS and the consortium made their initial offer in April 2007, the strategic rationale also included the fact that ABN AMRO's US banking subsidiary, LaSalle, would accelerate RBS's US growth ambitions.
272 RBS records, 2006 to 2007. Also shown by the way that the firm's outlook was described by the RBS CEO in analysts' calls (transcripts sourced from Thomson StreetEvents).

Table 2.4: RBS asset growth by division, end-2004 to end-2007, showing separately growth due to ABN AMRO in 2007[273]

£bn	end-2004	end-2005	end-2006	end-2007	% annualised growth
GBM	298.8	422.6	498.4	725.2	34%
UK corporate	54.7	77.2	89.1	103.2	24%
UK retail	105.5	113.8	118.3	119.7	4%
Ulster	27.7	36.1	43.4	55.0	26%
Citizens	71.6	92.2	82.5	80.4	4%
Insurance	11.6	13.0	12.6	12.9	3%
Other[274]	18.3	22.0	27.1	29.8	18%
TOTAL ASSETS excluding ABN AMRO	**588.1**	**776.8**	**871.4**	**1,126.2**	**24%**
RBS's share of ABN AMRO	–	–	–	533.9	N/A
RFS minority interests	–	–	–	240.5	N/A
TOTAL ASSETS including ABN AMRO	**588.1**	**776.8**	**871.4**	**1,900.5**	**48%**

221 While this growth was rapid, however, RBS's growth was not unusual amongst its peers. Other banks which had significant international operations, such as Standard Chartered, Barclays and HSBC, also grew rapidly (as shown in Graph 2.7).

222 The acquisition of ABN AMRO, however, combined with continued organic growth, led to a substantial increase in RBS's total assets during 2007 and 2008. While RBS continued to grow organically (by 29% from end-2006 to end-2007, largely reflecting growth in derivative assets), the acquisition was the most important driver of the more than doubling in size of RBS's balance sheet. This asset growth, and particularly the increase in wholesale banking and derivative assets as a result of the acquisition, is shown on Graph 2.8.

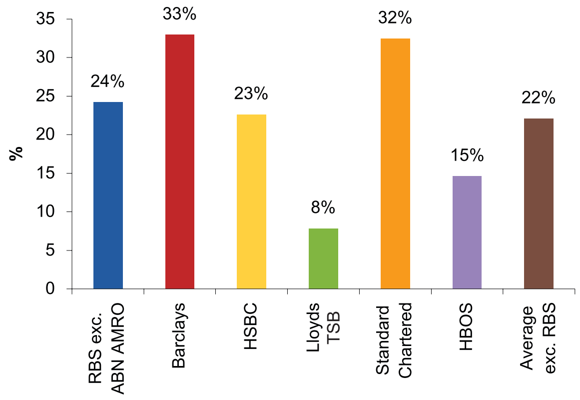
223 RBS's statutory balance sheet at end-2007 was swollen by the role which RBS played as consortium leader, consolidating all of ABN AMRO and recognising the minority interests of Santander and Fortis (see Section 1.5). But, even on the basis of pro forma figures provided to the market by RBS, which included only the parts of ABN AMRO businesses that RBS intended to retain (and therefore excluding Fortis and Santander's minority interests), the overall picture remained one of significant growth. Although RBS's share of the consortium was only 38%, the businesses acquired by RBS were more asset-intensive and comprised over 70% of ABN AMRO's balance sheet as at end-2007.[275] Therefore, most of

273 2005, 2006 and 2007 RBS annual report and accounts. Assets include derivative assets, growth of which (as shown in Table 2.3) was significant and had a large effect on GBM (as noted in paragraph 219), but not on other divisions. Table does not cast due to rounding of figures taken from annual report and accounts. Note that end-2004 figures are based on comparative data in 2005 annual report and accounts and measure derivatives on a different basis to other periods due to changes in accounting standards.

274 Comprises Wealth Management and Central items.

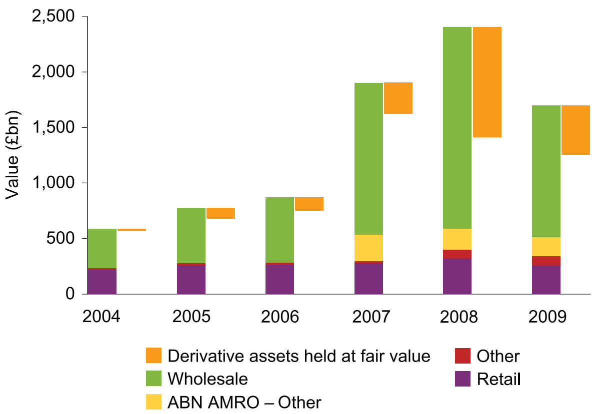
275 2008 RBS and ABN AMRO annual report and accounts.

Graph 2.7: Growth of total assets at RBS and peers from end-2004 to end-2007, excluding the effects of the ABN AMRO acquisition[276]



Source: 2004 to 2007 named banks' annual reports and accounts.

Graph 2.8: RBS's total assets (under IFRS) from 2004 to 2009, by sector, showing derivatives assets separately[277]



Source: 2004 to 2009 RBS annual report and accounts.

the £774.2bn increase in total assets that was due to the acquisition of ABN AMRO reflected growth for RBS, rather than the consortium partners.[278]

224 Growth in derivative exposures drove a significant further increase to RBS's balance sheet during 2008, with total assets growing by 26% from those reported at end-2007.[279] This was in line with the average balance sheet growth at peers during 2008[280], as price movements hugely increased the value of derivative contracts.

225 An RBS Group Internal Audit report found that, prior to Q2 2008, RBS did not have any divisional or group caps on total assets. This reflected a focus on income objectives and '*business plans which project asset growth based upon new business targets required to achieve revenue targets*'. When the report was completed, discussions were in progress within RBS to consider alternative targets, including the use of notional limits on balance sheet size.[281]

1.3.2 Categories of losses incurred

226 Table 2.5 distinguishes the three major categories of loss suffered by RBS from 2007 to 2010. The full extent and composition of these losses would not have been apparent to market participants at the time of RBS's failure: the losses for 2008, for instance, were declared in February 2009. The Review Team's analysis of the exposures on which RBS suffered the greatest losses was necessarily

276 Total assets include derivative assets. In 2005, Standard Chartered acquired Korea First Bank (increasing total assets by £24bn) and Barclays acquired Absa (increasing total assets by £39bn). Between 2005 and 2007, HSBC made several acquisitions (in total increasing total assets by £22bn). However, none of the acquisitions made by RBS's peers had a comparable effect on those peers' total assets to RBS's acquisition of ABN AMRO.

277 The Review Team was not able to apportion derivative assets to segments throughout the Review Period. However, the Review Team believed that GBM was the major contributor to derivative asset growth (due to its trading activities), and therefore the derivative assets are shown for comparison next to the wholesale segment. Categories as follows:
Retail = Ulster Bank, RBS Insurance, Citizens, Retail, Wealth Management.
Other = Central items, Manufacturing.
ABN AMRO – Other = RFS Holdings Minority Interest, shared assets not allocated in advance of acquisition among consortium members.
Wholesale = GBM, UK corporate banking, non-core. Includes ABN AMRO's wholesale business from end-2007. Non-core was created as part of the Group restructuring, and is to be run-down; circa 90% relate to GBM.

278 2007 and 2008 RBS annual report and accounts.

279 2008 RBS annual report and accounts.

280 Published annual reports and accounts.

281 RBS Group Internal Audit report, July 2008.

conducted with hindsight. It demonstrated, however, RBS's involvement in asset classes that became sources of market concerns.

Table 2.5: Major sources of losses incurred by RBS from 2007 to 2010[282]

£m	2007	2008	2009	2010	Total 2007-2010
Loss/income on credit trading[283]	(1,430)	(12,200)	(4,108)	41	(17,697)
Impairment of goodwill	(40)	(30,062)	(363)	(10)	(30,475)
Impairment losses on loans and advances	(2,106)	(7,091)	(14,134)	(9,144)	(32,475)
TOTAL	**(3,576)**	**(49,353)**	**(18,605)**	**(9,113)**	**(80,647)**

227 Awareness of or expectations about the potential for a sharp increase in lending losses, and uncertainties surrounding how large these losses might be, were important to market participants in autumn 2008. It is difficult, in retrospect, to be certain about the mix of known facts and market perceptions which drove the collapse of confidence in RBS and the withdrawal of wholesale funding at that time. Nonetheless, the Review Team believes that emerging signs of weaknesses in RBS's asset quality, combined with concerns in a number of areas, did play a role in RBS's failure.

228 RBS had already announced losses on credit trading of £1.4bn for 2007 in February 2008. Further losses were announced in April and August 2008 and £12.2bn losses on credit trading were subsequently recognised for the whole of 2008. The mistakes of strategy and execution which led to these losses are discussed in Section 1.4.

229 In numerical terms, the single largest contributor to the £40.7bn operating loss announced in February 2009 was the £30.1bn write-down taken on goodwill, of which £22.0bn related to the acquisition of ABN AMRO.[284] Some of this write-off related to Fortis's share of the acquisition (and so did not directly affect the equity attributable to RBS's shareholders) and overall the write-down did not affect the firm's total or tier 1 capital resources. The impact of the ABN AMRO acquisition is discussed further in Section 1.5.

230 In terms of the eventual impact on RBS's capital resources, by far the most important category of loss was the £32.5bn of impairments on loans and advances recognised between 2007 and 2010. RBS Board papers noted signs of increasing credit risk across a range of portfolios from March 2008 onwards.[285] However, the full extent of RBS's subsequent losses was not apparent to the market at the time of the firm's failure in autumn 2008. Impairment charges in 2007 had been only £2.1bn and the impairment losses declared for H1 2008 were £1.6bn. Impairment charges of £7.1bn on loans and advances for the whole of 2008 were declared in February 2009, but the majority were incurred in 2009 and 2010 (£14.1bn and £9.1bn respectively).[286]

282 2007, 2008, 2009 and 2010 RBS annual report and accounts.
283 Includes ABS, corporate bonds, credit derivatives and related hedges and funding.
284 RBS records, February 2008 and 2007 and 2008 RBS annual report and accounts.
285 RBS records, 2008.
286 2008, 2009, 2010 RBS annual report and accounts and 2008 RBS interim results.

231 Assets held for trading are held at fair value and gains or losses recognised as soon as there is any movement in this value (regardless of expectations about subsequent value movements in the longer term). In contrast, losses are only taken against banking book assets (held at amortised cost) once there have been known events of credit quality deterioration (such as payment defaults) or when it is reasonable to infer that such events have already occurred (even if evidence in respect of individual loans is not yet available). Therefore, in the event of a downturn, trading losses often precede lending losses, as objective evidence of borrower difficulties may take longer to emerge. To a degree, indeed, the huge size of the impairment losses subsequently recognised across the banking sector was as much a consequence of the financial crisis and the macroeconomic recession which it induced as a direct cause. In the febrile conditions of autumn 2008, however, uncertainties about the asset quality of major banks and the potential for future losses played an important role in undermining confidence.

1.3.3 Growth of loans and advances and impairment losses by sector

232 It is not possible, either from data publicly available at the time, or from FSA records, to construct a fully consistent and detailed picture of the sectoral breakdown of RBS's balance sheet growth from end-2004 to end-2008. But some key features are apparent:

- As Table 2.4 showed, asset growth in GBM was particularly rapid, reflecting RBS's desire to increase the scale and reach of its investment banking activities. This expansion entailed asset growth in multiple business sectors and geographies, including many where RBS did not have long established relationships or deep local presence.[287] Rapid growth of this sort often results in low asset quality, with market share being bought via aggressive deal participation.
- A combination of evidence sources seen by the Review Team suggested that RBS was a particularly aggressive competitor in leveraged finance deals (as discussed in Section 1.4) and commercial real estate.[288]
- At end-2008, FSA market data showed that RBS had much higher market shares in UK commercial real estate lending (at 32%) than in other UK corporate lending, residential mortgages or personal unsecured lending (where the firm's market share was 25%, 10% and 15% respectively).[289]

233 For 2008 onwards, more detailed information about RBS's loan portfolio and the lending losses realised is available from the firm's annual reports. Table 2.6 sets out the composition of RBS's loan book as at end-2008, the losses incurred in 2008, 2009 and 2010 and the cumulative impairment losses taken over those three years. Table 2.7 shows these losses as a percentage of RBS's loans and advances in each category as at end-2008. The pattern of losses has been split by division, both in absolute terms in Table 2.8 and, in Table 2.9, as a percentage of each division's loans and advances as at end-2008.

287 2007 RBS annual report and accounts.
288 Review Team meetings with market participants, July 2011 and also the Merrill Lynch survey note referred to in paragraph 245.
289 FSA returns. RBS had had significant market shares in UK commercial property lending since at least the beginning of the Review Period: at end-2004, RBS accounted for 28% of the market (FSA records, June 2005).

234 This analysis revealed the following:

- About a third of all losses were incurred in various categories of lending related to corporate property (see Table 2.6). And losses in this sector (9.8% cumulative impairments from 2008 to 2010) proved to be far higher than on other corporate lending (with a cumulative loss rate of 1.8%, as seen in Table 2.7).
- Within this property-related category, £4.4bn impairment losses were incurred in Ulster Bank between 2008 and 2010, reflecting the scale of poor corporate property lending in Ireland, in which RBS participated. A further £3.4bn of corporate property losses recognised in GBM reflected growth in international markets, including Germany (where ABN AMRO had significant exposures).
- As shown in Table 2.8, GBM accounted for £8.6bn, or 28%, of RBS's total losses. While as a percentage of loans and advances this loss rate was below average for RBS overall, the asset intensity and low margin nature of GBM's business would have meant that anticipated impairment levels would have been very low compared to other divisions.
- Losses on personal lending, at £4.6bn, were significant and amounted to 12.4% of exposures between 2008 and 2010. However, high loan loss rates are normal for this category and tend to be matched by high gross margins (unlike commercial property and corporate lending).
- Losses on residential mortgages were not a key element in RBS's asset quality problems, whether in the UK or elsewhere. The three year loss rate of 5.9% on US home equity loans, however, reflected conditions in the US housing market.

235 As Tables 2.6 and 2.7 show, the high losses incurred on commercial property lending arose in several different divisions.[290] It seems likely that RBS senior management and its Board were not sufficiently aware of the firm's aggregate exposure to this sector.

- A visit by FSA specialists in October 2008 noted weaknesses in RBS's management information, including that RBS was not able to provide management information on real estate finance which consolidated exposures held in GBM and in its UK Corporate banking segment.[291]
- The then RBS Chief Risk Officer recalled that he had been concerned about RBS's ability to understand the aggregate of its concentration in different types of lending. Before his arrival in January 2007, lending limits were not broken down by probability of default, geography, industry or sector.[292]

This failure adequately to identify aggregate group risks is one of the possible deficiencies in RBS's management and governance, which are considered in Section 2.

290 These included UK Corporate, GBM, Ulster Bank and RBS's US operations. 2008 RBS annual report and accounts.
291 FSA records, October 2008. Also, '*It is not possible to see the breakdown between prime and secondary asset quality or the geographic distribution of lending, both of which are significant drivers of risk. Other than that, the M.I. was of a reasonable quality for a 'high level' overview of this type of book.*'
292 Review Team meeting with the then RBS Chief Risk Officer, July 2011.

Table 2.6: Impairment losses by category in 2008, 2009 and 2010[293]

£m	Gross loans and advances as at end-2008	Impairment losses on loans and advances			
		2008	2009	2010	Cumulative 2008-2010
Residential mortgages					
- UK	74,400	(32)	(129)	(182)	(343)
- Ulster	24,600	(23)	(116)	(336)	(475)
- US	10,621	(47)	(127)	(62)	(236)
- US home equity (including SBO)	23,830	(388)	(612)	(403)	(1,403)
Total residential mortgages	**133,451**	**(490)**	**(984)**	**(983)**	**(2,457)**
Personal lending					
- UK personal	16,400	(672)	(1,071)	(690)	(2,433)
- UK cards	6,300	(420)	(532)	(301)	(1,253)
- US cards	700	(63)	(130)	(23)	(216)
- US auto and consumer	13,995	(288)	(273)	(179)	(740)
Total personal lending	**37,395**	**(1,443)**	**(2,006)**	**(1,193)**	**(4,642)**
Corporate – property					
- UK house building, property and construction	48,300	(347)	(1,002)	(813)	(2,162)
- Ulster corporate property, commercial and residential investment and development	19,700	(275)	(1,324)	(2,764)	(4,363)
- US commercial real estate	3,000	(54)	(228)	(185)	(467)
- Other property and construction (GBM)	35,633	(722)	(1,441)	(1,267)	(3,430)
Total corporate – property	**106,633**	**(1,398)**	**(3,995)**	**(5,029)**	**(10,422)**
Corporate – other					
- Banks and financial institutions	285,550	(388)	(413)	(490)	(1,291)
- Manufacturing and infrastructure	75,489	(1,370)	(1,586)	315	(2,641)
- Asset and invoice finance (including Lombard)	12,900	(161)	(238)	(190)	(589)
- Telecoms, media and technology	4,105	(55)	(438)	(9)	(502)
- Other	173,790	(759)	(2,755)	(1,143)	(4,657)
Total corporate – other	**551,834**	**(2,733)**	**(5,430)**	**(1,517)**	**(9,680)**
Other					
- Wealth	16,000	(189)	(284)	(69)	(542)
- Ulster and EME other	4,500	(221)	(390)	(351)	(962)
- Other	29,001	(4)	(1)	(2)	(7)
- RFS MI	145,122	(633)	(1,051)	0	(1,684)
Other	**194,623**	**(1,047)**	**(1,726)**	**(422)**	**(3,195)**
TOTAL	**1,023,935**	**(7,111)**	**(14,141)**	**(9,144)**	**(30,396)**

293 2008, 2009 and 2010 RBS annual report and accounts and data provided by RBS in September and October 2011. Note that these data are based on the 2009 and 2010 annual reports (2008 figures based on comparative information provided in the 2009 annual report); similar data were not published in 2008. Also, data on impairment charges on securities used comparative data from 2010 (which differed by £7m for 2009 charge from data in 2009 annual report). Gross loans and advances for certain categories have been estimated by the Review Team: 'Other property and construction', 'Banks and financial institutions' and 'Manufacturing and infrastructure' use 2008 annual report industrial sector disclosures for Property, Finance and Manufacturing; 'Telecoms' use 2009 comparative GBM data to provide a pro rata split of GBM gross loans and advances in 2008; 'Other – other' is calculated from 2009 divisional information as the balancing item between total gross loans and advances and all named divisions apart from Central and RBS Insurance; 'RFS MI' combines 2008 data on loans and advances to customers, loans and advances to banks, reverse repos and stock borrowing and the impairment allowance on loans and advances; and 'Corporate – other – other' is calculated as a balancing item.

Table 2.7: RBS impairment losses by category, as a percentage of gross loans and advances as at end-2008, in 2008, 2009 and 2010[294]

	Impairment losses on loans and advances			
% of end-2008 gross loans and advances	2008	2009	2010	Cumulative 2008-2010
Residential mortgages				
- UK	0.04%	0.17%	0.24%	0.46%
- Ulster	0.09%	0.47%	1.37%	1.93%
- US	0.44%	1.20%	0.58%	2.22%
- US home equity (including SBO)	1.63%	2.57%	1.69%	5.89%
Total residential mortgages	**0.37%**	**0.74%**	**0.74%**	**1.84%**
Personal lending				
- UK personal	4.10%	6.53%	4.21%	14.84%
- UK cards	6.67%	8.44%	4.78%	19.89%
- US cards	9.00%	18.57%	3.29%	30.86%
- US auto and consumer	2.06%	1.95%	1.28%	5.29%
Total personal lending	**3.86%**	**5.36%**	**3.19%**	**12.41%**
Corporate – property				
- UK housebuilding, property and construction	0.72%	2.07%	1.68%	4.48%
- Ulster corporate property, commercial and residential investment and development	1.40%	6.72%	14.03%	22.15%
- US commercial real estate	1.80%	7.60%	6.17%	15.57%
- Other property and construction (GBM)	2.03%	4.04%	3.56%	9.63%
Total corporate – property	**1.31%**	**3.75%**	**4.72%**	**9.77%**
Corporate – other				
- Banks and financial institutions	0.14%	0.14%	0.17%	0.45%
- Manufacturing and infrastructure	1.81%	2.10%	-0.42%	3.50%
- Asset and invoice finance (including Lombard)	1.25%	1.84%	1.47%	4.57%
- Telecoms, media and technology	1.34%	10.67%	0.22%	12.23%
- Other	0.44%	1.59%	0.66%	2.68%
Total corporate – other	**0.50%**	**0.98%**	**0.27%**	**1.75%**
Other				
- Wealth	1.18%	1.78%	0.43%	3.39%
- Ulster and EME other	4.91%	8.67%	7.80%	21.38%
- Other	0.01%	0.00%	0.01%	0.02%
- RFS MI	0.44%	0.72%	0.00%	1.16%
Other	**0.54%**	**0.89%**	**0.22%**	**1.64%**
TOTAL	**0.69%**	**1.38%**	**0.89%**	**2.97%**

294 2008, 2009 and 2010 RBS annual report and accounts and data provided by RBS in September and October 2011. Note that these data are mainly based on the 2009 and 2010 annual reports (2008 figures based on comparative information provided in the 2009 annual report); similar data were not published in 2008. Also, data on impairment charges on securities used comparative data from 2010 (which differed by £7m for 2009 charge from data in 2009 annual report). Gross loans and advances for some categories have been estimated by the Review Team; for details, see the notes to Table 2.6. Comparison does not take into account new lending or redemptions in 2009 or 2010.

Table 2.8: RBS impairment losses on loans and advances by division in 2008 to 2010[295]

£m	2008	2009	2010	Cumulative impairment charges 2008-2010	Significant losses
GBM	(2,702)	(4,571)	(1,335)	(8,608)	Main losses in manufacturing and infrastructure (2008: £1,314m; 2009: £1,448m; 2010: £342m recovery), property and construction (2008: £722m; 2009: £1,441m; 2010: £1,267m) and banks and financial institutions (2008: £375m; 2009: £297m; 2010: £401m).
UK retail banking	(1,124)	(1,732)	(1,173)	(4,029)	Driven by personal lending (2008: £672m; 2009: £1,071m; 2010: £690m).
UK corporate banking	(846)	(2,600)	(1,591)	(5,037)	Significant losses on property and construction (2009: £1,002m; 2010: £813m).
US retail and commercial banking	(1,041)	(1,781)	(1,071)	(3,893)	Main losses on home equity 'Serviced by Others' (SBO) portfolio (2008: £321m; 2009: £445m; 2010: £277m)
Ulster Bank	(526)	(2,033)	(3,895)	(6,454)	Driven by commercial property lending (2008: £275m; 2009: £1,324; 2010: £2,764m)
Other	(239)	(373)	(79)	(691)	
RFS[296] minority interests	(633)	(1,051)	0	(1,684)	
TOTAL impairment losses	**(7,111)**	**(14,141)**	**(9,144)**	**(30,396)**	

295 2009 and 2010 RBS annual report and accounts and 2008 trading update presentation and data received from RBS in September and October 2011. 2009 comparative data used for 2008 impairment losses, due to some restructuring during 2009; however, changes from original 2008 data are immaterial. 2010 comparative data on impairment charges on securities used for 2008 and 2009 data. Impairment losses for business units include losses both on core assets and on those exposures subsequently transferred to non-core. Other includes Wealth, Insurance, Central items and Global Transaction Services and is calculated as a balancing item.

296 RFS Holdings was set up by the consortium partners in order to acquire ABN AMRO.

Table 2.9: RBS impairment losses by division in 2008 to 2010 as a percentage of gross loans and advances as at end-2008[297]

% of end-2008 gross loans and advances	Impairment losses on loans and advances			
	2008	2009	2010	Cumulative impairment charges 2008-2010
GBM	0.65%	1.09%	0.32%	2.06%
UK retail banking	1.16%	1.78%	1.21%	4.15%
UK corporate banking	0.55%	1.68%	1.03%	3.25%
US retail and commercial banking	1.69%	2.89%	1.74%	6.31%
Ulster Bank	0.61%	2.36%	4.53%	7.50%
Other	0.74%	1.15%	0.24%	2.13%
RFS minority interests	0.44%	0.72%	0.00%	1.16%
TOTAL impairment losses	**0.71%**	**1.42%**	**0.92%**	**3.05%**

1.3.4 RBS's losses compared to other major UK banks

236 Despite the high losses which RBS suffered, comparative analysis of losses as a percentage of loans and advances does not show RBS as an outlier relative to its peers. For end-2008, HSBC, Lloyds TSB and HBOS all reported impairment losses which were higher than RBS's as a percentage of total customer loans. RBS's cumulative losses from 2008 to 2010 were above average, but not drastically so.

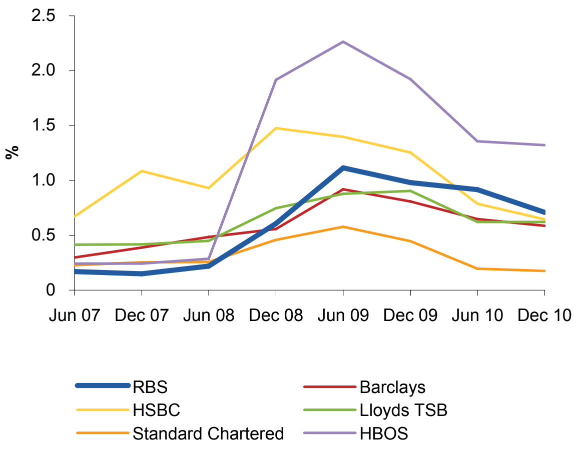
237 Graph 2.9, Graph 2.10 and Graph 2.11 compare asset quality and impairments of the six major UK banks[298] from 2007 to 2010 and show how RBS's relative position evolved on these measures.

- As shown in Graph 2.9, RBS initially had one of the lowest rates of impairment charge as compared to gross loans and advances to customers. This may raise questions about the conservatism of its impairment approach in the pre-crisis years. By 2010 it was recording the second highest impairment charges, but these remained notably lower than those seen at HBOS.
- A similar picture emerges when comparing non-performing loans and impairment allowances as a proportion of loans and advances to customers. In both Graph 2.10 and Graph 2.11, HBOS is a clear outlier. RBS's levels of non-performing loans and impairment allowances grew both in their own terms and relative to RBS's peers between mid-2007 and end-2010, RBS

297 2008, 2009 and 2010 RBS annual report and accounts and information received from RBS in September and October 2011. Non-Core impairments shown as part of donating division. Other includes Wealth, Insurance, Central items and Global Transaction Services and is calculated as a balancing item. Loans and advances estimated using available divisional information. These estimates give a total for loans and advances of £996.7bn compared to total gross loans and advances of £1,023.9bn (approximately 3% error). Comparison does not take into account new lending or redemptions in 2009 or 2010.

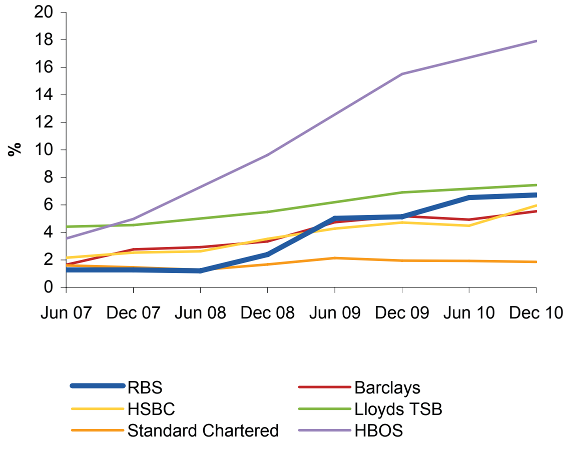
298 Peers for this analysis were Barclays, HSBC, Lloyds TSB, Standard Chartered and HBOS (with HBOS and Lloyds TSB shown separately even after the completion of their merger in early 2009).

Graph 2.9: Impairment expense for loans and advances to customers/gross loans and advances to customers, mid-2007 to end-2010[299]



Source: Published annual reports and interim results.

Graph 2.10: Non-performing loans/gross loans and advances to customers, mid-2007 to end-2010[300]



Source: Published annual reports and interim results.

moved from a very low starting point in 2007 to a relatively poor position in 2010.

238 Analysis by specific category of lending (such as commercial real estate) would be required to reach more precise conclusions about RBS's asset quality and credit underwriting practices relative to competitors. Unfortunately, the Review Team could not conduct such historic analysis of banks' portfolios given the information available (and in particular the lack of a clearly consistent approach across firms to the categorisation of exposures and losses by sector and geography in published annual reports). Therefore, caution is required in interpreting Graphs 2.9, 2.10 and 2.11.

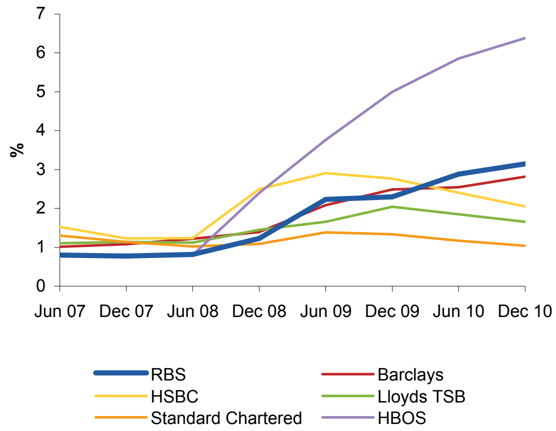
239 In particular, different asset portfolio compositions can have a significant effect on average impairment levels and some elements of the trends in the graphs above were due to firms' decisions about business strategy. Firms which were active in sub-prime lending or with large credit card portfolios, for instance, would have expected higher impairment levels in these portfolios and would have reflected those higher rates of expected loss by applying greater risk premia. For example, HSBC realised significant impairment losses between 2007 and 2010 on exposures to sub-prime lending in its US HSBC Finance subsidiary (which incorporated Household International, a consumer lending firm that HSBC had acquired in 2003). Different impairment methodologies also had an effect.

240 However, it is clear that, while not an outlier like HBOS, RBS's asset quality deteriorated from 2007 to 2010, with large losses across many sectors resulting from rapid asset growth before the crisis. During that time it moved away from its position of having some of the lowest levels of impairment and non-performing loans in its peer group to exhibiting asset quality below the average of its peers.

299 Note that data were not available for Lloyds TSB Group in interim or annual results for 2010 excluding HBOS. Therefore the impairment charge for Lloyds TSB Bank is used as a proxy for the measure for Lloyds TSB and, due to a lack of data in 2010 interim results, the impairment charges are assumed to accrue evenly throughout 2010.

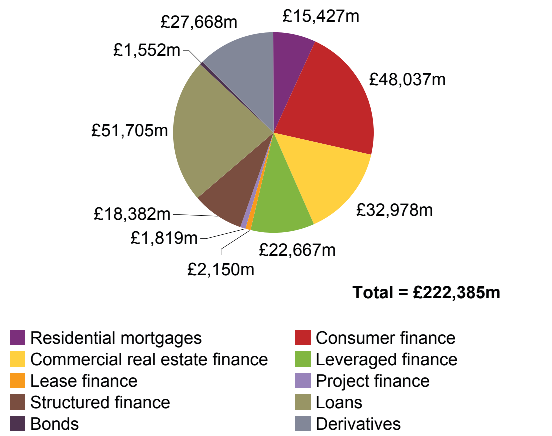
300 Comparable data on non-performing loans were not available in interim results for Lloyds TSB or HBOS, so annual figures were used. For mid-2007, the Review Team compared data for end-2006 and end-2007 to provide an average for both HBOS and Lloyds TSB. Lloyds TSB did not provide these data in its 2006 annual accounts, however, so the comparative figure for 2006 in the 2007 accounts was used.

Graph 2.11: Impairment allowance/gross loans and advances to customers, mid-2007 to end-2010[301]



Source: Published annual accounts and interim results.

Graph 2.12: Par value of assets covered by the APS by asset class as at end-2008



Source: *Royal Bank of Scotland: details of Asset Protection Scheme and launch of Asset Protection Agency*, HM Treasury, December 2009.

241 A combination of poor asset quality and inadequate capital drove the need for the provision of UK government tail-risk insurance through the Asset Protection Scheme (APS). This was put in place during 2009 and was a further indicator of the poor quality of many of RBS's assets and the inability of its capital levels (even after a public capital injection of £20bn in October 2008) to support the expected future losses on these assets.

242 Graph 2.12 shows the asset classes covered by the APS. The £222bn[302] assets (plus a further £59.6bn of potential exposures from undrawn commitments) initially covered by the scheme encompassed a range of different sectors and activities. Asset selection was driven by risk and degree of impairment expected in a base case and stressed scenarios, as well the liquidity and capital intensity of exposures.[303] Although structured credit assets and other trading assets from GBM comprised a significant proportion of covered assets (as shown in Section 1.5.2, 47% of the RBS assets covered originated from GBM), many banking book assets were also included. Other significant concentrations in assets covered included consumer finance (£48bn), commercial real estate (£33bn) and leveraged finance (£23bn).

1.3.5 Market perceptions about the quality of RBS's non-traded assets

243 While Sections 1.3.2, 1.3.3 and 1.3.4 describe the losses which RBS *actually* incurred over the period 2008 to 2010, the precise scale of these losses was not known in advance. In explaining RBS's failure in autumn 2008, it is important to identify and understand the market *perceptions* of RBS's asset quality that played a role in the collapse in confidence and which resulted in a funding crisis. The Review Team has attempted, from analysis of contemporaneous research reports and analysts' questions, and from interviews conducted with investors

301 Data for Lloyds TSB were not available in the 2010 interim results, and at end-2010 a Bank only figure was used, due to the consolidation of HBOS in the Lloyds TSB Group accounts.

302 Par value of covered assets as at end-2008. *Royal Bank of Scotland: details of Asset Protection Scheme and launch of Asset Protection Agency*, HM Treasury, December 2009.

303 2009 RBS annual report and accounts.

active at the time, to identify the extent to which market participants were concerned about RBS's overall banking book asset quality as well as about the structured credit trading losses which were already largely visible by mid-2008.

244 In 2005, RBS management faced general questions from analysts on the rate of balance sheet growth, and requests for guidance on the speed of risk-weighted asset growth and for indications as to sustainable balance sheet growth rates. This continued in the first half of 2006, when analysts also asked about the drivers for growth in GBM.[304]

245 RBS's commercial property exposures were a recurrent theme in analysts' calls and broker reports throughout the Review Period, particularly given RBS's significant market share.[305] This intensified in late 2007 and early 2008, when market participants raised commercial property exposures alongside structured credit, leveraged finance and other riskier asset classes. For example, in March 2008, Reuters reported on a Merrill Lynch survey note which identified RBS (along with three other banks) as having *'the most aggressive lending standards in the UK commercial property market*'.

246 In 2008, broker reports and credit rating agencies noted a general concern about the likelihood of rising impairments in the UK banking sector, given the outlook for the UK economy. Moody's considered RBS's exposures to commercial property lending in the UK, the USA and Northern Ireland as particularly vulnerable to higher impairment charges.[306]

247 In meetings with the Review Team, a few hedge funds and institutional investors articulated that, by mid-2008, they had become concerned about the growth of RBS's balance sheet in recent years and the capacity of RBS's Board and senior management to assess the consequent risks in the bank. Specific areas of concern mentioned included RBS's corporate lending, exposure to the Irish property market, and single name exposures. One fund manager noted he had warned RBS that it should expect a rise in impairments on corporate lending.[307]

248 However, these views contrasted with those captured in RBS's 2006 investor survey and some contemporaneous analyst reports. The latter indicated that RBS was well regarded for not having exposure to sub-prime lending, and that asset quality in Citizens was considered to be good. In late 2007 and early 2008, the predominant concern of many institutional investors was RBS's credit trading assets, rather than its loan book.

249 The inherent complexity of RBS's financial reporting from end-2007, following the acquisition of ABN AMRO via a complicated consortium structure, also affected market participants' view of RBS's exposures. This complexity made it more difficult to communicate with the market about the transaction risks and

304 Review Team analysis of analysts' calls, transcripts sourced from Thomson StreetEvents.
305 Review Team analysis of analysts' calls, transcripts sourced from Thomson StreetEvents. Comparing De Montfort University's UK Commercial Property Lending Market Survey for end-2007 to RBS's UK commercial real estate exposure of £60bn (as reported in a Lehman Brothers broker report in Feb 2008) suggests around a 30% share of the UK lending market. This is commensurate with RBS's market share of 28% in 2005 (FSA records, June 2005) and with exposure data provided in 2008 RBS annual report and accounts. However, the size of the market grew during the Review Period and hence RBS's exposure to commercial real estate grew in absolute terms.
306 Moody's report, 27 June 2008.
307 Review Team discussions with hedge funds and institutional investors, July 2011.

RBS's underlying position. The presentation of the acquisition and its impact, involving extensive use of pro forma[308] financial statements alongside statutory reporting formats, had the effect of obscuring the firm's presentation of risks and exposures, as well as its underlying capital position.[309] This occurred at the very point when market participants began to voice concerns about the lack of transparency of banks' exposures.[310]

250 In summary, it is clear that RBS's involvement in certain asset classes (such as structured credit and commercial real estate) left it vulnerable to a loss of market confidence as concerns about the potential for losses on those assets spread. It is less easy to tell, with any degree of certainty, how investors and market counterparties judged the quality of other parts of RBS's balance sheet during the Review Period, especially in comparison to peers. However, the Review Team saw that market perception of asset problems was not limited to structured credit. How market perceptions developed in mid-2008, prior to the firm's failure in October 2008, is discussed in Section 1.6.

1.3.6 FSA regulation and supervision of RBS's balance sheet and asset quality

251 The FSA's overall supervisory approach to RBS (and its peers) prior to the market turmoil in autumn 2007 involved little fundamental assessment of firms' underlying assets, or balance sheet structure.[311] Instead, the focus was primarily on encouraging the firm to improve its own stress-testing methodologies. This focus on management process for assessing asset quality, rather than on substantive analysis by the FSA of a firm's asset composition and quality or on senior management experience in relation to significant areas of new business, was characteristic of the FSA's pre-crisis supervisory approach.

Overall approach to asset quality

252 During the Review Period the FSA did not conduct the intensive balance sheet analysis which was later put in place to inform decisions relating to bank recapitalisation, the APS and the FSA's rolling programme of detailed and intensely supervised bank stress-tests. That work, which commenced in autumn 2008 and has intensified since, has required specialist resources significantly in excess of those available during the Review Period.[312]

253 The consequence of the prevailing approach was that the nature of the risks inherent in the assets held by RBS was not fully appreciated by the FSA until

308 In its financial reporting for the periods after the acquisition, RBS made use of pro forma financial reporting so as to present its performance on the basis of only the parts of ABN AMRO that would be retained by RBS. While potentially helpful to users wishing to assess the future development of RBS once it had integrated its share of ABN AMRO, such presentation did not fully capture RBS's role, during the transition phase, in relation to other parts of ABN AMRO.

309 For example, broker reports in Q1 2008 included comments such as '*These results are some of the poorest disclosure we have seen and the fact that there is no split in some cases between the standalone company and the acquisition vehicle is misleading*' (*Royal Bank of Scotland 2007 FY Results – The messiest set of figures we have seen – ALERT*, JPMorgan, 28 February 2008) and '*The effect of the ABN AMRO transaction makes the end-2007 numbers* [on loan impairment] *much less useful*' (*Barclays/RBS: Risky business*, Dresdner Kleinwort, 22 September 2008).

310 The reduction in market confidence in the banking sector in mid to late 2007 is discussed further in *The Turner Review*, March 2009 and *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience,* Financial Stability Forum, 7 April 2008.

311 FSA Discussion Paper (DP) 09/2, *A regulatory response to the global banking crisis*, March 2009.

312 *The Turner Review*, March 2009.

after the firm had accumulated substantial portfolios and market conditions had deteriorated. In retrospect, this demonstrates weaknesses with that approach: a limited focus on firms' underlying assets; a lack of focus on business risk; and an over-reliance on firms' senior managements' ability to control large, dispersed and complex operations. While the FSA's ARROW letter to RBS in 2007 reflected the inherent risks associated with the continued pace of growth in GBM, it did not raise concerns about the size, leverage or composition of RBS's balance sheet, nor about the understanding of RBS senior management of the risks inherent in this growth. The FSA's assessment and supervision of management quality, organisational structure and control systems at RBS is described in Section 2.3.4.

254 Nevertheless supervisors did raise some concerns. During the 2005 ARROW assessment, the Supervision Team considered a number of regulatory responses to RBS's growth strategy, including direct regulatory intervention by placing a cap on the level of commercial property lending[313] and increasing the firm's individual capital ratio. However, the Supervision Team concluded that these measures were not necessary at that stage, a view supported by the FSA's internal ARROW Panel. This conclusion not to use these tools and instead focus on the firm's own stress-testing reflected the then current perceptions of benign conditions in the market, which set the context for assessing the risks of RBS's strategy before August 2007. With hindsight it was an opportunity lost, given RBS's decision to continue to increase commercial property lending in Ulster Bank, UK Corporate Banking and GBM, with the resulting concentration of risk and the subsequent losses.

255 However, although the FSA did not directly intervene in relation to RBS's commercial property exposure, this was consistently highlighted by the FSA and Bank of England as a cause for concern. Papers prepared by the FSA and Bank of England to the Tripartite Standing Committee on Financial Stability highlighted RBS's significant growth and concentration in this sector from well before the Review Period, and it continued to be raised and monitored by the authorities in 2006, 2007 and 2008.

Stress-testing

256 Rather than focusing on ensuring direct FSA understanding of RBS's asset portfolio compositions and quality, the FSA's response to RBS's rapid asset growth was to require the bank to improve its stress-testing and risk oversight processes.[314] In the ARROW letter of 2005, the Supervision Team informed RBS that it had considered but rejected requiring the firm to limit its commercial property exposure or increasing RBS's capital requirements. But it said that RBS should develop a stress-testing approach which considered the impact of a sustained economic slowdown on its commercial property lending and overall loan portfolio. The RBS Board was also asked to review its exposure to the

313 A cap on lending was a tool used by the authorities in the 1973-1975 property finance banking crisis. But although it was explicitly considered in this instance, the use of the tool by the FSA during the Review Period would have been unusual.

314 This was discussed at a Supervision Policy Committee in January 2005 and agreed by the 2005 ARROW Panel as a more constructive approach. FSA records, January 2005.

corporate sector and the adequacy of risk management, including '*considering the current degree of concentration, what levels of market share would present unacceptable levels of concentration.*'

257 The use of stress-testing as a tool reflected the increasing emphasis given to macroeconomic stress-testing within the FSA's regulatory regime from 2005 to 2007. Stress-testing also had a prescribed role as part of the models-based approaches within the Basel II capital agreements (as discussed in Section 1.1.4). Firms' macroeconomic stress-testing methodologies and the FSA's expectations of firms' stress and scenario testing developed during this time. The prevailing FSA approach was that strategy and risk appetite were matters for a firm's Board. Stress-testing was an important part of this process. The FSA therefore sought comfort that Boards had adequately engaged with and debated these matters.

258 In a meeting to discuss the draft 2005 ARROW letter, the RBS CEO accepted the Supervision Team's recommendation to develop its macroeconomic stress-testing, although he admitted that RBS would not have done so '*if left to itself*'. As a result of this agreement, the wording of the letter was softened. The Review Team's view was that amending the letter in this manner may have reduced the force of the message to the RBS Board about the extent of the Supervision Team's concern about the sufficiency, to date, of RBS's risk management of its corporate lending portfolio.[315]

259 Consideration of RBS's commercial property exposure led the Supervision Team to work with RBS on a wider macroeconomic stress-testing initiative. RBS presented papers on the output of stress-testing exercises to its Board in 2005 and 2006. During 2006, the Supervision Team became concerned that the Board, and in particular the non-executive directors (NEDs), had not had a substantive debate or provided sufficient challenge or scrutiny on the firm's macroeconomic stress-testing (as noted following the Supervision Team's meeting with the NEDs in January 2006).[316] The Supervision Team also encouraged RBS to consider a '*destruction scenario*', with the aim that the Board would thereby quantify its risk appetite.[317] The RBS Board's discussions on stress-testing are discussed further in Section 2. However, it was considered difficult for the Supervision Team to do more to promote RBS Board discussion. The FSA was aware at that time that many firms found it challenging to establish sufficient Board engagement in stress and scenario testing.[318]

260 As part of the FSA's general strategy, the FSA and the Supervision Team continued to engage with RBS on stress-testing throughout the remainder of the Review Period.

315 The original wording of '*our primary concern now is that we judge there to be insufficient stress-testing of the corporate loan portfolio, which is both substantial and accounts for a significant share of UK banks' lending to UK corporates*' was changed to '*we are pleased that the Group has now agreed to undertaking a stress test of the Group's overall loan portfolio against a sustained economic slow-down more generally*'. The note for record of the meeting with the RBS CEO refers to a '*softening*' of the letter on this point. Both drafts of the letter noted that '*RBSG has a substantial UK corporate lending portfolio and accounts for 30-35% of the major UK banks' lending in many industrial and commercial sectors … The Group has continued to grow its commercial property portfolio rapidly … The FSA is concerned that a sustained deterioration in the corporate sector could have the potential to significantly impact on the Group's profitability and capital position*'. FSA records, January to February 2005.

316 FSA records, January 2006.

317 FSA records, May 2005.

318 FSA records, January 2006.

- In 2006, the FSA conducted a thematic review of stress-testing in ten firms, including RBS. This set out examples of good practice. Amongst its findings, the report noted that close engagement by senior management led to the most effective stress-testing practices. However, most firms, including RBS, were experiencing difficulties in conveying a '*severe but plausible*' stress to Board members and senior management.[319] Overall, the thematic review concluded that RBS's '*stress-testing framework stands up well within the peer group*'.[320]

- In direct feedback to RBS following the thematic review, FSA specialists and the Supervision Team highlighted the importance of Board engagement and noted some other weaknesses in the firm's stress-testing practices.[321] The Supervision Team told the firm that it intended to re-visit stress-testing through ongoing supervision and the Supervisory Review and Evaluation Process (SREP), and would be looking for continued development of the firm's macroeconomic stress-testing methodology to support Board and senior management debate.[322]

- Throughout 2006, the Supervision Team also learned more about the firm's 'CELT' system for considering credit risk. This identified the impact of stress scenarios on the firm's impairment charge at group level on a monthly basis. Some RBS directors recalled positive feedback from the FSA on this system.[323]

- During the SREP in 2007, the Supervision Team observed '*improvement in the quality of quantitative information available to aid decision making at Board level, most notably in the discussion of the outputs from stress-testing work with the Board examining the impact of macro economic scenario testing*'. As part of RBS's risk mitigation programme, the Supervision Team asked the firm to provide updates to the FSA twice a year on the development of its stress-testing methodology and outputs.[324]

261 Overall, the supervision of RBS in relation to stress-testing (and asset quality more generally) met prevailing practices. Indeed, the Supervision Team's encouragement to the firm to consider a point of failure scenario went beyond the prevailing practices. The Supervision Team was also clear in communicating to the firm its expectations on the severity of the stress to be performed and the desired output, despite challenge from the firm's senior management and NEDs on the probability of such a scenario.

262 However, the development of RBS's macroeconomic stress-testing had been defined by Supervision as the alternative that justified rejecting the options of specific caps on commercial real estate lending or an increase in RBS's capital requirement. Given the apparent lack of progress by RBS's Board and senior management to engage with macroeconomic stress-testing as an effective risk management tool, it is arguable that the Supervision Team should have done more to try to ensure that

319 FSA records, October 2006.
320 FSA records, October 2006.
321 FSA records, September and October 2006.
322 The Supervision Team also requested the underlying analysis from a paper presented by RBS to its Board in December 2006. FSA records, December 2006.
323 Review Team meetings with RBS senior management and non-executive directors, June to August 2011.
324 FSA records, October 2007.

the Board had adequately engaged in stress-testing. Moreover, given the imperfect progress of RBS to ensure robust stress-testing processes, the Review Team considered that Supervision should have revisited the judgement that stress-testing was an effective approach to mitigating commercial property lending risks. The fact that it did not do so represented a weakness in the FSA's supervision.

263 More generally, while the FSA was developing a focus on stress-testing during the Review Period, its approach to stress-testing at that time remained inadequate for firms of significant scale and complexity such as RBS. The approach focused too much on high-level process definition with inadequate FSA review of detailed stress-testing assumptions and methodologies and of stress test results. Key weaknesses in the FSA's prevailing stress-testing regime were identified in *The Northern Rock Report*.[325] These included a lack of robust supervisory focus on stress-testing and a lack of training for supervisors to support this. The FSA has subsequently revised its approach to the assessment of firms' underlying asset quality, including the impact of stressed scenarios (see Appendix 2D).

Conclusions on what happened in RBS

- RBS's organic balance sheet growth during the Review Period was rapid but in line with peers during the Review Period. However, the acquisition of ABN AMRO, when added to organic growth (largely driven by GBM and including growth in derivative assets), meant that growth in total assets in 2007 was very significant and in excess of that of peers.
- In addition to credit trading losses, RBS recognised significant losses due to impairment of loans and securities during 2008 and thereafter. These losses were above average, but did not make RBS an outlier amongst its peers.
- Market concerns were not restricted to RBS's structured credit and other trading assets. While most of the loan impairment losses were only recognised after the Review Period, market concerns about RBS's loan book were among the factors which drove a loss of confidence in autumn 2008.

Conclusions on the FSA's regulation and supervision

- Before the onset of the market disruption in August 2007, the FSA's supervisory approach involved little fundamental analysis of balance sheet composition or asset quality.
- Overall, however, in relation to both the general approach to asset quality and the development of macroeconomic stress-testing, the Supervision Team met the prevailing, but in hindsight inadequate, practices.

325 *The supervision of Northern Rock: a lessons learned review* (*The Northern Rock Report*), FSA Internal Audit Division, March 2008.

Lessons already identified where actions have been taken

- The FSA's supervisory approach during the Review Period did not focus sufficiently on analysis of firms' underlying assets and off balance sheet exposures. Work on asset quality now forms a key element of the FSA's supervision of the largest high impact firms.
- The FSA's stress-testing regime in place throughout the Review Period was inadequate and needed to be improved. Following the crisis and *The Northern Rock Report*, significant improvements have been made to the FSA's approach to the assessment of firms' underlying asset quality, including the impact of stressed scenarios.

Recommendations for further change

None

1.4 Losses in credit trading activities

264 As explained in Sections 1.1 and 1.2, the overall deficiencies of the capital and liquidity regimes, and RBS's relatively risky position even within the existing rules, made RBS highly vulnerable. When problems in US sub-prime mortgage markets spread to structured credit and other related asset classes in 2007, RBS became a target for market concerns.

265 Credit trading losses of £12.2bn drove RBS's £8.5bn overall trading loss for 2008. More generally, losses for 2008 were concentrated in RBS's investment banking division within Global Banking and Markets (GBM). GBM's losses are shown in Table 2.10.

266 These large losses on structured credit, leveraged finance and other credit trading activities eroded both capital and market confidence and were a factor in RBS's failure in 2008. The significant losses on structured credit also gave rise to concerns over the controls in GBM, and the Chairman of Global Markets (who oversaw GBM) was subsequently subject to an enforcement investigation. Additional details on RBS's structured credit and leveraged finance businesses are included in Part 3.

267 The key points made in this section are:

- In mid-2006, RBS took a strategic decision to expand aggressively its structured credit and leveraged finance businesses. By early 2007, this strategy had resulted in the accumulation of significant credit risk exposures in its trading portfolio, in particular via RBS's holdings of super senior tranches of collateralised debt obligations (CDOs) structured out of US sub-prime mortgages.

Table 2.10: Losses in GBM in 2008[326]		
	£bn	
Net interest income	4.0	
Net fees and commissions receivable, and other operating income (net of related funding costs)	2.1	
Gains on own debt carried at fair value	0.4	
Income from trading activities	**4.0**	
Other structured credit	(2.4)	Positions not included in the SAU credit market exposures below.
Counterparty failures	(2.3)	Including Lehman Brothers (£0.7bn), Madoff (£0.6bn) and the Icelandic banking sector (£0.6bn).
CDPCs[327]	(0.6)	CVAs[328]
Principal finance	(0.5)	Losses on merchant banking and private equity portfolios.
Trading asset write-downs	**(5.8)**	
Trading losses on SAU credit market exposures	(7.3)	
Impairment losses on SAU credit market exposures	(0.5)	CDOs of residential mortgage-backed securities (RMBSs) reclassified as available for sale (AFS).
Total losses on SAU credit market exposures	**(7.8)**	Including losses on CDOs, monoline exposures, leveraged loans and certain other US mortgage-backed security (MBS) products which had been specifically identified and managed as legacy business within a 'strategic assets unit' (SAU) since spring 2008.
Impairment (other than impairment recognised on reclassified assets)	(3.2)	Including impairment of a large single name exposure (£0.9bn).
Direct expenses (staff costs, operating lease depreciation and other)	(4.4)	
Contribution	**(10.5)**	

- In spring 2007, RBS ceased accumulating new exposures in its structured credit business. But it initially assumed, along with many other market participants, that super senior tranches would not be affected by increasing delinquencies in the underlying assets.

- The acquisition of ABN AMRO considerably increased RBS's exposures to these assets, and therefore its vulnerability to market concerns, at the

326 February 2009 RBS Results Slides; 2008 RBS annual report and accounts; and data provided in March 2011 by RBS. Table does not cast due to rounding of figures from annual report and accounts.
327 Credit derivative product companies (CDPCs).
328 Credit valuation adjustments (CVAs) are defined in the 2008 RBS annual report and accounts as representing '*an estimate of the adjustment to fair value that a market participant would make to incorporate the credit risk inherent in counterparty derivative exposures*'.

point when structured credit and other credit trading activities became less attractive. These exposures resulted in significant additional losses.

- RBS subsequently realised substantial losses on its credit trading activities. In its response to emerging evidence of deteriorating credit conditions and its ability to distribute positions to others, RBS (although not alone in this among other major banks and investment banks) was among the less successful. In addition, while RBS's approach to the valuation of its CDOs was within the bounds of what could be justified, it displayed a bias to optimism.
- In the context of a loss of confidence in US sub-prime that rapidly spread across the financial sector in 2007 and 2008, credit trading exposures acquired very great significance, with firms active in this area becoming a focus of market concerns.
- The FSA's supervisory approach to RBS (and its peers) did not involve sufficient focus on investment banking activities. With hindsight, the predominant regulatory approach to trading book risk (i.e. reliance on value-at-risk, or VaR, models) was deficient. In particular, it did not focus on analysing the underlying trading book inventory.

268 These points are explained in more detail in:

- Section 1.4.1, which describes the organic growth of RBS's credit trading activities and the impact of the ABN AMRO acquisition;
- Section 1.4.2, which sets out RBS's subsequent losses on credit trading; and
- Section 1.4.3, which describes the FSA's regulation and supervision of RBS's trading activities.

1.4.1 RBS's credit trading activities – organic growth and the impact of the ABN AMRO acquisition

269 This section considers RBS's developing exposure to asset-backed securities (ABSs), CDOs, related exposures to monoline insurers (which provided credit insurance on ABSs) and leveraged finance markets in the period to spring 2007. It describes both the organic growth of RBS's existing business and the expansion of RBS's exposures as a result of the acquisition of ABN AMRO.

270 The market in structured credit evolved rapidly from the mid-1990s, both in terms of the scale of credit securities in issue and the complexity of the structures created and distributed.

271 From mid-2006, RBS was committed to growing aggressively in structured credit. Its strategy in this market in autumn 2006 and in early 2007 was based on structuring and distributing CDOs constructed from mortgages originated by other firms; many of the underlying mortgages were 'sub-prime' in quality. This was not originally intended to result in a large accumulation of assets on the balance sheet, except for the period of time that a new CDO was in the

'warehouse' awaiting distribution (see Box 3.1 in Part 3 for an explanation of a CDO).

272 RBS's growth in this area continued until the structured credit markets deteriorated in early 2007. In its pursuit of growth, RBS at that time shared the mistaken beliefs of much of the market, and indeed regulators and other policy-makers, in two respects:

- A failure to understand how bad losses in sub-prime lending could be.
- An assumption that even if sub-prime losses could be significant, AAA and AA tranches would be safe. Indeed, there was a failure until spring 2007, on the part of some RBS senior management, to understand that the senior tranches that RBS held were actually constructed from underlying assets of sub-prime quality.[329]

273 The deterioration in the structured credit market meant that, whereas RBS had initially been able to distribute all of the assets, it became unable to do so. RBS, therefore, like other firms, accumulated significant holdings of super senior tranches because:

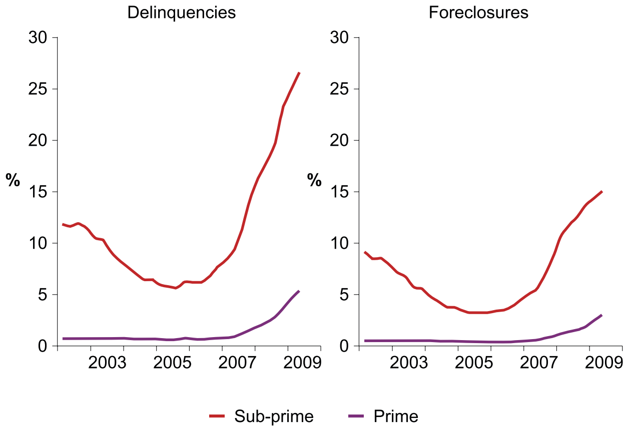
- It proved possible to distribute the junior tranches of the CDOs, which, while higher risk, promised higher yields. This met investor demand for increased yields in the face of very low rates of return on risk-free instruments such as Treasury bonds.
- But by the time RBS had reduced the CDO warehouse and sold off the junior tranches, there proved to be inadequate demand for the super senior tranches.[330]

274 It is not clear in retrospect how far RBS anticipated these market developments, but it is clear that RBS, like other firms, considered the risk of the open exposure retained by holding the super senior CDOs to be very low. This assumption was underpinned by the high credit ratings that super senior tranches had been awarded.[331] It was also reflected in the very low capital that regulators required against these supposedly low risk assets.

275 The pooling and tranching of loans to create products which attracted high credit ratings, making them appeal to a broad range of investors, had driven much of the complexity of the structured credit market. The labelling of certain tranches as '*super senior*' created an impression of strong creditworthiness, which proved to be an illusion in the face of the significant write-downs ultimately taken. The tranching and rating process often veiled liquidity and maturity mismatches within the underlying assets and created, from the investors' perspective, a degree of detachment from the underlying asset quality. The high credit ratings, at least for some investors, also increased the perceived liquidity and market price stability of these structured credit products.[332]

329 RBS records, February to March 2007; RBS records, April 2007 and FSA records, July 2009.
330 RBS records, March 2007 and FSA records, October 2009.
331 FSA records, July 2009.
332 *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience,* Financial Stability Forum, 7 April 2008; *The Turner Review*, March 2009; and FSA Discussion Paper (DP) 09/2, *A regulatory response to the global banking crisis*, March 2009.

Graph 2.13: US mortgage delinquencies and foreclosures (percentage of total residential loans outstanding, quarterly)[333]



Source: Bloomberg Finance LP.

276 As shown in Graph 2.13, defaults in US sub-prime and Alt-A loans began to increase in 2006, and arrears on sub-prime mortgages rose to over 13% in Q4 2006.[334] During 2007, market concerns about institutions' exposure to US sub-prime mortgages spread to other asset classes and to structured credit in particular. A steady rise in delinquencies led to losses and margin calls for holders of products backed by sub-prime, as indices based on sub-prime related assets fell sharply.[335] Firms active in these riskier asset classes suffered greater losses and were more vulnerable to a loss of confidence, especially as liquidity contracted in several markets, investors' risk appetite reduced, and positions became harder to value.[336]

RBS's organic growth

277 RBS was one of several of the UK's largest banks which, along with other global investment banks, were major players in structured credit markets and had significant trading activities.[337] GBM already had a significant credit markets business in structured credit and leveraged finance in 2005. In 2006, RBS decided to expand aggressively its structured credit business and in particular to issue more CDOs. This was seen as a key driver of revenue growth: GBM revenues from structured credit were projected to grow from £51m in 2005 to £128m in 2006, £200m in 2007 and £300m in 2008, with contributions expected to grow from £3m in 2005 to £200m by 2010. In 2007, this initiative was expressed as an objective for GBM to become the leading player by profits in structured credit and leveraged finance by 2010.[338]

278 The US arm of GBM, RBS Greenwich Capital, already structured, distributed and traded various types of ABS, and RBS had been acting as lead manager for clients issuing CDOs prior to 2006. In addition, RBS had been active in

333 Delinquencies defined as loans in arrears for more than 90 days.
334 *Financial Stability Report*, Bank of England, April 2007.
335 *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*, Financial Stability Forum, 7 April 2008.
336 *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*, Financial Stability Forum, 7 April 2008; and *Financial Stability Report*, Bank of England, October 2007.
337 *The Turner Review*, March 2009.
338 RBS records, February 2007.

leveraged finance since 1993. This was another area that the firm sought to expand in 2006 and 2007.[339]

279 RBS's strategy to expand its structured credit and leveraged finance business was clear to the markets: investor presentations in November 2006 noted that RBS aimed to '*Maintain leading rank in securitisation (market growth outside US and recovery in US)*' and to increase US market share in leveraged finance.[340] One aspect of the strategic rationale for the ABN AMRO acquisition was the opportunity that its global clients and wholesale banking business provided for RBS to accelerate its existing GBM and wholesale strategy.[341] In this period RBS can be seen as making decisions which in retrospect were very mistaken, but reflected the common failures of much of the industry, regulators and other policy-makers (against which the '*shorts*' were a minority of people with more foresight).[342]

280 A key illustration of the delusions of this time is that RBS simply did not view this business as particularly large relative to the size of the firm as a whole. This is because, in profit terms, it was not – as evidenced by the estimates of £200m profit by 2010. RBS perceived that what was at risk was a profit shortfall versus budget. It did not consider its structured credit exposures in balance sheet terms, and was unable to imagine a situation in which, for example, credit market exposures of £28.4bn as at end-2007 would contribute £7.8bn of losses in 2008.[343] RBS's monitoring and internal reporting of structured credit exposures is discussed in Part 3 Section 1.8.

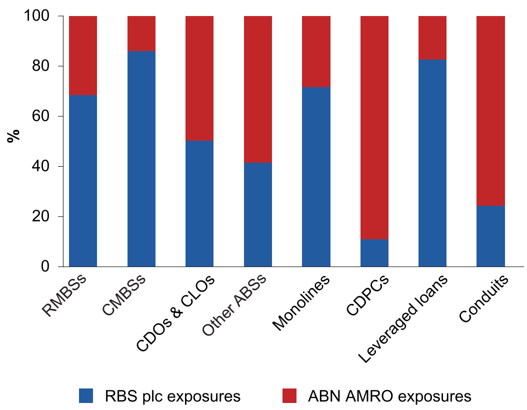
Additional exposures resulting from the ABN AMRO acquisition

281 ABN AMRO entered the structured CDO market in Q1 2007. This was later than many other banks and meant that the quality of assets underlying ABN AMRO's high grade CDO positions was weaker than those held by peers. So, as ABN AMRO was building up its exposures, accumulating a net balance sheet exposure of £1.5bn to super senior tranches of CDOs by end-2007, many other market participants were reducing theirs.[344]

282 RBS was well aware that ABN AMRO had exposures to these products. Indeed, synergies between ABN AMRO's and RBS's global clients and wholesale banking businesses were part of the rationale for proceeding with the acquisition after the purchase of LaSalle had been thwarted by LaSalle's sale to Bank of America (see Section 1.5.1). Therefore, given RBS's overall strategic attitude to this business, it is unclear whether additional due diligence would have given RBS significant cause for concern about the potential for additional losses in ABN AMRO's structured credit exposures or prevented it going ahead with the acquisition. Rather, the fact that RBS went ahead with the acquisition, on the basis of a predominantly

339 RBS records, 2006 and 2007.
340 RBS Divisional Investor Presentation, 9 November 2006.
341 Offer document, 20 July 2007. This referred to improving the combined entity's product ranking to market leader in both global securitisations and European leveraged loans.
342 *The Big Short: Inside the Doomsday Machine*, Michael Lewis, 2010.
343 RBS records, August 2008, 2008 RBS annual report and accounts, RBS records, Q1 2008 and Review Team meetings with RBS directors (May to August 2011). These credit market exposures were subsequently managed separately as part of the '*strategic assets unit*', as discussed in paragraph 304.
344 RBS Group Internal Audit report, July 2008.

Graph 2.14: Percentage of RBS's total net credit market exposures at end-2007 split between RBS plc and ABN AMRO[345]



Source: 2008 RBS Group, ABN AMRO NV and RBS plc annual reports and accounts.

wholesale banking rationale, and in the face of emerging problems in structured credit and other products in late spring 2007, illustrates weaknesses in its understanding of those emerging problems.

283 Graph 2.14 shows the proportion of RBS's total exposures to certain asset classes at end-2007 that it acquired through ABN AMRO. RBS accounted for most of the combined exposure to commercial MBS (CMBSs), RMBSs, monolines and leveraged loans, whereas the majority of exposures to conduits, credit derivative product companies (CDPCs) and other ABSs came from ABN AMRO. CDO and collateralised loan obligation (CLO) exposures were fairly evenly split.

1.4.2 RBS's credit market exposures and losses – the story after spring 2007

284 This section describes developments within RBS's trading business after the market turn of early 2007. It describes how:

- RBS ceased originating new structured credit in early 2007 but was left holding super senior tranches of CDOs which it was unable to distribute.
- RBS, like other banks in the same position, had to decide whether to close out or hedge structured credit positions, and how to value its positions in the face of steadily falling prices. While its decisions on these issues were not unreasonable, they appear to have been influenced by a bias to optimism.
- RBS incurred major losses on structured credit assets, monoline exposures and leveraged finance which eroded its capital base and undermined market confidence in its management strategy.

345 ABN AMRO exposures assumed to be the balance between RBS Group and RBS plc exposures.
Net exposure for ABS = carrying value after taking account of hedge protection purchased from monolines and other counterparties but excludes the effect of counterparty CVA.
Net exposure for monolines and CDPCs = gross exposure less CVA.
Net exposure for leveraged loans = drawn and undrawn balances.
Net exposure for conduits = maximum exposure to loss = total drawn and undrawn amount of liquidity commitments to conduits (excludes credit enhancements).

Spring 2007: response to market deterioration

285 As shown in Graph 2.13, delinquencies relating to US sub-prime lending began to increase from mid-2006. As this became increasingly apparent, assessments of the creditworthiness and value of the lower tranches of CDOs related to sub-prime lending deteriorated, and the demand for new CDOs reduced.

286 Faced with this deterioration, RBS, like others, halted its new origination of structured credit[346], perhaps slightly more slowly than some others, but not dramatically so. At the beginning of 2007, RBS recognised it needed to close all approved CDO deals in the warehouse before doing any more.[347] It continued to expand its leveraged finance business throughout the first half of 2007 but ceased all origination in July and August in the face of rapidly deteriorating market conditions.[348] But, like many others, it was by then holding positions which were bound to make some loss. The potential scale of these losses gradually became apparent as estimated 'marks' in structured credit, related monoline insurance and leveraged finance steadily deteriorated over the next 18 months (this deterioration is shown for RBS's super senior CDO exposures on Graph 2.15).

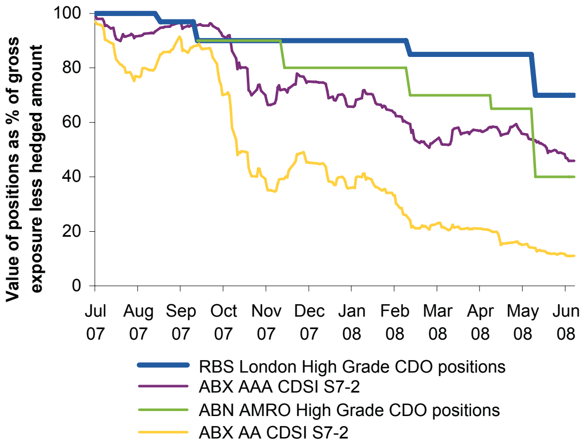
287 RBS's structured credit business, including its US-based ABS and CDO businesses, made it a target for market concerns once these problems began to emerge. In March 2007, a focus on sub-prime assets and related structured credit exposures emerged in analysts' calls with RBS. This continued throughout 2007. Similar concerns were expressed in brokers' reports and, once RBS and its consortium partners had launched their offer for ABN AMRO, market participants also began raising questions about the quality of ABN AMRO's wholesale assets in calls with RBS.[349]

288 The scale of losses which different firms made as a result of the falling values reflected the combination of (i) the effectiveness of their distribution capability (i.e. in effect the ability to hand on the asset to other investors before they in turn understood how bad the asset was); or (ii) the extent to which they were willing to take losses earlier by hedging or selling out based on more insightful analysis of how bad the situation could become.

289 In these attempts to avoid losses and to offload losses on to other market participants, RBS was among the less effective of its peers. That was in part because it had less distribution capability; and in part because it simply had less foresight in its judgement than more successful market participants.[350] As market conditions began to deteriorate in 2007, RBS concentrated on completing existing deals and focused on selling the junior, lower-rated and more risky tranches of CDOs on its warehoused ABSs.[351] By the time the warehouse had

346 FSA records, October 2009 and RBS records, March 2007.
347 FSA records, October 2009.
348 FSA records, July 2007 and November 2009.
349 Review Team analysis of broker reports between March 2007 and September 2008.
350 For an account of how some other market participants responded to changing market conditions, see *The Financial Crisis Inquiry Report*, The US Financial Crisis Inquiry Commission, January 2011; and *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*, Majority and Minority Staff Report, Permanent Subcommittee of Investigations, United States Senate, April 2011.
351 RBS records, March 2007 and FSA records, October 2009.

Graph 2.15: 'Marks' of RBS high grade CDO positions compared to price of AAA and AA ABX indices, July 2007 to June 2008[352]



Source: RBS records, October 2009 and data from Markit Group Limited.

been reduced, there was no market for super senior tranches, so RBS retained these exposures.[353]

2007–2008: decisions on hedging and valuation

290 Given the pattern of price decline shown in Graph 2.15, firms that had been left holding significant positions in super senior tranches had to make judgements on:

- Whether prices would stabilise, continue to decline, or recover. This assessment depended in part on a judgement as to whether the fundamental creditworthiness of the instruments was in danger.
- Whether to exit positions via sale or to hedge them via offsetting positions in other related markets. Such action would lock-in existing losses but limit future losses.
- How to value positions both for internal management purposes (to inform the decisions on whether to sell or hedge the exposures) and what values to use for external accounting and market communication.

291 Different firms struck a different balance between closing out positions rapidly at the cost of crystallised loss and maintaining them in the hope of market recovery. RBS's stance, while within the bounds of what could be justified, was characterised by a bias to optimism which increased the losses eventually faced.

292 RBS considered hedging its super senior CDO exposures in Q2 and Q3 2007, as recommended by GBM Market Risk, soon after market prices for super senior CDOs became unobservable. In July 2007 RBS purchased US$250m worth of hedges for super senior positions held by RBS Greenwich Capital.

352 'Marks' is a term used to describe where the front office has priced its positions. The graph shows the prices of ABX indices, which tracked the price of sub-prime mortgage-backed securities of various vintages, on the same scale as RBS's marks. Individual ABX indices were not perfectly correlated to individual firms' securities, but give an indication of price movements.

353 RBS records, October 2007 and FSA records, October 2009.

293 However, RBS did not undertake any further significant hedging thereafter. In part, this was because to have done so would have resulted in a loss on the positions and, faced with a gradual decline in values, RBS had a tendency to continue to believe that the market would stabilise or improve. In addition, effective hedging options were limited and increasingly expensive after Q2 2007. As a result, on a number of occasions, RBS made decisions not to crystallise losses. When interviewed as part of the enforcement investigation into his conduct, the Chairman of Global Markets recalled that '*I became aware of that sort of general feeling that, we always seemed to be thinking, 'Oh, if only we'd hedged last week' was the general sense I was getting. 'It's too late now – if only we'd hedged last week'.*' In line with the decision taken for its own exposures, RBS decided not to hedge ABN AMRO's CDO portfolio in Q4 2007. [354]

294 The Senior Supervisors Group[355] noted that firms that were able to consider the purchase of hedges at an early enough stage were generally successful in avoiding significant unexpected write-downs. Also, firms that '*did not consider that the positions might be of poorer credit quality than the external credit rating indicated and that even senior tranches could lose considerable market value if the underlying collateral suffered losses (or was downgraded) or if market liquidity receded for these products … typically sustained significant losses because they retained the super-senior position of CDOs backed by subprime mortgages or other similar assets and treated them as 'par' assets.*' [356] RBS was slow to realise, during the course of 2007, that the risk it was facing was not only to its annual profit targets, but massively greater and amounting to a major balance sheet hit.

295 As far as leveraged finance was concerned, RBS also began to encounter severe difficulties in July 2007 in completing and distributing deals. As the market in effect shut, RBS stopped all leveraged finance initiation and was left holding significant exposures including, for a time, its £3.6bn share of the largest leveraged finance deal in the world.[357]

Valuation of CDOs

296 Between RBS's trading statement in December 2007 and its 2007 results announcement in February 2008, several major investment banks (including UBS, Credit Suisse, Morgan Stanley, Citigroup and Merrill Lynch) announced significant write-downs on structured credit assets.[358] The CDO valuations reported by these firms appeared '*significantly lower*' than those that had been announced by RBS in December.[359] RBS also marked its positions above the available benchmark, the ABX index, which had declined from mid-2007 onwards (see Graph 2.15 and Graphs 1.9 and 1.10 in Part 1).[360]

354 RBS records, March to November 2007; FSA records, October to November 2009; and *Observations on Risk Management Practices during the Recent Market Turbulence*, Senior Supervisors' Group, 6 March 2008.
355 The Senior Supervisors' Group comprised seven supervisory agencies: the French Banking Commission, the German Federal Financial Supervisory Authority, the Swiss Federal Banking Commission, the UK FSA and, in the USA, the Office of the Comptroller of the Currency, the Securities and Exchange Commission and the Federal Reserve.
356 *Observations on Risk Management Practices during the Recent Market Turbulence*, Senior Supervisors' Group, 6 March 2008.
357 RBS committed this amount in relation to the leveraged buyout of Bell Canada, which was agreed in late June 2007. RBS remained on-risk until the deal collapsed in November 2008.
358 Review Team analysis of published announcements, April 2011.
359 RBS records, February 2008.
360 Data from Markit Group Limited and RBS records, April 2007 to October 2009.

297 Deloitte, as RBS's statutory auditor, included in its Audit Summary report to the Group Audit Committee a range of some £686m to £941m of additional mark-to-market losses that could be required on the CDO positions as at end-2007, depending on the valuation approach adopted.[361] Part of this adjustment (£450m to £533m) related to positions held by ABN AMRO; a revision of £188m was made to the valuation of these positions and was treated as a pre-acquisition adjustment.[362] No other adjustment was made.

298 Deloitte advised the Group Audit Committee in February 2008 that an additional minimum write-down of £200m was required to bring the valuations of super senior CDOs to within the acceptable range calculated by Deloitte.[363] This was discussed by the Group Audit Committee and then by the RBS Board before the accounts were finalised at end-February 2008. The Group Audit Committee and Deloitte concurred with RBS's management's view that the unadjusted difference of £200m was immaterial in the context of RBS's overall results. The decision as to whether there should be any further write-down was therefore left to the Board. The Board agreed that additional disclosures should be made in the annual report and accounts, but supported the view of RBS's management that no adjustment should be made to the valuation.[364]

299 A number of market commentators noted in early 2008 that RBS's write-downs were less severe than its peers.[365] RBS subsequently announced further estimated write-downs of £1.9bn on its ABS CDO portfolio at the time of its £12bn rights issue in April 2008.[366] These aligned RBS's valuations with those announced by other major investment banks. In summary, in early 2008, RBS appeared to have been on the optimistic side regarding its CDO valuations, and slightly (but not dramatically) behind the curve in recognising the scale of potential losses on its book and responding to deteriorating market conditions.[367]

300 RBS was not alone in this slow and optimistic response (for example, other UK banks also appeared slower than their US and Swiss counterparts to take write-downs on structured credit assets), but it was less effective than some others in responding to changes in market conditions. If it had acted more aggressively to take losses and close positions, its losses, while still significant, would have been considerably reduced.

The impact of RBS's credit trading losses in 2007 and 2008

301 The structured credit and leveraged finance businesses discussed in Section 1.4.1 were only part of GBM's product offering, which also included a range of other investment banking businesses. The structured credit revenue target of £200m in

361 RBS records, February 2008. The reduction of liquidity in structured credit markets during 2007 increased the complexity and amount of judgement involved in valuing exposures at this time.
362 This had the effect that such write-downs were not recognised in the income statement as profit or loss, but were taken straight to equity.
363 RBS records, February 2008.
364 RBS records, February 2008.
365 Review Team analysis of contemporaneous broker reports, May 2011. For example, Credit Suisse noted that RBS's 17% write-down (as a proportion of exposures) against its ABS CDO portfolio looked very low compared to a 58% average taken by Merrill Lynch, Citigroup and Morgan Stanley. Another from JPMorgan felt that the write-downs were inadequate.
366 *Update on Credit Market Exposures, Disposals, Capital, Trading Conditions and Outlook*, RBS, April 2008.
367 RBS's external reporting and valuation of structured credit exposures is also discussed in Part 3 Section 1.9.

2007 was in the context of actual external revenue of £12,512m for GBM in the same year, and £54,467m revenue for RBS as a whole.[368] The carrying value of credit derivative contracts (captured within credit trading) of £34bn at end-2007 appeared small compared to, for example, interest rate contracts of £202bn.[369] Similarly, RBS's net exposure to leveraged finance at end-2007 was £8.7bn, compared to total assets in GBM of £725bn and RBS total assets of £1,901bn.[370]

302 However, RBS's credit trading business took on greater prominence than its proportion of the firm's total assets and revenues would suggest:

- First, the losses sustained on those exposures had a much greater effect on RBS's profitability than the initial profit targets suggested. This can be seen by the impact of the loss on trading activities in Table 1.4 in Part 1.
- Second, those exposures became a focus of concerns by market participants and thus played a significant role in undermining confidence in institutions active in these areas. As discussed in paragraphs 296 to 299, RBS's relatively high valuations of super senior CDOs were scrutinised by market comment in early 2008, and there was concern among market participants that further write-downs would be needed, at a time when RBS's low core capital ratio was already a source of market comment.[371]

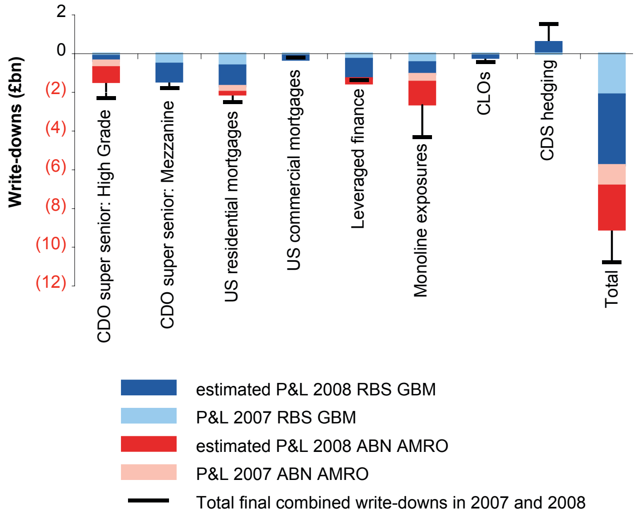
303 As shown in Table 2.10, structured credit activities made a significant contribution to GBM's losses in 2008. In terms of exposures, at end-2007 the effect of the implementation of RBS's growth strategy for GBM, including the acquisition of ABN AMRO, was to leave RBS with significant exposures to ABSs, CDOs, related monoline insurers, leveraged finance and other similar asset classes. Graph 1.8 in Part 1 analyses the relative size and origin of RBS's net credit market exposures at end-2007.

304 Write-downs on credit trading assets were first taken at end-2007, although (as noted in paragraph 296) at this point RBS had recognised fewer losses than were seen at some other firms.[372] However, when announcing its rights issue in April 2008, RBS announced significant increases to its expected losses on these asset classes. From that point on, RBS managed a group of CDOs, monoline exposures, leveraged loans and certain other US MBSs within a separate '*strategic assets unit*' (SAU). These assets were classed as legacy business and continued to be tracked and reported separately until the firm was restructured into '*Core*' and '*Non-Core*' divisions in 2009.[373]

305 Graph 2.16 shows the losses realised and expected on these assets, at end-2007 and in spring 2008 respectively. A significant proportion of the actual losses experienced arose from assets originally from RBS rather than those acquired as part of ABN AMRO, including RBS's exposure to leveraged finance.

368 2007 RBS annual report and accounts.
369 2007 RBS annual report and accounts.
370 2007 RBS annual report and accounts. Leveraged finance exposure represents the carrying value of the drawn balances.
371 Review Team analysis of contemporaneous broker reports, May 2011.
372 This included several US investment banks (Review Team analysis of published announcements, May 2011).
373 2009 RBS annual report and accounts.

Graph 2.16: Losses suffered in 2007 and estimated in April 2008 on credit market portfolios, split by assets originating from RBS and ABN AMRO, also showing total final losses in 2007 and 2008[374]



Source: RBS Group Internal Audit report, July 2008 and 2008 RBS annual report and accounts.

306 In total, RBS (including ABN AMRO) realised losses of £3.2bn[375] on these credit market exposures in 2007 and reported further expected losses of £5.9bn in April 2008.[376] As shown in Table 2.10, GBM subsequently realised losses of £7.8bn on SAU credit market exposures for 2008.

307 Of this £7.8bn, £5.5bn was attributable to assets originated by RBS and £2.3bn to assets acquired as part of ABN AMRO. Losses on US commercial mortgages, leveraged finance and CLOs were driven by RBS assets, while the losses on monoline exposures doubled as a result of assets consolidated following the acquisition of ABN AMRO (which also saw significantly increased losses on exposures to CDPCs and a conduit brought back on balance sheet). Losses on these exposures (subsequently managed by the SAU) had been realised on RBS and ABN AMRO-originated assets in a similar proportion in 2007 (when £2.1bn of the £3.2bn losses realised was attributable to assets originated by RBS).[377]

308 These credit market exposures were only part of RBS's trading book. During 2007 and 2008, RBS recognised trading losses on corporate bonds, ABSs, super senior CDOs, exposure to a securities arbitrage conduit which had been brought on balance sheet, credit derivatives and related hedges (including monoline counterparties) and funding.[378] The losses described in paragraph 306 therefore represent only part (albeit the majority) of the total trading losses.

309 Losses on trading activities were substantial and directly eroded RBS's core capital which, at end-2007, had already been weakened by the acquisition of

374 Credit default swap (CDS) hedging assumed to reduce losses on RBS GBM exposures.
375 RBS records, August 2008.
376 *Update on Credit market Exposures, Disposals, Capital, Trading Conditions and Outlook*, RBS, 22 April 2008.
377 RBS records, August 2008 and 2008 RBS Group and RBS plc annual report and accounts. CDS hedging assumed to reduce losses on RBS GBM exposures.
378 FSA loss attribution exercise. This project collected data from major investment banks and investment banking divisions on significant investment banking losses (as defined, in general, as exceeding at least US$100m) suffered between January 2007 and March 2009. Summary details were included in FSA DP10/4, *The prudential regime for trading activities*, August 2010.

ABN AMRO. In April 2008, as noted in paragraph 299, RBS recognised the full scale of the problems in structured credit, announced its £12bn rights issue and published estimates of future potential losses which were reasonable against what subsequently occurred.

310 An argument could therefore be made that, whereas the losses in structured credit were undoubtedly drivers of the fall in RBS's share price in late 2007 and spring 2008 and a major driver of the rights issue in April 2008, these losses were not necessarily the predominant or even major driver of the failure in autumn 2008. By that time sufficient equity had already been raised (£12bn) to offset almost all of the credit trading losses of £12.2bn that were subsequently reported for 2008.[379] However, in autumn 2008 there was still significant uncertainty about valuations, the scale of losses in structured credit and the extent to which yet further write-downs would be realised. The fact that RBS had already incurred major trading losses, and had been slow in its anticipation of those losses in late 2007 and early 2008 is likely to have contributed materially to the collapse in confidence in the firm and to funding concerns in September and October 2008.

1.4.3 FSA regulation and supervision of RBS's structured credit (from 2005 to April 2008)

311 The FSA's regulation and supervision of RBS with respect to structured credit and other related portfolios was, with hindsight, severely handicapped by three failures:

- a failure to think in systemic terms, combined with a tendency to share the delusions of the then conventional confidence in the benefits of financial innovation;
- a capital regime and approach to assessing risks in trading books which were severely deficient; and
- a supervisory approach which devoted limited attention to investment banking activities until too late, and which (in line with the regulatory regime at that time) did not focus on the full range of risks.

312 These three failings and the major changes in approach introduced since the crisis are described in paragraphs 313 to 324.

Systemic considerations

313 The FSA's *Financial Risk Outlook* (FRO) and the Bank of England's *Financial Stability Report* (FSR) did, to some degree and at a fairly high level, identify some of the risks of financial innovation during the Review Period. The FRO noted innovation and increased complexity and illiquidity in products used to transfer credit risk in 2005; legal and reputational risks associated with the development of structured products in 2006; difficulties in valuing illiquid instruments (including structured products) in 2007; and valuations and market

379 Furthermore, the total trading losses of £8.5bn reported for 2008 might have appeared manageable in the context of a total capital base of £68bn at the start of 2008, and subsequently boosted by the £12bn rights issue during 2008.

confidence in 2008.[380] The FSR also noted the risks associated with increasing interconnectedness and rapid innovation in credit risk transfer during the Review Period.[381] However, there were no effective mechanisms for moving from the identification of systemic risks to supervisory actions which mitigated the risks, and the focus of the FSA's supervision during the Review Period was on individual institutions, rather than system-wide risks.[382] Therefore, understanding the development of the market in structured credit and the associated complex web of connections that developed within the financial system was not defined as a priority for the FSA during the Review Period. The issue of why the FSA Board failed to identify such matters as a priority is addressed in Section 3.1.3.

314 Despite the insights of the FRO and FSR mentioned above, on the whole the FSA did not challenge, and at least implicitly shared, the dominant assumptions of the time: that financial innovations such as credit securitisation and tranching had made the financial system more resilient, and that financial regulators could rely on the market to ensure that risk was dispersed efficiently and priced appropriately. The failure of public authorities to address growing system-wide risks was global.[383] As an example, the International Monetary Fund's April 2006 *Global Financial Stability Review* noted '*growing recognition that the dispersion of credit risk by banks to a broader and more diverse group of investors, rather than warehousing such risk on their balance sheets, has helped make the banking and overall financial system more resilient*'. The FSA shared this view and, as one result, did not ask appropriately searching questions about the development of RBS's structured credit business.

Capital regime

315 Structured credit exposures were held within firms' trading books, and (as discussed in Section 1.1) the trading book was the area where the pre-crisis capital regime was, with hindsight, most severely deficient. During the Review Period the amount of capital to be held against trading book risks was determined by the market risk capital regime, which (subject to regulatory approval) permitted the use of value-at-risk (VaR) models. These models looked at variations in prices over recent periods and attempted to use this information to estimate how large subsequent price movements could be.

316 In retrospect, this framework suffered from severe deficiencies. It failed to allow for the inherent credit risks of assets, as distinct from potential variations in their market price. It was typically based on observation of time periods which were too short to capture past extreme events; it was potentially 'procyclical'[384]; and the whole assumption that future price volatility could be inferred from observation of past price movements was highly questionable. As a result, the

380 2005, 2006, 2007 and 2008 *Financial Risk Outlook*, FSA.
381 2005, 2006, 2007 and 2008 *Financial Stability Report*, Bank of England.
382 *The Turner Review*, March 2009.
383 *The Turner Review*, March 2009 and *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*, Financial Stability Forum, 7 April 2008.
384 A 'procyclical' capital regime is one which produces decreasing estimates of capital required in a period of economic upswing/market exuberance and then (sometimes suddenly) increasing estimates in the face of an economic downswing/market turbulence. In the case of VaR models, this procyclicality arises because periods of market exuberance may be periods of low volatility, with measured risk falling at the very point when underlying risks are increasing.

capital requirements which were generated by VaR models proved insufficient to absorb the losses that occurred during the financial crisis.

317 The scale of deficiency can be illustrated by comparing the losses made in structured credit with the capital required to be held against it. RBS made £12.2bn of losses on credit trading in 2008 and, at the beginning of that year, the notional amount of core tier 1 capital which RBS considered appropriate (and was permitted) to hold against its trading book assets was only £2.3bn (as shown in Table 1.2 in Part 1). Furthermore, even where structured credit exposures were held in the banking book under Basel II, the AAA rating of many such instruments meant that only US$0.60 capital was required against each US$100 of exposure to such tranches.[385]

Supervisory approach to trading activities

318 The FSA's focus on investment banking activities was very limited; the supervisory approach to RBS (and its peers) prior to autumn 2007 and the difficult market conditions at that time involved little fundamental assessment of trading assets. This reflected the FSA's overall approach not to challenge firms' business models and their inherent risks, but instead to focus on systems and controls. It also, in the case of RBS, reflected the resource available within the Supervision Team, where one person was responsible for supervising GBM, as well as, from February 2007, Barclays' investment banking division.[386]

319 The FSA's supervision of market risk focused on the modelling aspects of the firm's market risk framework, specifically the approval, periodic review, maintenance and monitoring of VaR models (considering back-testing results, for example; see also Section 1.1.4). Traded risk specialists were closely involved in this work. The FSA's approach was not to look in detail at the trading book inventory[387], although the consideration of models did give some more insight into RBS's portfolios and capital management than might otherwise have been the case. Similarly, limited consideration was given to risks that were not fully captured by VaR models, including credit risk associated with particular instruments held in the trading book.

320 However, the FSA did show a more intrusive approach towards the supervision of some aspects of RBS's trading assets at some points during the Review Period, particularly following the onset of market disruption (although by that point the firm had already accumulated many of the exposures on which it subsequently realised losses). Examples of the FSA's more intensive approach are shown below. However, as some of the examples illustrate, the FSA did not show any signs of challenging RBS's overall approach, nor of greater awareness of risks in early 2007 than RBS itself had.

385 FSA DP09/2, *A regulatory response to the global banking crisis*, March 2009. In the case of RBS, the Review Team believes that most (if not all) credit market exposures were held in the trading book for most of the Review Period.
386 For more detail on supervisory resources, see Part 2 Section 3.3.
387 As noted in DP09/2, '*In the past the FSA has not involved itself in reviewing and valuing detailed position data*'. FSA DP09/2, *A regulatory response to the global banking crisis*, March 2009.

- Triggered by market concerns, the FSA reviewed the exposures of large UK banks to the leveraged lending market in July 2005.[388] At end-2004, RBS was one of the leading banks in this sector. The review concluded that the banks most active in leveraged lending had strong controls over underwriting and distribution. This was discussed again with the CEO of RBS Corporate Markets in June 2006.[389] The topic was periodically raised during the Review Period as part of regular 'close and continuous'[390] meetings between the Supervision Team and the firm, and when the Supervision Team received management information.[391] The Review Team did not see evidence of further supervisory work being conducted with RBS on leveraged finance.

- The Supervision Team and specialists sought information from RBS in March 2007 on GBM's exposure to sub-prime mortgages, in reaction to developments in the sub-prime market.[392] Based on discussions at that time, the FSA considered that RBS had a good understanding of its positions and gave a credible account of actions being taken to monitor them. The Supervision Team continued to review RBS's sub-prime exposures over the summer of 2007.[393]

- Greater supervisory focus was placed on conduit exposures from autumn 2007 (these having previously attracted limited supervisory attention). This included an assessment by the Supervision Team, conducted shortly before the ABN AMRO acquisition was completed, that RBS could manage the capital risk from the acquisition even in an extreme scenario. This scenario included conduits coming back on balance sheet and the commercial paper markets being closed. This assessment was based on information received from the firm as well as information from the Dutch regulator (*De Nederlandsche Bank*, or DNB).[394]

- From August 2007, there was greater supervisory focus by the Supervisory Team on trading book valuation and inventory[395] as a result of difficult market conditions, when the firm's trading book models started to show significant back-testing exceptions.

- From November 2007, data were also collected in respect of monoline exposures, and peer analysis was conducted by FSA specialists. This led to a paper to the FSA's Firms and Markets Committee (FMC) in February 2008[396] and another to the Tripartite Standing Committee on Financial Stability in June 2008.[397] These identified RBS as having the largest

388 FSA records, July 2005.
389 FSA records, June 2006.
390 The supervisory approach to RBS is discussed in Part 2 Section 3.2.
391 FSA records, January to April 2006 and RBS records, May to August 2007.
392 FSA records, March 2007.
393 FSA and RBS records, April to August 2007.
394 Review Team analysis on conduit exposures; FSA records, September 2007; and DNB and the Dutch Ministry of Finance's declaration of no-objection, which noted support to conduits that could not unequivocally be allocated in advance to the consortium partners as a risk which could leave conflicts between the consortium members, and set out mitigating actions.
395 Review Team meeting with FSA specialists, January 2011; FSA records, November to December 2007; and Review Team meeting with the Supervision Team, January 2011.
396 FSA records, February 2008.
397 FSA records, June 2008.

- monoline exposures of the UK banks, with mark-to-market exposures of US$11.7bn, against which credit valuation adjustments (CVAs) of US$5.9bn had been made. The FSA Chairman and CEO also received a briefing in March 2008 on RBS's monoline exposures.
- FSA specialists produced several memos on RBS's structured credit assets between November 2007 and April 2008.[398] These were prepared for the Supervision Team and for FSA senior management. The Review Team believes that these did not provide sufficient information on the significance of RBS's exposures; and that the specialist teams had insufficient resource and inadequate information on which to base decisions. These memos also did not provide recommendations on necessary follow-up work.
- On 27 June 2008, a paper to the FSA's Firms and Markets Committee focusing on CVAs suggested that firms, including RBS, should take further CVAs to reflect the stressed nature of the monolines. In September 2008, the FSA wrote to RBS announcing a standardised data collection exercise to track valuation issues affecting various risky credit asset classes.

321 The Review Team did not see signs of detailed analysis of overall market risks from sub-prime exposures in CDO tranches in early 2007. However, given the then dominant assumption that financial innovation and complex securitisation had made the financial system more stable, there is no reason to believe that, if the FSA had devoted more resources to such risks, it would have more aggressively challenged RBS's (and the market's) belief that super senior securities were safe.

322 In particular, there is no sign that the FSA was more aware than RBS of the fact that there was major balance sheet exposure and risk posed by these exposures, not just a risk to budgeted profit. The FSA simply did not focus on overall trading book inventory, nor on the credit risks lying within the trading book to the extent that it should have and that it does now. Nor did the FSA explicitly assess firms' senior management experience in relation to new initiatives. The FSA's approach to assessing firms' management more generally is set out in Section 2.3 and its findings on the management of GBM within RBS in Part 3.

323 Nor was the FSA clearly focused on the issues of valuation. It was not involved in the comparison of how apparently similar assets were valued in different banks; nor involved in detailed interface with the auditors; nor aware of the detail of the debates and disagreement between RBS's statutory auditor and its management in early 2008 on the valuation of super senior CDOs.[399]

324 Overall, there was a gradual increase in focus by the FSA on risks associated with trading activities, and the emerging problems at RBS, from mid-2007 onwards. But given that the potential for loss was already in place, once the exposures had been created by early 2007, this was insufficient to alter

398 FSA records, November 2007 to April 2008.
399 Review Team meeting with the Supervision Team, July 2011.

fundamentally the effect that RBS's accumulated exposures had on its ability to retain market confidence in 2008.

Conclusions on what happened in RBS

- RBS's trading activities, and its credit trading in particular, gave rise to substantial losses during the financial crisis.
- The acquisition of ABN AMRO significantly increased RBS's exposures to credit-related asset classes that were the subject of market concern.
- The crucial determinant of the scale of losses was the extent to which a firm could distribute its existing positions or was willing to take losses earlier by hedging or closing out its positions. RBS was among the less effective banks in managing its positions through the deterioration in market conditions.
- These losses were critical in making RBS particularly vulnerable to a loss of market confidence, within the context of a wider loss of market confidence in structured credit products.
- In addition, while RBS's approach to the valuation of its CDOs was within the bounds of what could be justified, it displayed a bias to optimism.

Conclusions on the global regulatory framework and the FSA's supervision

- The FSA, along with other public authorities globally, shared the dominant assumption that financial innovations had made the financial system more resilient.
- With hindsight, there were severe deficiences in the globally agreed market risk capital regime.
- Before the onset of the market disruption in August 2007, the FSA's overall approach did not challenge firms' business models and their inherent risks. This was reflected in the little fundamental analysis carried out of RBS's trading book.

Lessons already identified where actions have been taken

- **Systemic approach**: There has been a fundamental shift to greatly enhanced analysis over the last two years, now formalised in the Financial Policy Committee (and, at European and global level, the European Systemic Risk Board and Financial Stability Board). There is now a continuous process of attempting to link system-wide issues to supervisory priorities at a firm-specific level, and a determination as far as possible to avoid group-think which made the FSA (and the rest of the policy world) overly confident in financial innovation and market efficiency before the crisis. The UK regulatory reform programme should ensure that greater attention is paid to system-wide risks in future. Work is also underway in international policy fora.

- **Regulation**: A fundamental review of the market risk capital regime (for example reliance on VaR measures) was required. This was recommended by *The Turner Review* and is being undertaken by the Basel Committee. In the meantime, the Basel Committee has already agreed a package of measures to increase regulatory capital requirements in the trading book, which are being implemented in the European Union. These include introducing a stressed VaR capital charge to capture more extreme market events and enhancing the capture of credit risks as well as market risks in the trading book (for example, through the incremental risk charge). These changes have resulted in increases in total capital of at least three to four times for some categories of trading book assets.

- **Supervision**: The FSA's supervisory approach during the Review Period did not focus sufficiently on analysis of firms' underlying assets and off balance sheet exposures. Work on asset quality now forms a key element of the FSA's supervision of large, high impact firms. In particular, the FSA now applies greater resources to investment banking, trading activities and valuation issues within major banking groups.

Recommendations for further change

- None

1.5 ABN AMRO acquisition: 'the wrong price, the wrong way to pay, at the wrong time and the wrong deal'

325 The takeover of ABN AMRO by a consortium led by RBS was the biggest takeover in banking history.[400]

326 The ABN AMRO acquisition was, in the then RBS Chairman's subsequent words, '*a bad mistake*'.[401] And, in the words of the current RBS Chairman, '*the wrong price, the wrong way to pay, at the wrong time and the wrong deal*'.[402] It contributed to RBS's vulnerability and, ultimately, failure in four ways:

400 RBS website, Our story: history highlights – takeovers and acquisitions, see http://rbs.com/about-rbs/g2/heritage/our-story/history-highlights.ashx.
401 The then RBS Chairman to the House of Commons Treasury Committee on 10 February 2009, *Banking Crisis Volume 1 Oral Evidence*, 1 April 2009.
402 RBS press release, *Royal Bank of Scotland Group PLC – Annual General Meeting/General Meeting*, paragraph 15, 3 April 2009.

- It greatly increased RBS's exposure to risky trading assets that gave rise to market concern.
- RBS's decision to fund the acquisition primarily with debt rather than equity was a misjudgement that weakened its already thin capital position and left it heavily dependent on minority interests. As most of that debt was short-term, it also increased RBS's reliance on short-term wholesale funding.
- RBS did not anticipate the impact on its ability to meet its regulatory capital requirements if ABN AMRO was not to receive approval for its Basel II credit risk models.
- The structure of the deal, under which RBS led the consortium, was that RBS took responsibility for the whole of ABN AMRO during the restructuring phase. This gave it a greater exposure to downside risk than its consortium partners. The complexity of the arrangements, combined with limited information on ABN AMRO, also had the effect of obscuring RBS's underlying position from the regulatory authorities and from the market (thereby increasing market concerns).

327 Whether the acquisition of ABN AMRO was the crucial factor which brought RBS down is a matter for debate. Many of the factors that led to RBS's failure were present, to varying degrees, without ABN AMRO. For example, RBS already had a relatively low core capital ratio prior to the acquisition, but ABN AMRO stretched RBS's core capital position. In terms of liquidity, RBS was already dependent on short-term wholesale funding, but the acquisition increased this and exacerbated pressure on RBS's liquidity position. Also, a significant proportion of the losses experienced by RBS arose from assets originally from RBS rather than those acquired as part of ABN AMRO. Therefore, it is possible that RBS would have failed even without the acquisition. However, it is clear that the acquisition undoubtedly contributed significantly to RBS's vulnerability.

328 RBS launched a contested bid for ABN AMRO on the basis of only very limited due diligence. While the limited due diligence was in line with market practice for contested bids, the result was that RBS proceeded with the biggest takeover in banking history based on due diligence which was inadequate in scope and depth and hence inappropriate in light of the nature and scale of the acquisition and the major risks involved (see Part 3, Section 2.1). The Review Team judged that the decision to make a bid of this scale on the basis of limited due diligence entailed a degree of risk-taking that can reasonably be criticised as a gamble (see Section 2, paragraph 599).

329 RBS's track record of successful acquisitions and integration, particularly of National Westminster Bank (NatWest), may have led the RBS executive management to be confident in its ability to integrate the ABN AMRO business (see paragraph 417). It is clear that RBS underestimated the operational and integration risks that arose from the acquisition (see paragraph 375). It also

underestimated the extent to which the process of integration would distract it from the management of risks at RBS.[403]

330 The FSA's overall supervisory response was inadequate for the major risks inherent in the acquisition of ABN AMRO. This was consistent with the fact that FSA approval was not required and with the prevailing FSA philosophy and approach of the time. Supervisory attention, under FSA senior management direction, should have been more proactively engaged from the time in April 2007 that the FSA was informed of the consortium's intention to make a bid for ABN AMRO, with particular focus on testing in detail the potential capital and liquidity implications for RBS. There have already been significant changes in supervisory practice in relation to the FSA's approach to major acquisitions. These changes are discussed in Section 1.5.4. However, there remain public policy issues about whether contested takeovers by banks should require the FSA's formal approval, indeed whether contested takeovers by banks should be allowed at all.

331 This section is structured in four parts:

- 1.5.1 sets out the chronology of the acquisition and a description of the deal, including the structure of the consortium.
- 1.5.2 considers in detail the four principal ways in which the acquisition of ABN AMRO contributed to RBS's vulnerability and how important the acquisition was to the story of RBS's failure.
- 1.5.3 highlights the decisions of the RBS Board and executive management in relation to the acquisition.
- 1.5.4 considers the FSA's regulation and supervision of RBS in respect of the acquisition and discusses the changes already introduced to the FSA's approach to acquisitions. It also highlights possible remaining policy issues relating to the appropriate treatment of bank takeovers.

1.5.1 A description of the ABN AMRO acquisition

332 This section provides a description of the consortium's offer for, and subsequent acquisition of, ABN AMRO and sets out the sequence of events, the takeover structure and the allocation of business.

333 On 17 October 2007, a consortium of banks made up of RBS, Santander and Fortis acquired ABN AMRO. The consortium's offer price of €71.1bn made it, at the time, the world's biggest takeover in banking history.

334 This followed nearly seven months of contested bid activity, in which the consortium sought to acquire ABN AMRO, against a competing bid from Barclays which the Board of Directors of ABN AMRO had recommended. Barclays announced on 19 March 2007 that it was in exclusive preliminary discussions with ABN AMRO concerning a potential merger and was a catalyst for RBS to consider an acquisition more seriously. On 20 March, Barclays and ABN AMRO announced the principles of a potential combination of the two firms and their agreement on terms on 23 April 2007.

403 RBS Group Internal Audit report, July 2008.

335 The consortium's plan was to break up ABN AMRO, with each member taking specific ABN AMRO businesses. RBS was the largest member of the consortium, contributing 38.3% of the offer price, equivalent to approximately 61% of RBS's reported tier 1 capital at 31 December 2006.

336 RBS's stated strategic rationale for the bid focused on acquiring a number of ABN AMRO's businesses:

- The North American business unit, largely LaSalle, which was considered a particularly attractive opportunity for RBS as it was a good fit for RBS's existing US business, Citizens, and the combination of the two banks would mean that RBS would become the fifth largest bank in the US by asset size.
- The global clients and wholesale banking business. It was considered that ABN AMRO's geographical network and broad client base would provide an opportunity for RBS to accelerate its existing Global Banking and Markets (GBM) and wholesale strategy and to release significant synergies.
- ABN AMRO's global payments system.
- ABN AMRO's international retail banking operations. It was thought that ABN AMRO's branch networks in Asia and the Middle East would provide opportunities for growth.

RBS estimated that the combined business would be the third largest corporate and institutional banking and markets business globally as measured by fixed income revenues. By client relationships, GBM (after the incorporation of ABN AMRO's business) would rank first in the UK and continental Europe, and fifth in the USA, as well as being number one globally in a number of product lines (for example, global securitisations and all international bonds).[404]

Sequence of events from April 2007

337 On 11 April 2007, the RBS Chairman's Committee unanimously approved a proposal that the consortium should notify ABN AMRO of its intention to make an offer and request the same due diligence material as had been made available to Barclays.[405]

338 RBS saw LaSalle, at least initially, as the primary focus for its bid and its focal point for value creation. This strategic rationale was put at risk when ABN AMRO announced on 23 April 2007 its agreement to sell LaSalle to Bank of America.

339 The Review Team understood that on 30 April 2007, in a meeting between RBS and an institutional investor (with the then RBS CEO present), RBS said that it would proceed with the acquisition of ABN AMRO without LaSalle (in the event the latter was sold) because LaSalle was only part of what RBS was looking to acquire. The note of this meeting also recorded that '*RBS does not need to do this deal*' and that RBS would '*walk away*' if the price for ABN

404 Offer document, p.45, 20 July 2007.
405 RBS records, April 2007.

AMRO became too high.[406] This is consistent with the minutes of the RBS Board meeting in March 2007 which recorded that the acquisition was not seen as a *'must do'* deal.[407]

340 On 3 May 2007, a Dutch Court granted the Dutch Investors' Association a provisional injunction which prevented ABN AMRO from proceeding with the sale of LaSalle without ABN AMRO shareholder approval.

341 Also on 3 May, having received information from ABN AMRO on 29 April 2007, the due diligence findings were presented to the RBS Chairman's Committee.[408] The time constraint under which RBS was operating at that time was that ABN AMRO had until 6 May to enter into an alternative agreement for the sale of LaSalle.[409]

342 As the consortium wished to make an offer for LaSalle that was linked to and conditional on the acceptance of the offer for ABN AMRO, the consortium needed to provide details of its proposed offer for ABN AMRO at the same time as the bid for LaSalle.

343 With regard to the due diligence performed, market practice in respect of bids for large listed companies had developed in such a way that that even where a takeover approach was not hostile, target companies would often cite the possibility of Rule 20.2 of the City Code being invoked as a reason for limiting the information they were prepared to make available for due diligence.[410] As a consequence, the due diligence on targets that are large public companies tends to proceed with little information being provided by the target. While there was no equivalent rule in the Netherlands, it is the Review Team's understanding that the same practice was followed there.

344 RBS understood that ABN AMRO would provide only a small amount of information to it and the due diligence performed by the consortium was extremely limited as a result. RBS would not, therefore, have been able to determine, for example, any significant deficiencies in ABN AMRO's key risk management practices, the quality of the assets in its structured credit portfolios or the valuation of those positions (see Part 3, paragraph 218).[411]

345 Following its review of the limited due diligence findings, on 5 May 2007 the consortium submitted a bid for LaSalle valued at US$24.5bn. The proposal was conditional on the completion of a proposed public offer for ABN AMRO and set out an indicative price of €38.40 per ABN AMRO share. However, ABN AMRO concluded that Bank of America's offer for LaSalle was superior to the consortium's offer and it rejected the consortium's proposal on 6 May.

406 Review Team meetings with sample of institutional investors, June to July 2011.
407 RBS records, March 2007.
408 RBS records, May 2007.
409 The time constraints were dictated by certain deadlines in the LaSalle sale and purchase agreement between ABN AMRO and Bank of America. This agreement included a provision that permitted ABN AMRO, for a period of 14 days ending on 6 May, to enter into an alternative agreement for the sale of LaSalle with another bidder, provided that (among other things) the alternative acquisition proposal was a 'superior proposal' from a financial point of view.
410 The City Code on Takeovers and Mergers, Rule 20 '*Equality of Information*'. This Rule states that any information given to one offeror must also be given to another, even if the latter's offer is less welcome.
411 The Offer document also noted that '*The Banks* [the consortium members] *have conducted only a limited due diligence review of ABN AMRO and, therefore, RBS may become subject to unknown liabilities of ABN AMRO, which may have an adverse effect on RBS's financial condition and results of operations'*, Offer document, 20 July 2007.

346 On 15 May, ABN AMRO, Bank of America and Barclays filed separate appeals in the Supreme Court of the Netherlands to request that it overturn the provisional injunction that had been in place since 3 May which had prevented ABN AMRO from proceeding with the sale of LaSalle without shareholder approval.

347 On 24 May, with the appeal still to be heard, the RBS Chairman's Committee met and unanimously agreed that the consortium should announce its proposed offer for ABN AMRO, including LaSalle.[412] The consortium held press and investor conferences on 29 May to announce details of its offer.[413]

348 The process by which decisions were reached by the consortium partners involved their Boards determining their own positions before coordinating across the consortium to arrive at a unified view. On 28 May 2007, this coordination was formalised when, through RFS Holdings (RFS), a specially created holding company owned jointly by the consortium, the partners entered into a Consortium and Shareholders' Agreement.

349 On 13 July 2007, the Dutch Supreme Court overturned the provisional injunction, ruling that ABN AMRO could sell LaSalle without shareholder approval. This decision enabled Bank of America to proceed with its acquisition of LaSalle. The decision therefore presented RBS with an opportunity to reconsider its bid. Despite the importance of LaSalle to its bid, RBS had already begun to assess the prospect of the acquisition without LaSalle.

350 The merits of proceeding with the acquisition excluding LaSalle had been discussed at the RBS Board during its annual strategy session on 20 June 2007[414] and then, after the Dutch Supreme Court overturned the provisional injunction, at the RBS Chairman's Committee on 15 July 2007.[415] Following this, the decision was taken by the consortium to communicate an offer to ABN AMRO for €38.40 per ABN AMRO share, despite the exclusion of LaSalle. This was on the basis that RBS would receive the proceeds of the LaSalle sale. The consortium announced the offer terms on 16 July and the Offer document was subsequently published on 20 July 2007.

351 The key terms of the offer included: (1) €35.60 in cash plus 0.296 RBS ordinary shares for each ABN AMRO ordinary share; and (2) valuation at €38.40 per ABN AMRO ordinary share, with a total value of €71.1bn.

352 Although the overall price did not change from the 5 May 2007 offer, the proportion of the consideration to be paid in cash increased substantially under this revised offer from €56.2bn (79% of total consideration) to €66.1bn (93%). This reflected the cash proceeds from the LaSalle sale. Given that these would accrue to RBS, RBS decided to fund some of the increased cash element of the bid with bridge finance.[416] This had a weighted average maturity of six months.

412 See Part 3, paragraphs 230 to 233.
413 The proposed offer was conditional, among other things, on the Dutch Supreme Court upholding the provisional injunction granted on 3 May and ABN AMRO shareholders voting to reject the sale of LaSalle.
414 RBS records, June 2007.
415 RBS records, July 2007.
416 In June 2007, RBS expected the proceeds of the LaSalle sale (which was completed in October 2007) to be repatriated within three months. However, repatriation was delayed during 2008 and subsequent FSA records suggest that the proceeds were eventually absorbed by losses made by ABN AMRO in the Netherlands rather than being transferred to RBS in the UK, FSA records, February 2008 and March 2011.

Overall, more than half of the cash consideration was funded by debt with a term of one year or less. The sale of LaSalle to Bank of America was settled on 1 October 2007 from which ABN AMRO recognised a gain of €7.17bn in its 2007 accounts.[417]

353 Having published its offer on 20 July 2007, RBS and the consortium were committed to proceeding with the acquisition, subject to the conditions of the offer being met. The only ways that the consortium could have withdrawn after 20 July were to have exercised the Material Adverse Change (MAC) condition or the Regulatory Approvals (RA) condition in the Offer document or if any of the consortium members had been unable to obtain the approval of their shareholders.[418]

354 The RA condition permits a member of the consortium to withdraw from the deal in the event of regulatory intervention. The exact nature of what constitutes a 'trigger' regulatory event is decided on a case by case basis under the relevant jurisdiction. It is the Review Team's understanding that the RA condition could have been invoked in response to a wide range of regulatory events, but with a high materiality threshold. If the FSA had intervened in the acquisition of ABN AMRO at this stage, whether the intervention would have constituted a 'trigger' regulatory event under the RA condition would have been dependent on the nature, as well as the materiality, of the intervention. The FSA's decision-making around whether to intervene in the acquisition is discussed in Section 1.5.4.

355 *De Nederlandsche Bank* (DNB) told the Review Team that, in light of the deteriorating conditions in the funding markets in late summer 2007, it was concerned about whether the consortium could finance the acquisition. At that time, Fortis still had to raise a substantial proportion of the funding required for its share of the acquisition (including €13.2bn via a rights issue) and RBS also had to complete its fundraising for the deal. DNB and the Dutch Ministry of Finance therefore included an additional condition in its declaration of no-objection to the consortium. This required the consortium's financing to be '*adequately safeguarded*'[419] before the declaration of no-objection would come into effect.[420]

356 When it became apparent that market conditions were deteriorating, the consortium sought legal advice on the exercise of the MAC and RA conditions in August and September 2007. In particular, although there was still unanimity within RBS in wishing to proceed with the acquisition, the RBS Board considered exercising the MAC condition as a means of reducing the offer price; it received legal advice as to whether there had been a material adverse change (see Part 3, paragraph 243).

357 On 10 August 2007, RBS shareholders approved the proposed acquisition of ABN AMRO by RBS and its consortium partners; 94.5% of the votes cast were

417 2007 ABN AMRO annual report and accounts (operating review), p.126, note 2.
418 Offer document, 20 July 2007.
419 *De Nederlandsche Bank*'s (DNB) advice to the Dutch Minister of Finance on declaration of no-objection application '*Consortium*', Clause 5.4.10, 17 September 2007.
420 Review Team meeting with DNB, June 2011.

in favour of the transaction.[421] On 10 October 2007, the consortium declared its offer unconditional. The acquisition was completed on 17 October 2007.

358 As part of the Review Team's work to understand market perceptions of RBS at the time, the Review Team met a sample of RBS's institutional investors from the time of the acquisition and a sample of hedge funds (see also Section 1.6, paragraphs 502 to 511). The Review Team also reviewed contemporaneous investor feedback from April to July 2007 regarding the consortium's bid for ABN AMRO.[422] In considering this evidence, the Review Team acknowledged that any recollection today of opinions held at the time may be coloured by the fact that subsequent events proved the acquisition of ABN AMRO to be a mistake.

359 The meetings held and the Review Team's analysis of contemporaneous investor feedback suggested mixed views among market participants as to the merits of and motivations for the bid for ABN AMRO.

360 Of the institutional investors the Review Team met, several of those recalled not being altogether comfortable voting in favour of the deal but, ultimately, they did, as shown by the percentage of votes cast in favour of the acquisition.[423]

361 The May 2007 RBS Chairman's Committee minutes[424] recorded that the RBS Chairman and CEO had sought views on the bid from the '*top 20*' RBS institutional investors and noted a range of views on its merits. These views indicated that there existed common concerns in relation to the bid for ABN AMRO.

362 In contrast, the majority of the other contemporaneous investor feedback that the Review Team saw was supportive of the bid. For example, feedback collected on 16 July 2007, after the consortium had announced that day its offer terms, recorded that the consortium's announcement was very well received.

363 Many of the hedge funds that the Review Team met were critical of the acquisition of ABN AMRO which they remembered considering was an expensive, '*unpopular*' and '*ridiculous vanity purchase*'. A few commented that, at the time of the acquisition, they could not understand why RBS was proceeding with the deal after ABN AMRO had agreed to sell LaSalle to Bank of America and when market conditions had deteriorated. Some of the hedge funds suggested that RBS was looking for a '*transformative*', '*trophy*' deal and that the RBS CEO was under pressure from the other consortium partners and shareholders to complete the acquisition, '*a deal that Sir Fred Goodwin had to close to keep his job*'.

364 Other comments from the hedge funds included that the acquisition at the onset of the crisis period resulted in RBS acquiring lower quality, '*toxic*' assets at the '*worst possible moment in time*'. One mentioned that it had expressed concern at the time that RBS was not clear as to what it was buying. However, as a

421 RBS Extraordinary General Meeting Result and Statement, 10 August 2007.
422 Investor feedback provided to the Review Team, April to July 2007.
423 Review Team meetings with sample of RBS institutional investors, June to July 2011.
424 RBS records, May 2007.

factor in RBS's failure, the hedge funds identified other reasons ahead of the impact on RBS of the ABN AMRO acquisition.[425]

365 Overall, it is clear that there was a mix of reactions to the consortium's bid for ABN AMRO and some concerns existed. The fact remains, however, that 94.5% of the votes cast by RBS shareholders were in favour of the transaction. Those shareholders must themselves share some of the responsibility for the problems at RBS which the acquisition of ABN AMRO created.

Structure of the acquisition

366 The takeover was effected through RFS Holdings (RFS), a specially created holding company owned jointly by the consortium. The three banking groups of the consortium each owned ordinary shares in RFS, which in turn purchased ABN AMRO. Four classes of shares in RFS were issued: three individual classes relating to each of RBS, Fortis and Santander and a further class issued to all three. The three individual classes tracked the net assets and income of the parts of ABN AMRO to be acquired by each consortium member. The fourth class was issued in proportion to the members' respective funding commitments and reflected their interest in the residual shared assets.[426]

367 Although RBS's share in RFS – and hence in ABN AMRO – was only 38.3%, the structure of the acquisition gave RBS a controlling position and it was required to consolidate ABN AMRO in full for both regulatory and accounting purposes.

368 IAS 27 (Consolidated and separate financial statements) sets out criteria for establishing when an entity is controlled and, therefore, must be accounted for as a subsidiary. The concept of control is dependent not only on the level of shareholding and votes, but also on qualitative factors such as Board representation and agreements between parties. Accordingly, while RBS held only 38.3% of RFS, it controlled RFS through its control of the Board and therefore accounting consolidation was required.

369 The Banking Consolidation Directive, as implemented in the FSA Handbook, sets out the requirements for regulatory consolidation. Consolidation is required where a parent/subsidiary relationship exists. The control that RBS exerted over RFS made it a parent undertaking of RFS and as such regulatory consolidation was required.

370 This consolidation was also a requirement of DNB and the Dutch Ministry of Finance's declaration of no-objection in relation to the consortium's acquisition of ABN AMRO, which made RBS '*responsible for compliance with the supervisory regulations applicable to the ABN AMRO Group in all relevant jurisdictions*[427]', including – but not limited to – any liquidity or solvency

425 Review Team meetings with sample of hedge funds, June to July 2011.

426 Although RBS, Fortis and Santander had shareholdings in RFS Holdings in proportion to their contribution, they were each issued with '*tracking shares*', the purpose of which was to track the net assets and income of the business units which each had agreed to acquire. So RBS was issued 'R Shares', Fortis 'F Shares', and Santander 'S Shares'. They each also owned a proportionate share of the 'Retained Business Shares'. The intention was that this arrangement would persist for the transition period.

427 DNB advice to the Dutch Minister of Finance on declaration of no-objection application '*Consortium*', Clause 5.4.1 and 5.4.7, 17 September 2007.

problems at ABN AMRO until it was restructured. RBS's lead responsibility was noted in the Consortium and Shareholders' Agreement.

371 RBS, therefore, bore greater downside risk than its consortium partners while ABN AMRO was restructured and businesses transferred to their intended owners.

The allocation of business and the transition plan

372 A transition document dated 9 December 2007 set out how the consortium planned to allocate the assets.[428] A breakdown of the businesses to be acquired by each consortium member is shown in Table 2.11.

373 A three-phase timetable was devised for dispersal. The first phase was intended to be an accelerated process for a number of prioritised units, which included Banca Antonveneta. The second phase would involve the majority of transition activity, while the third phase would deal with any residual entities.[429]

374 DNB considered it '*imperative*' that it should give a declaration of no-objection or permission in relation to each of the various regulated business units and other entities that were to be dispersed to the consortium members.[430] In practice this meant that the consortium members had to seek separate approval from DNB for each business transfer. DNB considered that this would help to manage and control the process of splitting up ABN AMRO and to ensure that each transfer occurred after adequate risk assessment by the relevant consortium member.[431]

375 It appears that the timings of the plan changed significantly during execution, with at least some aspects taking longer than RBS had envisaged.[432] The RBS Board noted, for example that, with regard to the integration of parts of ABN AMRO into GBM, '*progress had been slower than anticipated as a result of DNB requirements*'.[433] Also, the December 2007 transition plan for Banca Antonveneta had envisaged legal separation by January 2008.[434] FSA and RBS records from January to March 2008 noted that this was delayed until end-February 2008 and then planned for August 2008.[435] Banca Antonveneta was sold on 30 May 2008 to Banca Monte dei Paschi di Siena S.p.A.[436] In addition, in a presentation given to DNB in January 2008, ABN AMRO stated that the allocation of conduits between consortium members had yet to be decided definitively.[437]

428 RBS records, December 2007.
429 RBS records, December 2007.
430 DNB advice to Dutch Minister of Finance on declaration of no-objection application '*Consortium*', 17 September 2007.
431 Review Team meeting with DNB, June 2011.
432 See also footnote 416.
433 RBS records, March 2008.
434 RBS records, December 2007.
435 FSA records, January 2008; RBS records, March 2008.
436 2008 ABN AMRO annual report and accounts.
437 RBS records, January 2008.

Table 2.11: ABN AMRO businesses allocated to consortium members[438]

Consortium member	Allocated businesses
RBS	Business Unit North America Business Unit Global Clients (excluding Latin America) Dutch wholesale clients and wholesale clients in Latin America (excluding Brazil) Business Unit Asia (excluding interest in Saudi Hollandi Bank) Business Unit Europe (excluding Antonveneta)
Fortis	Business Unit Netherlands (excluding former Dutch wholesale clients) Business Unit Private Clients (excluding Latin America) Business Unit Asset Management
Santander	Business Unit Latin America (excluding wholesale clients outside Brazil) Banca Antonveneta Asset Management Antonveneta Private Clients business in Latin America

1.5.2 The impact of the ABN AMRO acquisition on RBS

376 Approximately a year after the consortium acquired ABN AMRO, RBS received Emergency Liquidity Assistance (ELA) from the Bank of England on 7 October 2008. On 8 October 2008, the UK government announced a recapitalisation package and RBS was one of three major UK banks to obtain capital through this scheme.[439]

377 As described in paragraph 326, the acquisition of ABN AMRO increased RBS's vulnerability in four ways, which are explained in more detail in this section.

378 In fact, it is not possible to state definitively what might have happened had RBS not acquired ABN AMRO. It is, however, possible to consider RBS's position immediately prior to the acquisition and, from that, to form a view on the extent to which ABN AMRO contributed to RBS's failure. With regard to RBS's capital position, liquidity risk and exposure to risky assets:

- Although ABN AMRO stretched RBS's core capital position, RBS already had a relatively low core capital ratio prior to the acquisition. At mid-year 2007, RBS published the lowest tier 1 ratio of its peers (see Section 1.1).[440]

- Data gathered around the time of the acquisition showed that RBS was dependent on short-term wholesale funding prior to acquiring ABN AMRO. So RBS would have been vulnerable to the deterioration in liquidity in the wholesale funding market even without the acquisition of ABN AMRO; however, the acquisition exacerbated existing liquidity pressure on RBS (see Section 1.2).

438 Offer document, 20 July 2007; also 2007 ABN AMRO annual report and accounts.
439 The other two were HBOS and Lloyds TSB, combined as Lloyds Banking Group after they merged in January 2009. The UK government announced that it would be injecting capital to these banks on 13 October 2008. HM Treasury, National Archives website, 8 and 13 October 2008.
440 At 7.4%, RBS's tier 1 ratio was lower than those published by Barclays (7.7%), HBOS (8.0%), HSBC (8.4%), Lloyds TSB (8.1%) and Standard Chartered (9.7%).

- A significant proportion of the actual losses incurred arose from assets originally from RBS rather than those acquired as part of ABN AMRO. Also, a significant proportion of the asset quality concerns over the crisis period related to RBS rather than ABN AMRO (see Sections 1.4 and 1.6).

379 Even without ABN AMRO, therefore, RBS had relatively low capital, high leverage and was reliant on short-term wholesale funding. Concerns, both perceived and ultimately realised, about its assets, as well as its capital and liquidity positions left it vulnerable to changes in the market. Even without ABN AMRO, RBS would have had significant problems; but ABN AMRO made the situation much worse. The Review Team considered that losses and capital strain suffered as a result of the acquisition of ABN AMRO significantly increased the extent of UK government support provided to RBS.

ABN AMRO assets: increase in exposure to assets of market concern

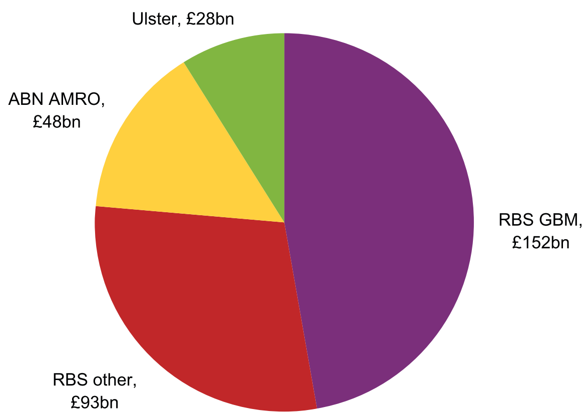
380 The ABN AMRO deal greatly increased RBS's exposure to risky trading assets, and in particular to those categories of asset, including structured credit and leveraged finance assets, and monoline insurers, which later turned out to be the cause of major losses or of market concern (see Section 1.4, paragraphs 281 to 283).

381 As shown in Section 1.4, RBS had accumulated more residential mortgage-backed securities, commercial mortgage-backed securities and monoline exposures than ABN AMRO. However, the acquisition meant that RBS's exposure to own-sponsored[441] asset-backed commercial paper (ABCP) conduits had more than quadrupled in terms of committed liquidity facilities by end-2007[442], resulting in a corresponding increase in RBS's off balance sheet liquidity risk.

382 At end-June 2008, the liquidity drawn by RBS's and ABN AMRO's own-sponsored conduits under the committed liquidity facilities and still outstanding (i.e. had been drawn but not yet repaid) was £8.6bn. The highest drawn balance for each of RBS's and ABN AMRO's own-sponsored conduits peaked at different points during the six months between January and June 2008. In total, the maximum drawn balance reached by these conduits was £10.2bn (of which £8.5bn related to ABN AMRO own-sponsored conduits).[443] These data demonstrated that RBS's and ABN AMRO's own-sponsored ABCP conduits suffered significant liquidity problems during 2008. The Review Team noted that these data did not include instances where RBS bought commercial paper as a means to provide funding to these conduits. Therefore, the liquidity provided may have been greater than indicated here. The Review Team considered that the liquidity provided to RBS's and ABN AMRO's own-sponsored conduits represented a significant liquidity drain on RBS. See Section 1.2, paragraphs 131 to 133 and Appendix 2G for more detail.

441 The Review Team was not able to estimate comparable figures for third-party asset-backed commercial paper (ABCP) conduits as RBS could not provide the required information.
442 Data provided by RBS to the Review Team in August 2011.
443 Data provided by RBS to the Review Team in August 2011.

Graph 2.17: Origin of assets covered by the APS, as at 31 December 2008[444]



383 It was GBM which absorbed many of the ABN AMRO assets that were assigned to RBS.[445] In early 2008, following the onset of market disruption, certain assets originating from ABN AMRO were absorbed into RBS's Strategic Asset Unit (SAU) and were subsequently managed separately as legacy business, alongside assets originated by RBS.

384 In both 2007 and 2008, RBS recognised losses of £3.2bn and £7.8bn respectively on assets which were absorbed into the SAU. In both years, those losses were split between the assets originating respectively from RBS and ABN AMRO roughly in the ratio 2:1, with RBS assets bearing the greater losses.[446] The ABN AMRO share experienced proportionately larger write-downs on high-grade super senior collateralised debt obligations. These tranches were backed by poorer quality assets mainly due to ABN AMRO entering the market relatively late compared with its peers.[447] For more detail on the impact of ABN AMRO on RBS's credit market exposures and losses, see Section 1.4.

385 In December 2009, the UK government announced details of the agreement reached with RBS through the Asset Protection Scheme (APS), which provided protection against losses on certain assets held on RBS's consolidated balance sheet as at 31 December 2008. Protection was provided directly to RBS plc, and was then down-streamed to other group entities where necessary. The details of the APS[448] gave more information on the origin of exposures admitted to the scheme and, therefore, an indication of the relative quality of assets acquired by RBS through ABN AMRO.

386 Graph 2.17 estimates the proportion of APS assets attributable to ABN AMRO, Ulster Bank, RBS GBM and other parts of the RBS Group.

444 *Royal Bank of Scotland: details of Asset Protection Scheme and launch of the Asset Protection Agency*, HM Treasury, December 2009.
445 Offer document, p. 43 'Strategic Rationale' and pp 44-46, 20 July 2007.
446 2008 RBS annual report and accounts; also RBS records, October 2007 to February 2008. Credit default swap hedging assumed to reduce losses on exposures originated by RBS. See also Table 1.6 in Part 1.
447 RBS Group Internal Audit report, July 2008.
448 *Royal Bank of Scotland: details of Asset Protection Scheme and launch of the Asset Protection Agency*, HM Treasury, December 2009.

RBS's decision to fund the acquisition primarily with debt rather than equity

387 After ABN AMRO rejected the consortium's bid for LaSalle, the consortium continued its bid for ABN AMRO, without LaSalle. The consortium did not change its offer price but did increase the proportion of the consideration to be paid in cash, from 79% to 93%.[449] This reflected the fact that, following the acquisition, the LaSalle sale proceeds would accrue to RBS. This increase in the cash component of the offer intensified the effect of a second issue that the Review Team concluded was significant. This was RBS's decision to fund the cash consideration for the acquisition primarily with debt rather than equity, and for most of that debt to be short-term.[450] The structure of the funding is set out in Table 2.12.

Table 2.12: Funding raised by RBS to fund ABN AMRO acquisition, as at 26 September 2007[451]

	€m	
Issue of new ordinary shares	4,281	
TOTAL equity component	**4,281**	
Preference shares	4,567	19%
Other tier 1 securities	1,557	7%
Senior funding	9,941	42%
Bridge funding	7,400	32%
TOTAL cash component	**23,465**	100%
Cash funding required	22,600	
Cash funding surplus as at 26 September 2007	865	

388 RBS's decision to finance the acquisition primarily with debt rather than equity had a number of serious consequences. It served to reduce an already low capital ratio. RBS's anticipated reduction in its core tier 1 capital ratio (from 5.07% in December 2006 to 4.65% in December 2007[452]) as a consequence of the acquisition left it with less room for unexpected changes in circumstances. RBS viewed this reduction as an acceptable consequence of the acquisition.[453] Furthermore, the scenario analysis performed by RBS before the acquisition suggested that, despite low forecast ratios, its total capital ratio would remain above its minimum requirements even in a '*market crisis scenario*'.[454]

449 Offer document, 20 July 2007.
450 In the context of the financing raised by RBS for the ABN AMRO acquisition, short-term is defined as funding falling due in one year or less.
451 FSA records, September 2007.
452 In fact, the reduction in the core tier 1 capital ratio was greater than anticipated. After the acquisition, the firm's public statements indicated a '*worst point*' core tier 1 ratio of 4% at 1 January 2008 (see Section 1.1, paragraph 30).
453 Change in capital ratios as forecast in FSA records, June 2007; 'core tier 1' is not explicitly defined in this record but appears to be defined as equity tier 1 before deductions. See also RBS 2007 results announcements, 28 February 2008, where the RBS CEO's Review stated: '*At the time of the bid for ABN AMRO we indicated that it was our intention to continue to rebuild our capital ratios … the improved financial returns now expected on the acquisition will help to accelerate delivery of the Group's capital regeneration commitments.*'
454 FSA records, September 2007.

389 The effect of goodwill was also very significant. RBS recognised £23.9bn goodwill on the acquisition of ABN AMRO, of which £6.3bn was due to its own share of the ABN AMRO business and £17.6bn to the share of the ABN AMRO businesses attributable to the minority interests. Because of RBS's decision to fund the acquisition mainly with debt rather than equity, a corresponding increase in equity was not recorded. Therefore, when at end-2007 RBS deducted goodwill recognised on the acquisition from its capital resources, this had the effect of depleting RBS's capital position. This was less of a problem in 2008 as, by then, the goodwill had been written down (as discussed in paragraphs 403 to 405). It follows that the recognition of goodwill amplified the adverse effect on RBS's capital position of its decision to fund the acquisition primarily with debt rather than equity.

390 So the decision to fund the acquisition primarily with debt rather than equity weakened RBS's already thin capital position. RBS's judgement that this was an acceptable consequence of the acquisition, therefore, increased its vulnerability.

391 The decision to finance the acquisition primarily with debt rather than equity and for most of that debt to be short-term increased RBS's reliance on short-term wholesale funding. RBS's total payment comprised €4.3bn in RBS shares given to ABN AMRO investors and €22.6bn cash consideration (of which the majority was funded by debt, see Table 2.12). Of the €22.6bn, €12.3bn was through debt with a term of one year or less.[455] Although €10.9bn cash was due to RBS following the sale of LaSalle in October 2007, these funds were retained in the Netherlands longer than RBS initially expected.[456] As a consequence, having raised €12.3bn from the short-term wholesale markets in anticipation that some of this would be paid down promptly through the receipt of cash proceeds from the sale of LaSalle, RBS had to extend the period for which this funding was outstanding. The Review Team judged the decision to finance a major acquisition primarily with debt, of which the majority was short-term, to be a risky financing strategy.

392 As noted in Section 1.2, the Review Team was not able to quantify the impact of the acquisition of ABN AMRO on the combined entity's reliance on wholesale funding during the Review Period.[457] However, RBS Group Assets and Liabilities Committee minutes from June 2008 noted '*the Group's increased reliance* [on short-term funding] *as a result of the ABN AMRO acquisition with the result that it now has a greater reliance on the short-term markets than many of its peers*'.[458]

455 This comprised €4.9bn senior funding with a term of one year or less plus €7.4bn bridge funding. Given that the bridge funding was raised from the interbank market and had an average maturity of six months, the Review Team assumed that none of the bridge funding had a maturity of more than one year. RBS records, September 2007. RBS was not able to provide further breakdown of the bridge funding.

456 In June 2007, RBS expected the proceeds of the sale (which was completed in October 2007) to be repatriated within three months. However, repatriation was delayed during 2008 and subsequent FSA records suggested that the proceeds were eventually absorbed by losses made in ABN AMRO in the Netherlands, rather than being transferred to RBS in the UK, FSA records, February 2008 and March 2011.

457 The liquidity data collected at that time, the CSI reports, from RBS did not include ABN AMRO. ABN AMRO had a high impact EEA branch in the UK. Under the Banking Consolidation Directive, the FSA was responsible for branch liquidity, conduct of business and financial crime as host state regulator. However, there was a Global Liquidity Concession (GLC) in place which meant that the day-to-day supervision of branch liquidity was transferred back to the home state regulator (DNB). Under the IPRU Bank section of the FSA Handbook, there was provision for the FSA to obtain branch liquidity data even if there was a GLC, however, this was not routinely requested by the FSA at that time. The FSA also had a legal right under Article 42 to request group wide liquidity data if it considered it necessary to facilitate the supervision and monitoring of ABN AMRO's UK branch. The Supervision Team of ABN AMRO did not request any information of this nature from ABN AMRO or DNB, aside from routine annual confirmations to maintain the GLC. FSA records, April and May 2011; Review Team meeting with DNB, June 2011.

458 RBS records, June 2008; also Review Team meeting with the then RBS Group Finance Director, June 2011.

393 In addition, some market counterparties reduced the amount they were willing to lend the combined entity of RBS and ABN AMRO. This reduced RBS's borrowing capacity in those markets. By way of illustration, while before the acquisition a counterparty might have had a lending limit of £500m to RBS and £500m to ABN AMRO, its limit for the combined entity might be less than £1bn. The Review Team saw evidence that indicated RBS executive management had not fully considered this risk in advance of the acquisition of ABN AMRO.[459]

394 So in addition to weakening RBS's capital position, the decision to fund the acquisition primarily with debt rather than equity, and for most of that debt to be short-term, increased RBS's reliance on short-term wholesale funding and so the firm's vulnerability.

The effect of ABN AMRO's Basel II application on RBS's capital position

395 On 1 January 2008, 11 weeks after the acquisition of ABN AMRO, both RBS and ABN AMRO were obliged to move to Basel II under the Capital Requirements Directive.[460] Both firms had applied for permission to allow them to use their own internal ratings based (IRB) models to calculate their respective credit risk capital requirements (for details on RBS's IRB model approvals, see Section 1.1.4). Prior to the acquisition, RBS understood that ABN AMRO was on track to receive approval for its IRB models.[461] However, following the acquisition in October 2007, ABN AMRO's progress towards IRB approval raised questions about how RBS, at the consolidated level, would be able to comply with Basel II. ABN AMRO withdrew its application to move to an IRB approach in March 2008 and therefore did not receive approval from DNB for its models.[462] It had not made contingency plans to move to the Basel II standardised approach (the alternative approach allowed for firms that had not received permission to use model-based approaches).[463]

396 It is the Review Team's understanding that, in early 2008, ABN AMRO and DNB agreed that ABN AMRO would withdraw its application and continue to report capital on the basis of Basel I.[464] This approach included revised minimum ratios of 9% for tier 1 and 12.5% for total capital and the requirement to treat capital deductions in the same manner as under Basel II.[465]

397 From December 2007, the Supervision Team was aware of the risks associated with the fact that ABN AMRO had not yet received IRB approval and the fact that the firm was not well placed to move to a Basel II standardised approach.[466] In February 2008, the Supervision Team pursued this matter with DNB. In March 2008, it was escalated to the FSA Supervision Director. There were internal FSA discussions as to the approach to be adopted for RBS's first quarter reporting, given that the FSA had not yet agreed a capital methodology to be used by the two firms,

459 RBS records, November 2007; FSA records, November 2007; Review Team meeting with the then RBS Global Markets Chairman, June 2011.
460 European Directive 2006/EC/48 and recast Capital Adequacy Directive.
461 Review Team meeting with the RBS Group Chief Accountant, July 2011.
462 RBS records, March to April 2008.
463 FSA discussions with RBS, December 2007 to February 2008.
464 FSA records of discussions with RBS, February 2008; RBS records, April 2008.
465 2008 ABN AMRO annual report and accounts.
466 FSA records, December 2007 to February 2008; Review Team meeting with the RBS Group Chief Accountant, July 2011.

and the resulting legal risks this posed to the FSA. This included consideration of whether the proposed approach was sufficiently conservative to compensate for the loss of risk sensitivity that remaining on a Basel I basis entailed.[467]

398 ExCo members discussed the situation in April 2008. A record of ExCo's decision stated that the FSA was content to allow ABN AMRO to calculate risk-weighted assets (RWAs) on a Basel I basis for consolidated capital purposes, following the proposed approach, subject to receipt of written confirmation from DNB that it agreed with ABN AMRO's approach to implementing Basel II at that time.[468] ExCo stressed that this would not be a long-term measure.

399 From March to July 2008, the FSA carried out more detailed work to establish an appropriate level of conservatism. The approach finally adopted by the FSA required ABN AMRO to calculate its capital requirements based on Basel I RWAs with an uplift of 30%[469], and ABN AMRO continued to operate on this basis well beyond the end of the Review Period. This Basel I basis produced a higher capital figure than the Basel II IRB model-based approach would have done. The resulting higher capital requirements placed additional strain on RBS's capital resources and contributed to RBS's apparent fall below individual capital guidance as at end-March 2008 (see Section 1.1.5).

The structure of the acquisition and RBS's decision to lead the consortium

400 As discussed in paragraphs 367 to 370, RBS was required to consolidate the whole of ABN AMRO. The inherent complexity of the transaction structure and the inevitably complex financial reporting that followed, together with ongoing difficulties that RBS experienced in information flow from the Dutch entities,[470] made it difficult for RBS to communicate with the market about the transaction risks and the underlying position. RBS's use of pro forma financial statements, while potentially helpful to users wishing to assess the future development of RBS once it had integrated its share of ABN AMRO, did not fully capture RBS's role during the transition phase in relation to other parts of ABN AMRO. As a result, the presentation of the acquisition and its impact had the effect of obscuring the underlying position of RBS from the market. It also had the effect of obscuring the overall exposures of ABN AMRO, RBS and the other entities in the consortium from the market and from the regulatory authorities.

401 Therefore, from late 2007 onwards, market concerns attached to RBS due to opacity in its group reporting as a result of the ABN AMRO acquisition.[471] These concerns particularly related to wholesale assets acquired by RBS and the obligations (both real and perceived) that RBS had taken on as leader of the consortium. This role gave RBS responsibility for the whole of ABN AMRO during the restructuring phase, leaving it with greater downside risk than its consortium partners (see paragraphs 366 to 371).[472]

467 FSA records, March to April 2008 and March 2010.
468 FSA records, April 2008 and March 2010.
469 FSA records, March to July 2008; Review Team meeting with the RBS Group Chief Accountant, July 2011.
470 RBS Group Internal Audit report, July 2008; Review Team meeting with the RBS Group Chief Accountant, July 2011.
471 Broker Reports: Deutsche Bank, 6 December 2007; Credit Suisse, 1 February 2008; JP Morgan, 28 February 2008.
472 Review Team analysis of RBS records and publicly available data.

402 As noted in Section 1.1.3, RBS recognised significant minority interests in its capital resources due to capital contributed in respect of the consortium partners' interest in ABN AMRO. This had the effect of overstating the amount of capital available to absorb losses through the combined entity. In addition, the tracker share mechanism, which reflected the performance of the individual businesses within ABN AMRO, meant that capital contributed by its partners was not available to absorb losses associated with the businesses RBS had acquired.

403 Furthermore, when it consolidated ABN AMRO, RBS recognised significant goodwill and other intangible assets, which had arisen as a result of the acquisition (of the £23.9bn goodwill, £17.6bn was attributable to minority interests).[473] Goodwill arises in business combinations and is the excess of the cost of an acquired business over the fair value of its net assets. RBS had also recognised goodwill on earlier acquisitions, including NatWest, Charter One and Churchill.

404 This goodwill gave rise to significant losses for RBS when it announced its 2008 results in February 2009. Given the market turmoil and subsequent reappraisals of business forecasts, RBS determined that GBM could no longer support any goodwill and that significant write-downs were also needed in other business units. The total loss recorded at end-2008 due to the impairment of goodwill (on the acquisition of ABN AMRO and other entities) was £30.1bn. This was, in numerical terms, the single largest contributor to the £40.7bn operating loss reported for that year. Table 2.13 shows the business units where the main impairment losses on goodwill were recognised.

Table 2.13: Breakdown of write-downs on intangible assets[474]

Business unit	£bn	Main relevant acquisition
GBM	(8.9)	Principally ABN AMRO, but also NatWest.
Global Transaction Services	–	
UK R&C banking	–	
US R&C banking	(4.4)	Charter One
Europe & Middle East R&C banking	(1.2)	NatWest and First Active
Asia R&C banking	(0.9)	ABN AMRO Asia
RBS Insurance	–	
RFS minority interests	(14.5)	ABN AMRO
Other intangible assets	(2.5)	
TOTAL write-down of goodwill and other intangible assets	(32.6)	(of which goodwill 30.1)

405 As goodwill had already been deducted in full from regulatory capital, these write-downs did not affect RBS's tier 1 or total capital resources. Furthermore, much of the goodwill write-down (£14.5bn) related to Fortis's minority interest

473 2008 RBS annual report and accounts.
474 2008 RBS annual report and accounts. Table does not cast due to rounding of figures from annual report and accounts.

in ABN AMRO.[475] However, given market focus on headline profit or loss figures, the scale of the write-down did have a significant signalling effect to the market. It also gave information on RBS's view of the future profitability of the businesses it had acquired (since a write-down of goodwill signifies an expectation of a reduction in the future cash flows).

406 Therefore, the fact that RBS decided that RBS should act as the leader of the consortium, consolidating the whole of ABN AMRO on to its balance sheet before the transfer of assets to the other consortium partners, introduced vulnerabilities and uncertainties. These had the potential to affect market confidence, even if none of these vulnerabilities actually resulted in a reduction in capital resources. This uncertainty became apparent through market concern in September 2008 following the rescue of Fortis (see Section 1.6, paragraphs 463, 488 and 499). Regardless of whether these market fears were justified, there was speculation that RBS might have to meet Fortis's obligations under the acquisition terms since the restructuring had not yet been completed.[476] There were also fears that the Fortis crisis could cause other collateral damage to RBS.[477]

1.5.3 RBS Board's decision to proceed with the large and complex acquisition of ABN AMRO

407 This section considers the decision-making processes employed by RBS during the acquisition. It focuses in particular on the extent of the due diligence undertaken by RBS and the RBS Board's decision to proceed with the acquisition. More detail is provided in Part 2, Section 2.2.2 and Part 3, Section 2.1.

408 Within RBS the acquisition was considered in two principal fora at Group Board level: the Board of Directors and the Chairman's Committee. These met regularly between March and October 2007 to consider the acquisition. The former met seven times between 28 March and 26 September 2007; the latter 12 times between 11 April and 24 September 2007.

409 In launching a contested bid, RBS and its consortium partners chose to proceed in the knowledge that it would not be able to undertake meaningful due diligence.

410 The FSA was made aware that the materials available to the RBS bid team comprised two lever arch files and information contained on a CD. This material was in addition to information on LaSalle which was provided via an online data room. ABN AMRO confirmed that this was the same information that had been provided to Barclays. RBS employees were sent to the Netherlands to gather further information but evidence suggested that there was limited access after 4 May 2007. Before gaining access to ABN AMRO's confidential information, RBS also reviewed publicly available information on ABN AMRO.[478]

475 RBS records, February 2008.
476 FT Article, 30 September 2008; also highlighted in The Guardian, 29 September 2008; Review Team meeting with DNB, June 2011.
477 The Guardian, 29 September 2008.
478 This included legal and regulatory filings (including prospectuses); interim and annual accounts and associated presentations; company announcements and other investor relations material; equity analyst and rating agency coverage; company, legal and property searches; and industry records covering, for example, transaction participation (for example league tables).

411 Such limited due diligence as was possible focused primarily on potential cost savings and synergies. RBS did, however, also set out to investigate ABN AMRO's balance sheet risks and exposures. A number of specialist workstreams from RBS (including those tasked with reporting on global and wholesale clients, risk and finance operations) included the verification of balance sheet positions in the due diligence objectives.[479] The due diligence objectives set by the risk workstream included two areas which proved to be key contributors to the subsequent losses incurred by RBS as a consequence of the acquisition.[480] The analysis that RBS was able to perform on the balance sheet was, however, severely limited by the restrictions on access to relevant risk information. This impaired RBS's ability adequately to assess the associated risks.

412 Notwithstanding the limitations, RBS concluded that nothing emerged from the due diligence which undermined the commercial rationale of the acquisition. The RBS Board did request and receive assurance from the executive management and the RBS Chairman's Committee was informed that, for the majority of due diligence workstreams, there were '*no show stoppers*'.[481] The RBS Board also took comfort from the fact that ABN AMRO was a regulated, public entity, in particular that it was registered with and subject to the regulatory regime of the US Securities and Exchange Commission.

413 The Review Team learned from DNB that it had expressed concerns in relation to the acquisition due to the cross-jurisdictional and contested nature of the bid (which meant that the consortium proceeded with the acquisition on the basis of limited due diligence), and the combination of other unprecedented factors. In accordance with Dutch legislation, DNB focused on assessing the application for a declaration of no-objection in relation to its supervisory responsibility of ABN AMRO. Given the complexity of the acquisition, this assessment took some time and led to DNB and Dutch Ministry of Finance attaching conditions to the declaration of no-objection. For example, as discussed in paragraph 374, DNB insisted on a staged process for dispersing the separate parts of ABN AMRO, whereby the relevant consortium member would first need to demonstrate its readiness to acquire its respective share of ABN AMRO. DNB repeatedly insisted on realistic timelines to satisfy the conditions of the staged process. RBS, however, underestimated the complexity of splitting up ABN AMRO. This led to continual adjustment of timelines.[482]

414 In summary, although RBS set out to conduct a more thorough due diligence exercise, it was unable to do so because of limitations on information and access (and indeed it was not surprised when it did not get access). Nevertheless, RBS concluded from the due diligence that it was able to do that there was nothing that should dissuade it from proceeding (see Part 3, paragraph 226).

479 Neither the RBS Board nor the executive management set out specific high-level objectives that they were seeking to achieve in the due diligence exercise. See Part 3, paragraph 214.
480 These were (a) the valuation assumptions in respect of provision for impairment losses of credit portfolios, and (b) profit and loss volatility arising from market risk.
481 RBS records, May 2007.
482 Review Team meeting with DNB, June 2011; RBS full year 2007 analysts' call, 28 February 2008. Transcripts sourced from Thomson StreetEvents.

415 The RBS Board was unanimous in its support for the acquisition.[483] The RBS Board's decision to launch a bid of this scale on the basis of due diligence which was insufficient in scope and depth for the major risks involved entailed a degree of risk-taking that can reasonably be criticised as a gamble. The Review Team reached this conclusion in the knowledge that had a fully adequate due diligence process been possible, the RBS Board might still have been satisfied with the outcome and decided to proceed.

416 The investment banking advice commissioned by the RBS Board was provided by brokers whose fees would for the most part be payable only on completion of the acquisition.[484] While this was common practice at the time, it did mean that, as the adviser had a substantial financial interest in the successful completion of the transaction, it is difficult to regard the adviser as independent (see Section 2, paragraph 599).

417 RBS enjoyed a reputation among investors and the UK analyst community for being an effective integrator of acquired businesses. This opinion was based largely on its experience in successfully integrating NatWest, a retail and commercial bank operating primarily in the UK. In addition, Supervision informed the Review Team that the degree of reliance which it placed on RBS's executive management with regard to the acquisition was, at least in part, informed by the view that the earlier integration of NatWest had been a success.[485] Supervision also took some reassurance from RBS's decision to nominate the same individual who had led the NatWest integration to lead the integration of ABN AMRO.[486] While the RBS Board minutes recorded that '*execution risk would be high*' and '*that any bid for* [ABN AMRO] *and subsequent integration would be more difficult than previous transactions*',[487] RBS's decision to proceed with the acquisition was taken against this background of the firm's track record of successful acquisition and integration, particularly of NatWest, and the RBS CEO's personal contribution to it. However, that domestic UK retail merger, although contested, was a less complex challenge than a cross-jurisdiction, consortium takeover on the scale of the ABN AMRO acquisition; NatWest essentially did the same business as RBS at the time but on a larger scale. While this sense of past success may have been justified, it may also have led the RBS Board to be overconfident in its appraisal and challenge of new proposals (see Section 2, paragraph 599). It may also have contributed to RBS executive management's confidence that it would be able to manage the ABN AMRO acquisition.[488] It is clear that it underestimated the operational and integration risks that arose from the acquisition (see paragraph 375), and the extent to which the process of integration would distract it from the management of risks at RBS.[489]

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483 Review Team meetings with the then RBS Chairman, CEO, Group Finance Director and NEDs, May to July 2011.
484 83.33% of fees were payable by RBS to the brokers on the completion of the offer for ABN AMRO, RBS records, May 2007.
485 Review Team meeting with the then FSA Chairman, February 2011; Review Team meeting with the then FSA Supervision Director, January 2011.
486 FSA records, September 2011.
487 RBS records, March 2007.
488 Review Team meeting with the then RBS Chairman, May 2011; Review Team meeting with the then RBS Global Markets Chairman, May 2011; Review Team meeting with DNB, June 2011.
489 RBS Group Internal Audit report, July 2008.

418 All of the factors mentioned above hindered the ability of RBS to assess adequately the scope and scale of risks associated with the acquisition. The Review Team also judged that the limited due diligence compounded RBS's ability to provide the FSA with complete, accurate and timely data on the impact of the acquisition, for example on its capital position.

419 The issue as to whether the inadequacy of the due diligence performed by RBS could be the basis for enforcement action is considered in Part 3. The conclusion reached by the Enforcement Division was that the absence of defined standards and market practice for due diligence in the case of contested takeovers was one of the reasons why it was not appropriate to bring enforcement action against RBS or individuals. This in no way negates the fact that the due diligence performed was inadequate and inappropriate given the risks involved. This suggests issues relating to future policy which are considered in Section 1.5.4.

1.5.4 The FSA's regulation and supervision of the acquisition of ABN AMRO

420 The FSA's supervisory approach to the acquisition of ABN AMRO did not entail adequate assessment of the risks which RBS was taking.[490] This reflected that:

- FSA approval was not required for the acquisition and the FSA did not consider that it had a major responsibility in respect of it;
- at the time, Supervision lacked a defined approach to major takeovers (contested or otherwise); and
- the prevailing FSA philosophy and approach were that strategy, business model and key business decisions were matters for firms' senior management and boards (see Section 3, paragraph 680).

Clearly this was a significant mistake.

421 FSA approval was not (and still is not) required when a UK regulated firm seeks to make an acquisition of a non-UK regulated firm, regardless of its size or whether it is a contested bid. The FSA is responsible for the Change in Control decision for a firm being acquired if it is UK regulated; Change in Control approval does not apply to the acquiring firm. In the case of the acquisition of ABN AMRO, DNB was responsible for the Change in Control decision as the acquired firm was primarily regulated in the Netherlands.[491]

422 However, irrespective of the formal position and prevailing supervisory approach, the FSA should have acknowledged early in the process that the unprecedented scale of the proposed acquisition required a judgement to be made on the

490 By contrast, RBS's commodities joint venture with Sempra Energy in July 2007 was subject to more detailed scrutiny and challenge by the Supervision Team. This was because it was seen as a significant new departure for RBS giving rise to increased risks. As this was a private sale, Supervision had access to the results of more detailed due diligence than RBS was able to undertake for the ABN AMRO transaction, providing scope for more in-depth review and challenge. However, in terms of its impact on RBS's balance sheet and risk profile, the joint venture with Sempra was not an event of material importance.

491 There were, however, nine ABN AMRO subsidiaries in the UK for which the FSA needed to approve a Change in Control (CiC). These were immaterial in the context of the acquisition. Technically the FSA might have been able to use the CiC approval process for these nine subsidiaries as a lever to intervene in the acquisition. However, the Review Team considered that for the FSA to act in this way would have been seen as artificial and, as discussed in paragraphs 424 to 425, the FSA had (and still has) powers to intervene in the event it concluded strong grounds existed to do so.

appropriate supervisory response to determine whether the risks were acceptable. This should also have included greater interaction between the FSA and DNB, given the scale and cross-jurisdictional (and contested) nature of the consortium bid for ABN AMRO and the fact that DNB was responsible for the Change in Control decision for the biggest takeover in banking history which, if it went wrong, could (and did) have a significant effect on RBS, a major UK bank.

423 Since the crisis, Supervision has fundamentally changed its approach to the assessment of major acquisitions, using existing powers far more aggressively. More significant changes to the regulatory framework for takeovers by banks could, however, be considered, to reflect the fact that major acquisitions by banks pose potential social risks which are not present in the case of contested takeovers by non-banks.

Could the FSA have intervened in the acquisition?

424 While FSA approval was not required, it did have (and still has) powers to intervene in an acquisition. These powers are exercisable if it appears to the FSA:

- that a firm is, or is likely to, breach any of the Threshold Conditions (in particular in relation to regulatory requirements for capital and liquidity); or
- that it is desirable to exercise its powers to intervene to protect the interests of the consumer.

425 If the FSA had determined that either of these conditions were met in respect of the acquisition of ABN AMRO, it could have intervened in a number of ways. In particular:

- If the FSA considered that the acquisition entailed risks to capital or liquidity which might threaten Threshold Conditions, it could have directed RBS not to launch the bid until it had raised more capital.
- If the FSA had considered the bid would create undue risks to consumers, it could have directed RBS not to make the bid.

The appropriate time for FSA intervention

426 The Review Team believes that if the FSA was to intervene the most appropriate time to do so would have been before the consortium published its offer on 20 July 2007. This judgement reflects the greater complexities and risks involved in intervention after that point in the process:

- From 20 July 2007, RBS and the consortium were committed to proceeding with the acquisition subject to the conditions of the offer being met. After that date, under the terms of the offer, the ways in which the consortium could have withdrawn were if it had exercised the MAC condition or the RA condition in the Offer document, or if any of the consortium members had been unable to obtain the approval of their shareholders. Whether an intervention by the FSA would have constituted a 'trigger' regulatory event under the RA condition would have been dependent on the nature, as well as the materiality, of the FSA's intervention (see paragraphs 353 to 354).

- Any intervention after the offer had been published on 20 July 2007 would likely have been interpreted as based on major concerns about the capital and liquidity position of RBS, and therefore could itself have had a serious destabilising effect.

427 In fact the FSA did not consider whether it should use its powers to intervene at any time between being informed in April 2007 of the consortium's intention to make an offer for ABN AMRO and the consortium publishing its offer on 20 July. This was consistent with the fact that FSA approval was not required and with the prevailing FSA philosophy and approach of the time.

428 In autumn 2007, however, in light of market conditions, the FSA CEO and Chairman did consider whether the FSA should intervene in the acquisition but determined that it should not.

429 The FSA's approach to the acquisition both before and after 20 July and the factors which led the FSA CEO and Chairman to conclude against a later intervention are discussed in paragraphs 430 to 439 below.

The FSA's supervisory approach to the acquisition: before and after the start of the crisis period

430 In the period up to 20 July 2007, the FSA's supervisory focus was governed by an overriding concern to ensure that the FSA was impartial in the treatment of the competing RBS and Barclays bids. The FSA's focus was on the regulatory arrangements for RFS and the structure of the bid. From the available evidence, the FSA's approach involved minimal assessment of the fundamental risks involved in the acquisition and only limited assessment of the capital and liquidity consequences. A number of factors (such as the consortium structure, the size of the acquisition and the fact that it was cross-jurisdictional and contested) made a detailed assessment of the prudential position of the combined entity of RBS and ABN AMRO more complex than in other cases. However, the Review Team considered that supervisory attention, under FSA senior management direction, should have been more actively engaged in performing such an assessment from the time in April 2007[492] that the FSA was informed of the consortium's intention to make a bid. The Review Team judged the lack of such an assessment early in the acquisition process to have been a weakness of the supervisory approach followed in this case. Supervisory practice has since been rectified accordingly.

431 Over summer 2007, the financial system entered the early stages of the crisis. Liquidity dried up in key markets and on 14 September 2007, Northern Rock received ELA from the Bank of England and suffered a subsequent run on deposits. In response to market conditions, the FSA increased its focus on capital and liquidity issues (see Sections 1.1 and 1.2). This included a more detailed analysis of the capital and liquidity risks involved in the ABN AMRO acquisition at the request of the FSA CEO and Chairman.

492 FSA records, April 2007.

432 RBS's capital and liquidity positions were considered by the FSA Supervision Director, Managing Director of Retail Markets, CEO and Chairman shortly before the ABN AMRO acquisition was concluded on 17 October 2007.[493] In September and October 2007, the Supervision Team briefed, in three memos, these members of FSA senior management on the impact on RBS of the acquisition. These briefings assessed capital and liquidity risk, with a focus on ABCP conduits (due to the significant size of ABN AMRO's ABCP conduit business,[494] see paragraph 381 to 382) and were based on information provided by RBS in September and October 2007.[495] The Review Team was also informed that FSA senior management, including the Chairman and CEO, was regularly updated as to the progress and assessment of the bid. These were predominantly oral updates for which, in the majority of cases, written records were not produced.

433 The September and October 2007 briefings from the Supervision Team concluded that RBS would be able to deal with the impact of the acquisition from a capital perspective, bearing in mind the minimum capital requirements at that time.[496] The memos concluded that RBS was at risk of liquidity difficulties in the event of an extreme scenario, such as it being unable to roll over all or a large part of its significant overnight wholesale funding position. While FSA senior management was concerned by liquidity conditions in the markets at that time (see Section 1.2.5), the scenario under which those risks could crystallise for RBS was considered '*very unlikely*'.[497]

434 At that time, therefore, there was no indication from the analysis performed by the Supervision Team that RBS would not be able to complete the acquisition and continue to meet the Threshold Conditions.[498] Based on the information available to the FSA, the FSA considered that RBS met the prevailing capital and liquidity requirements and RBS was also on course to raise the required financing for the acquisition. On this basis, in addition to their concerns over the potential and significant destabilising impact, the FSA CEO and Chairman concluded in autumn 2007 that an intervention could not be justified.

435 The FSA also engaged with DNB and, in September 2007, received some information from DNB on the risks associated with ABN AMRO's ABCP conduit business in the context of market conditions at that time.[499] DNB told the Review Team that it had also taken comfort from the fact that RBS's responses to its information requests were sent to DNB via the Supervision Team at the FSA. The DNB informed the Review Team that it believed that the FSA would supplement the answers provided by RBS from its own information and understanding of RBS.[500] The Review Team has not seen evidence that the Supervision Team did this or that it was aware of these expectations.

493 FSA records, September and October 2007.
494 Market participants were aware of the significant size of ABN AMRO's committed liquidity facilities to ABCP conduits at this time, JP Morgan European Equity Research Note, 27 September 2007; also FSA records, September 2007.
495 FSA records, September and October 2007.
496 FSA records, September and October 2007.
497 FSA records, October 2007.
498 FSA records, September and October 2007.
499 FSA records, September 2007.
500 Review Team meeting with DNB, June 2011.

436 The Review Team saw evidence that the Supervision Team did, at a high level, assess, corroborate and follow up, on occasion, the information provided by RBS in September and October 2007 in response to the questions from DNB and FSA; however, the Review Team identified points in the information where the Supervision Team could have reasonably probed further.[501]

437 The Review Team considered that the FSA's approach to the acquisition of ABN AMRO in September and October 2007, after the consortium had published its offer and following the start of the crisis period, was hampered by three factors:

- For the reasons set out in paragraph 426, the period before the publication of the consortium's offer on 20 July 2007 was the better time for the FSA to intervene.
- It was limited by the overall inadequacies of the prevailing approach to capital and liquidity described in Sections 1.1 and 1.2.
- The analysis performed by the FSA excluded, as being '*very unlikely*'[502], the scenario which would crystallise the risk of liquidity difficulties for RBS. This reflected the fact that RBS, the FSA, market participants and other policy-makers considered that a scenario in which a firm such as RBS would not be able to fund itself was a low probability, albeit high impact, event. In hindsight, this low probability, high impact scenario was exactly that which crystallised for RBS in October 2008.

Conclusion on the FSA's approach to the acquisition

438 The Review Team concluded that the FSA's overall approach was an inadequate response to the major risks inherent in the acquisition of ABN AMRO. Given that this was the largest ever cross-jurisdictional (and contested) banking acquisition, the FSA appeared to have taken limited account of the very substantial uncertainties and risks, which were compounded by the limited due diligence that could be performed. In the unprecedented circumstances of this case, supervisory attention, under FSA senior management direction, should have been more actively engaged from the time in April 2007 that the FSA was informed of the consortium's intention to make a bid for ABN AMRO. The attention should have entailed a particular focus on testing in detail the potential capital and liquidity implications of the acquisition for RBS.

439 While it is now recognised that the events of autumn 2007 were a precursor to the crisis of 2008 during which RBS failed, the Review Team judged that, in the context of the time, the decision by the FSA CEO and Chairman not to intervene in September/October 2007, in the period after the offer had been published, was reasonable, given both the low probability of extreme liquidity stresses emerging, and the FSA CEO's and Chairman's judgement that the intervention could itself have destabilised RBS.

501 FSA records, September to October 2007.
502 FSA records, October 2007.

Supervisory practice for acquisitions after the Review Period: a case study

440 Following the Review Period, the FSA takes a more intensive approach to the supervision of major corporate transactions. In a 2010 transaction involving a proposed major overseas acquisition funded by a rights issue, the FSA's approach included the following:

- Imposing higher capital requirements upon the acquiring firm to reflect the risks involved, thus using the Threshold Conditions powers more aggressively.
- Three key internal decision checkpoints during the assessment process, involving the FSA Executive Supervisory Committee, a sub-committee of ExCo.
- Setting up a multi-disciplinary team, including internal specialists, to assess the risks associated with the transaction at an early stage.
- An assessment of significant amounts of information requested from the firm about the impact of the proposed transaction; in particular the adequacy of the combined group capital position at deal closure, at forward projections and under stressed conditions.
- How the FSA could discharge its responsibilities as lead supervisor, and any additional steps necessary to ensure this.
- Meeting the firm's board members to assess board oversight of the transaction.
- Close working between Supervision and the UK Listing Authority.

Further policy issues: a special regulatory regime for major bank takeovers?

441 The due diligence that RBS conducted on ABN AMRO was very limited and clearly inadequate to assess the major risks involved. But the absence of rules, codes and standards of practice which define the appropriate and required level of due diligence in a takeover reflects the assumption that decisions on how much due diligence is appropriate can be left to individual firms and to the processes of market discipline. In contested takeovers only very limited due diligence is possible. Management and boards have to decide whether the potential benefits of proceeding on the basis of limited due diligence outweigh the risks involved. Institutional investors are well aware of the limited nature of the due diligence possible in these circumstances, and have the ability to vote against approval of the acquisition if they consider the risks are too great. If the acquisition turns out to be unsuccessful, they can dismiss the board and management.

442 In most sectors of the economy, this market discipline approach remains appropriate because the downside risks affect only the equity shareholders. Banks, however, are different because, if a major takeover goes wrong, it can have wider financial stability and macroeconomic effects. The potential downside is social, not just private.

443 As a result, further public policy responses to the lessons of the ABN AMRO acquisition need to be considered. These should include, but not be limited to, the following points for consideration:

- Making it a requirement that FSA regulated banks should seek formal FSA approval for any major takeover (the term 'major' would be defined by reference to the target firm's size relative to the size of the acquiring bank).
- Establishing within this formal approval regime a strong presumption that major contested takeovers would not be approved, or would only be approved if supported by exceptionally strong capital backing, given that specific risks are created by an inability to conduct adequate due diligence.

Conclusions on what happened in RBS

- It is possible that RBS would have failed even without the acquisition of ABN AMRO. However, it is clear that the acquisition undoubtedly contributed significantly to RBS's vulnerability.
- The acquisition of ABN AMRO increased RBS's exposures in a number of asset classes that would later lead to major losses, whilst the decision to fund the acquisition primarily with debt rather than equity, and for most of that to be short-term, weakened RBS's capital position and exposed it to greater liquidity risk.
- RBS chose to proceed with the acquisition in the knowledge that it would not be able to undertake meaningful due diligence. The due diligence performed was inadequate in scope and depth in light of the nature and scale of the acquisition and the major risks involved. This reflected the limited information and access available given the contested nature of the takeover.
- Notwithstanding the limitations, RBS concluded that nothing emerged from the due diligence which undermined the commercial rationale of the acquisition; there were '*no show stoppers*'.
- The RBS Board's decision to make a bid of this scale on the basis of inadequate due diligence entailed a degree of risk-taking that can reasonably be criticised as a gamble.
- RBS's decision to proceed with the acquisition was taken against a background of the firm's track record of successful acquisition and integration, particularly of NatWest. This may also have led the Board to be overconfident in its appraisal and challenge of new proposals and contributed to RBS executive management's confidence that it would be able to manage the ABN AMRO acquisition. It is clear that RBS underestimated the operational and integration risks that arose from the acquisition and the extent to which the process of integration would distract it from the management of risks at RBS.

Conclusions on the FSA's regulation and supervision

- The FSA's overall supervisory approach to the acquisition of ABN AMRO was an inadequate response to the major risks inherent in the acquisition. This reflected the fact that: FSA approval was not required; Supervision did not have a defined approach to major takeovers (contested or otherwise); and the prevailing FSA philosophy and approach of the time that strategy, business model and key business decisions were matters for firms' senior management and boards. Clearly this was a significant mistake.

- Given that this was the largest ever cross-jurisdictional (and contested) banking acquisition, supervisory attention, under FSA senior management direction, should have been more actively engaged from the time in April 2007 that the FSA was informed of the consortium's intention to bid for ABN AMRO. This attention should have entailed a particular focus on testing in detail the potential capital and liquidity implications of the acquisition for RBS.
- The most appropriate time for the FSA to intervene was before the consortium published its offer on 20 July 2007. The FSA did not consider whether it should use its powers to intervene before that date and this was consistent with the fact that FSA approval was not required and with the prevailing FSA philosophy and approach.
- The Review Team judged that, in the context of the time, the decision by the FSA CEO and Chairman not to intervene in September/October 2007, in the period after the offer had been published, was reasonable, given both the low probability of extreme liquidity stresses emerging and the FSA CEO's and Chairman's judgement that intervention at that point could itself have destabilised RBS.

Lessons already identified where actions have been taken

- Supervision has since modified its current approach to acquisitions to ensure that it is considerably more intrusive and challenging in its handling of major takeovers.

Recommendations for further change

- The Review Team recommends that the FSA formalise its more intensive approach to major corporate transactions involving high impact regulated firms, by producing guidelines. These might, subject to complying with the Acquisitions Directive, incorporate:
  - key internal decision checkpoints during the assessment process;
  - setting up a multi-disciplinary team, including internal specialists, to assess the key risks (including, in particular, capital and liquidity risks) associated with the transaction at an early stage;
  - consideration of the requirements and information flows imposed by European legislation;
  - coordinated engagement with overseas regulators in cases of cross-jurisdictional transactions where expectations, roles and responsibilities of each regulator are mutually agreed and understood, for example through the establishment of a Joint Liaison Committee;
  - the assessment of comprehensive (in particular, key prudential) information from the firm that sets out the impact of the proposed transaction; the adequacy of the combined group capital position at deal closure, taking into account financing, at forward projections and under stressed conditions;
  - meeting board members of the firm to discuss and agree FSA expectations for board oversight of the transaction;
  - assessing the capability, experience and track record of the firm's management to successfully conclude the acquisition;

- early consideration, where appropriate, of the need for any collaboration between the UK Listing Authority and Supervision;
- early confirmation of the regulatory approach to be followed by the FSA (for example, a need for approval of a Change in Control (CiC), or a need to assess disclosures in an associated prospectus), in addition to the Threshold Conditions;
- exploring whether the firm's board had considered independent advice on the merits of the transaction;
- an assessment of financial stability issues resulting from the transaction; and
- in the case of a contested takeover, considering setting an additional capital buffer where the bidder proceeds on limited due diligence. This would include considering the capital requirement of a UK regulated bidder where the FSA is not the decision-maker on a CiC. The capital buffer could, in certain circumstances, be set at a level which renders the deal less likely to proceed.

• In addition, the Chairman's Foreword and paragraph 443 highlight another point for consideration which would require a change in law rather than a change in FSA practice: making it a requirement that FSA regulated banks should seek formal FSA approval for any major takeover.

1.6 Systemic vulnerabilities and confidence collapse: failure of the banks in worse relative positions

444 On 7 October 2008, RBS became reliant on Emergency Liquidity Assistance (ELA) provided by the Bank of England. This was necessary following RBS's loss of liquidity driven by concerns of wholesale counterparties and retail and corporate depositors about its solvency position. The Review Team considered this to be the point of failure for RBS.

445 This section describes market conditions and the market perceptions of RBS in the months between the announcement of the rights issue on 22 April 2008 and its failure on 7 October. It considers how these external factors, combined with RBS's weak capital and vulnerable liquidity positions, as well as poor asset quality, contributed to its failure. The key points, which are explained in 1.6.1 to 1.6.4, are:

- RBS suffered a gradual liquidity run which reached extreme proportions following the collapse of Lehman Brothers on 15 September 2008;
- a factor in this liquidity run was the general deterioration in market conditions and intensification of market uncertainty from summer 2008, which became catastrophic after the failure of Lehman Brothers; and
- although these conditions affected all banks in some way, those banks which failed experienced the most extreme liquidity problems because they

were, and/or were *perceived* to be, in a relatively worse position in terms of capital, liquidity and asset quality; this was the case with RBS.

446 This section also considers the FSA's supervision of RBS's capital and liquidity and asset quality, extending the analysis in Sections 1.1 to 1.4 to cover the period following the rights issue announced in April 2008 to RBS's failure on 7 October 2008. The key points, which are explained in 1.6.5, are:

- The Supervision Team's focus during this period was to ensure RBS continued to meet the FSA's new core capital target ratio of 5% for major UK banks through monitoring RBS's progress against its asset disposal plan. This was consistent with the FSA's supervisory strategy for RBS as set out at end-April 2008.[503]
- This focus took priority over the other FSA objectives for RBS also set out at end-April 2008, namely to improve its capital planning/forecasting capabilities; ensure the downside risks to capital were fully understood; and resolve ABN AMRO's approach to the implementation of Basel II for its credit risk capital requirements.
- The Review Team concluded that this was an appropriate prioritisation, reflecting the FSA's focus on aiming to ensure that RBS had adequate core capital to absorb losses and maintain confidence in its solvency.
- The approach to the supervision of liquidity was predominantly based on monitoring and was consistent with the Supervision Team's, Supervision's, and FSA senior management's view that RBS's liquidity position was not an immediate risk. With hindsight, this assessment was wrong and RBS's loss of liquidity resulted in its failure. The Review Team acknowledged, however, that once the crisis period started there was limited action that RBS or the FSA could take to improve the firm's liquidity position, given market conditions.
- The supervision of RBS's asset quality was limited and focused on the immediate risks arising from RBS's structured credit portfolio. This was consistent with the FSA's general approach to supervision, which involved limited fundamental analysis of balance sheet composition and asset quality.

1.6.1 RBS's liquidity run followed by failure

447 When RBS announced its H1 2008 results on 8 August 2008, few if any market participants would have anticipated the failure of the bank within two months. The rights issue had passed smoothly; capital had been raised which seemed at the time sufficient to cover the structured credit losses; and it was funding itself at maturities not radically different from those of a year earlier (albeit that this meant that RBS remained concentrated in the short-term and, in particular, overnight wholesale markets).

448 In mid-July 2008, conditions in the wholesale markets suddenly and sharply deteriorated as the possibility emerged that market participants might refuse to

503 FSA records, April 2008.

extend credit to Fannie Mae and Freddie Mac, leaving them increasingly reliant on US government support.[504] There was evidence of deterioration on available wholesale funding[505] maturities for major UK banks and building societies and an increase in the aggregate reliance on very short-term[506] wholesale funding across the markets.[507] Three major banks, including RBS, largely accounted for that sudden increase.[508] RBS explained to the FSA that this was partly because of negative investor sentiment, '*investors "don't want to do term*"'.[509] However, another of the three banks stated that it had deliberately shortened the maturity profile of its wholesale funding, and this decision was not influenced by investors.[510]

449 From this point, RBS faced increasingly difficult funding conditions in the wholesale markets.

450 From the beginning of August to early October 2008, RBS lost £8.7bn of retail (including small and medium-sized entities) and £10.4bn of corporate deposits (including from financials and non-financials).[511] This put pressure on RBS to replace those funds in the wholesale markets at a time when term funding was limited, thus increasing RBS's dependence on short-term wholesale funding.

451 Although RBS's liquidity position was vulnerable, this did not reach extreme proportions until immediately after Lehman Brothers' failure on 15 September 2008 when RBS described funding conditions as '*really, really awful*'.[512] Together with one of its peers, RBS told the FSA that term funding in the wholesale markets had disappeared and that they were now reliant on overnight funding in their major trading currencies.[513]

452 The simultaneous attempt by multiple banks to improve their liquidity positions by limiting the amount and shortening the maturities of their placements in the interbank market, contributed to a generalised collapse of liquidity.[514] Although some of RBS's peers were able to get small amounts of wholesale funding with a maturity longer than overnight, this was still of a short tenure.[515]

504 Congressional Research Service Report, *Fannie Mae and Freddie Mac in Conservatorship*, 15 September 2008 and *The Turner Review*, Box 1B, March 2009.
505 Wholesale funding as defined in this section includes both unsecured and repurchase agreements (repo) funding from the wholesale markets. A repo is the sale of securities with an agreement to buy the securities back later; it is a form of short-term borrowing.
506 Very short-term wholesale funding defined here as wholesale funding falling due within five business days.
507 FSA records May to August 2008.
508 FSA records, July 2008.
509 FSA records, August 2008.
510 This firm did not state why it had decided to shorten the term of some of its funding, FSA records, August 2008.
511 FSA records, August to October 2008. The Review Team was not able to perform this analysis for earlier periods as the data on which this analysis was based were taken from Liquidity Risk Profile (LRP) reports which the FSA collected from firms from August 2008. For further detail on LRP reports, see Section 1.2, paragraphs 173 to 181. Also, records from RBS stated that *'groups deposits (excl GBM* [sic]*) fell by c£20bn in the month of October largely in Jersey, UK Corporate and Ulster'*, RBS records, November 2008.
512 FSA records, September 2008.
513 FSA records, September 2008.
514 *The Turner Review: a regulatory response to the global banking crisis*, 2.2 (vii), March 2009. The interbank market, a sub-set of the money markets, is where banks lend to one another, usually on maturities of one week or less and predominantly overnight. Interbank markets perform a key role in banks' liquidity management – to cover short-term liquidity shortfalls – and, in normal times, are among the most liquid in the financial sector.
515 FSA records, September to October 2008.

453 The last two weeks of September saw the collapse, or near collapse, of a number of institutions such as, AIG, Washington Mutual, Fortis, Bradford and Bingley and the Icelandic Bank Glitnir.

454 Ultimately it was the collapse of Lehman Brothers that broke market confidence that certain institutions were too big to fail[516] and resulted in a liquidity run on RBS. It is arguable that implicit government support, rather than its fundamental soundness, had played a critical role in assuring market participants of RBS's survival and that, when this support was suddenly thrown into doubt, the consequences for RBS were fatal.

455 RBS's liquidity problems were at that time exacerbated by requests to buy back commercial paper (CP) issued by its asset-backed commercial paper (ABCP) conduits which were finding it increasingly difficult to roll over CP.[517]

456 The Irish government's announcement on 30 September 2008 that it would guarantee the deposits of Irish banks but not banks such as RBS's subsidiary Ulster Bank (as it was part of a UK group) further intensified pressure on RBS's liquidity position in the period that followed the failure of Lehman Brothers. According to data from daily and intra-day calls held by the FSA with RBS at the time, Ulster Bank lost the equivalent of £732m in deposits in the four days following the Irish government's announcement.[518]

457 By 3 October 2008, RBS's very short-term[519] wholesale funding gap[520] had increased to over £100bn (see Graph 2.20).

458 Then by 7 October 2008 the continual maturing of RBS's overnight wholesale funding gap had become so great that RBS was unable to raise new money to replace these liabilities as they fell due. On that day alone, RBS also '*lost £6bn in customer deposits*'[521]; government and large financial and non-financial institutions also withdrew significant corporate deposits.[522] To prevent actual default, the Bank of England began extending ELA to RBS on 7 October 2008.

459 On 8 October 2008, the UK government announced a recapitalisation package, asking banks to increase their tier 1 capital ratios.[523] '*The objective was to ensure that the banks had a level of capital "where people could absolutely clearly and without doubt have confidence in them"*'.[524] Participating banks could either obtain capital through the UK government's recapitalisation scheme or raise capital in the markets. RBS was one of three major UK banks to obtain

516 *The Turner Review*, Box 1B, March 2009.
517 FSA records, September to October 2008.
518 FSA records, September to October 2008. For more detail on the daily and intra-day calls, see Section 1.2, paragraphs 176 to 177.
519 Very short-term wholesale funding defined here as wholesale funding falling due within five business days.
520 The wholesale funding gap is defined in this section as wholesale outflows less wholesale inflows on a contractual basis without taking collateral into account.
521 FSA records, October 2008.
522 Data provided by RBS to the Review Team in July 2011.
523 HM Treasury, National Archives website, 8 October 2008.
524 *Banking in Scotland: Second Report of Session 2009–10*, House of Commons Scottish Affairs Committee, 24 February 2010.

capital through the recapitalisation scheme.[525] In 2008, it received a £20bn injection of capital from the UK government in exchange for ordinary shares (£15bn) and preference shares (£5bn).[526]

460 The liquidity run that led to this point of failure for RBS was, in part, a system-wide phenomenon with market-wide causes. But within this market confidence collapse, some banks faced far greater liquidity pressures than others. Indeed some of the banks which the market perceived to be stronger were recipients of a 'flight to quality' effect[527], as corporates and other depositors switched money to them from those banks perceived to be weaker. The banks which benefited in turn had to make difficult decisions about whether, and at what maturities, to place surplus money in the interbank markets.

1.6.2 Market conditions and the intensification of market uncertainty

461 The overall market context in which the events of August to October 2008 described above occurred was one that had changed radically since mid-2007, particularly the conditions in funding markets.

462 Spreads of three-month London Interbank Offered Rate (LIBOR) over overnight index swap (OIS) rates had widened substantially in early August 2007 and remained at much higher levels than previously experienced. These widening spreads primarily reflected rising credit risk premia (driven by the perception of credit risk in wholesale funding markets), rather than simply increasing demand for term (rather than overnight) funding.[528] Following the failure of Lehman Brothers, the three-month LIBOR-OIS spread rapidly widened further, reflecting the disappearance of wholesale funding and collapse in market confidence.

463 In the aftermath of Lehman Brothers' bankruptcy, a mix of credit problems, wholesale deposit runs and incipient retail deposit runs led to the collapse or near collapse of a number of financial institutions, including RBS and Fortis, one of RBS's consortium partners in the acquisition for ABN AMRO (see Box 2.4). Concerns about Fortis's solvency and the resulting implications for RBS's exposure to ABN AMRO, may have exacerbated concern about RBS itself (see Section 1.5, paragraph 406).

525 The other two were HBOS and Lloyds TSB, combined as Lloyds Banking Group when they merged in January 2009. The UK government announced that it would be injecting capital to these banks on 13 October 2008, HM Treasury, National Archives website, 13 October 2008.

526 The preference share capital was later converted to ordinary share capital, UK Financial Investments Limited, annual report and accounts, 2010/11. RBS also participated in the UK government's Asset Protection Scheme (APS), *Royal Bank of Scotland: details of Asset Protection Scheme and launch of the Asset Protection Agency*, HM Treasury, December 2009.

527 As RBS stated it had benefited from immediately following the failure of Northern Rock, see Section 1.2 paragraph 126.

528 Quarterly Review, *What drives interbank rates? Evidence from the Libor panel*, Bank for International Settlements, March 2008.

Box 2.3

Intensification of market uncertainty during 2008

March	Federal Reserve Bank of New York supplied liquidity to Bear Stearns (through JP Morgan Chase) to avert the collapse of the firm.
Mid-July	Evidence of deterioration on available wholesale funding maturities for major UK banks and building societies, including aggregate increase in reliance on very short-term wholesale funding.
8 to 15 July	Fannie Mae and Freddie Mac share prices plunged sharply. Possibility that market participants might refuse credit, making US government support necessary.
8 August	RBS announced its first loss in 40 years, a statutory operating loss before tax of £692m after credit market write-downs of £5.9bn for H1 2008.[529]
7 September	Fannie Mae and Freddie Mac placed in conservatorship.[530]
15 September	Bankruptcy of Lehman Brothers broke confidence that major institutions were too big to fail.
Following collapse of Lehman Brothers	Already impaired liquidity in the interbank markets dried up, as banks chose to hoard cash instead of lending it on even short maturities[531]; both secured (repo) and unsecured markets seized up.
	Firms, including RBS, experienced the most difficult funding conditions since the crisis period started.[532] Major banks significantly reliant on central bank support.
16 September	Federal Reserve Bank of New York announced that it would lend up to US$85bn to AIG to ensure it could meet its obligations as they fell due; in return the US government took a 79.9% equity interest in AIG.
17 September	Lloyds TSB and HBOS confirmed their intention to merge.
25 September	Collapse of Washington Mutual one of the largest US retail banks.
28 September	Governments of Belgium, the Netherlands and Luxembourg announced their intention to inject €11.2bn to shore up Fortis's position, protect the interests of account holders and help to ensure financial stability.
29 September	Bradford & Bingley transferred into public ownership with the retail deposit book and branch network transferred to Abbey National plc (now Santander).
	Icelandic government forced to take a 75% stake in the country's third-largest bank, Glitnir, after it experienced liquidity problems.[533]
30 September	The Irish government announced it would guarantee the deposits of Irish banks (this initial announcement did not apply to banks such as RBS's subsidiary Ulster Bank as it was part of a UK group).
7 October	RBS received Emergency Liquidity Assistance from the Bank of England.
	Landsbanki placed into receivership in Iceland.
8 October	UK government announced its recapitalisation package for banks to increase their tier 1 capital ratios.

529 2008 RBS interim results.
530 Congressional Research Service Report, *Fannie Mae and Freddie Mac in Conservatorship*, 15 September 2008.
531 *Liquidity hoarding and interbank market spreads – the role of counterparty risk*, European Central Bank, December 2009.
532 FSA records, September and October 2008.
533 *Banking Crisis: The impact of the failure of the Icelandic banks: Fifth Report of Session 2008–09*, House of Commons Treasury Committee, 31 March 2009.

Graph 2.18: LIBOR-OIS sterling three-month spread

Source: Bloomberg Finance LP.

Box 2.4

Benelux rescue of Fortis

Fortis, one of RBS's consortium partners for the acquisition of ABN AMRO, paid €24.4bn consideration for its share of ABN AMRO, financed in part by a rights issue (€13.2bn) offering existing shareholders the opportunity to purchase additional shares at €15 per share. Following the acquisition and amid concerns of worsening market conditions, Fortis took steps to improve its capital position.

In June 2008, Fortis announced a further rights issue of €1.5bn and a non-core asset disposal programme; it did not declare an interim dividend for 2008; and it proposed payment of the full year 2007 dividend in shares rather than cash. These actions led to downward pressure on its share price, which dropped 17% from €12 to just over €10 on 26 June 2008. On 11 July 2008, the Fortis CEO stepped down.

Following the collapse of Lehman Brothers, there were market rumours that Rabobank had been asked to assist Fortis in its financial difficulties. As a result of these renewed concerns over Fortis's solvency, on 26 September 2008 its share price fell by approximately 21%. Then, on 28 September, the governments of Belgium, the Netherlands and Luxembourg (Benelux) announced their intention to inject €11.2bn to shore up the bank's position, protect the interests of account holders and help to ensure financial stability. As part of this rescue package, the Fortis Chairman was required to step down. It was also announced that Fortis would sell the stake in ABN AMRO, which it had acquired in 2007.[534]

On 3 October the Dutch government stated that it would purchase Fortis's Dutch operations (banking and insurance) for €16.8bn[535] and on 5 October BNP Paribas announced that it would take a majority stake in Fortis, reducing the governments of Belgium and Luxembourg to minority shareholders.[536]

1.6.3 RBS in a relatively poor position: the facts

464 The banks that failed in the course of the funding crisis of autumn 2008 were those which were, or were perceived by the market to be, in a relatively weak position. RBS was one such bank. RBS's position in the months following its

534 *The Turner Review*, Box 1B, March 2009. Government of the Netherlands' website: see www.government.nl/News/Press_releases_and_news_items/2008/September/Benelux_comes_to_aid_of_Fortis.
535 Government of the Netherlands' website: see www.government.nl/News/Press_releases_and_news_items/2008/October/Dutch_State_acquires_Fortis_Nederland.
536 FT.com, 6 October 2008, see www.ft.com/cms/s/0/1523014a-9323-11dd-98b5-0000779fd18c.html#axzz1RRw3qa00.

£12bn rights issue is described in this section and Section 1.6.4 then discusses the perceptions of RBS within the market at that time.

465 Analysis of RBS's underlying position revealed that:

- While it appeared that the rights issue had placed RBS in a strong capital position, absolutely and relative to peers[537], with hindsight it is clear that its true loss absorbing capital (estimated on a Basel III basis) remained weak.
- In the months before Lehman Brothers' failure, RBS's liquidity position was among the weakest of its peers. This made it vulnerable to the market-wide funding crisis that followed Lehman Brothers' failure.
- Losses incurred in H1 2008 signalled emerging asset quality problems, including continuing large losses on credit market exposures.

466 RBS's capital and liquidity positions were *in fact* weaker than the average of its peers following the completion of the rights issue in June 2008; this situation persisted up to its failure. The combination of inadequate capital, a high reliance on short-term wholesale funding and asset quality problems, if apparent to the market, should logically have been drivers of significant market concern that RBS was one of the most vulnerable of the UK banks.

Capital position

467 Following the completion of the rights issue, RBS reported improved Basel II total capital and tier 1 capital ratios. At end-June 2008, following closure of the rights issue, RBS's reported total capital ratio was the second highest of its peers, and its reported tier 1 ratio the highest.

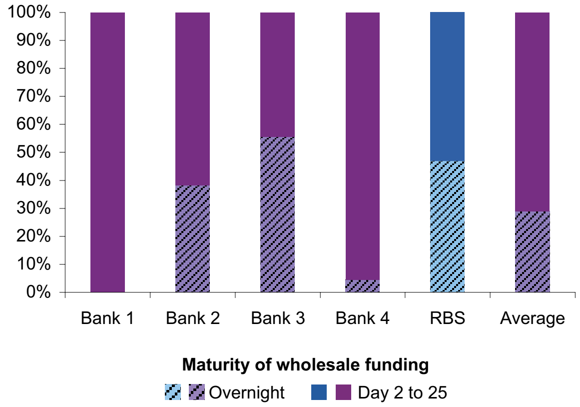
468 However, as discussed in Section 1.1, the Basel II framework was inadequate. With hindsight, RBS's underlying core capital position, a measure of the quality of a firm's capital, remained below average for its peer group. The Review Team estimated that RBS's Basel III common equity tier 1 capital ratio as at end-June 2008 would have been 2.79% (see also Section 1.1). This compares with an estimated average of 3.97% for RBS's peers (see Table 2.14).[538]

Table 2.14: Comparison of capital ratios at end-June 2008, on a Basel II and estimated Basel III basis

	Basel III proxy common equity tier 1 ratio[539]	Published Basel II tier 1 ratio[540]
RBS	2.79%	9.10%
Peer group average (excluding RBS)[541]	3.97%	8.22%

537 The peer group is Barclays, HBOS, HSBC, Lloyds TSB and Standard Chartered.
538 This average excludes RBS. FSA records, June 2011.
539 Review Team analysis of FSA returns, FSA records, published interim results and annual accounts of RBS and peers and data provided by RBS to the Review Team in March to September 2011.
540 Published interim accounts of RBS and peers.
541 The peer group is Barclays, HBOS, HSBC, Lloyds TSB, and Standard Chartered.

Graph 2.19: Overnight wholesale funding as a proportion of the short-term wholesale funding gap at end-June 2008[542]



469 A full description of the methodology used to calculate these estimates is set out in Appendix 2E. Of course, RBS was not subject to Basel III capital standards at the time. But RBS's relatively weak position on this basis, which the FSA now believes provides a more appropriate measure of capital truly available to absorb losses, gives an indication of why RBS's capital was unable to absorb losses whilst maintaining market confidence in autumn 2008, despite a £12bn rights issue earlier that year. The fact that RBS performed well under the prevailing Basel II standards highlights the shortcomings of those standards relative to the new Basel III framework.

Liquidity position

470 As described in Section 1.2 (paragraph 146), following the announcement of its £12bn rights issue, there was some improvement in RBS's liquidity position.[543] However, RBS remained more vulnerable than most of its peers in the months leading up to RBS's failure.

471 During May and into June 2008, RBS's reliance on short-term wholesale funding was one of the greatest in its peer group of the large UK banks. At end-June 2008, it had the second largest short-term wholesale funding gap[544] of its peers; this gap had increased by over 14% since end-December 2007. Overall, RBS remained more concentrated in the overnight wholesale funding markets than all but one peer at that time.[545] Graph 2.19 shows RBS's and

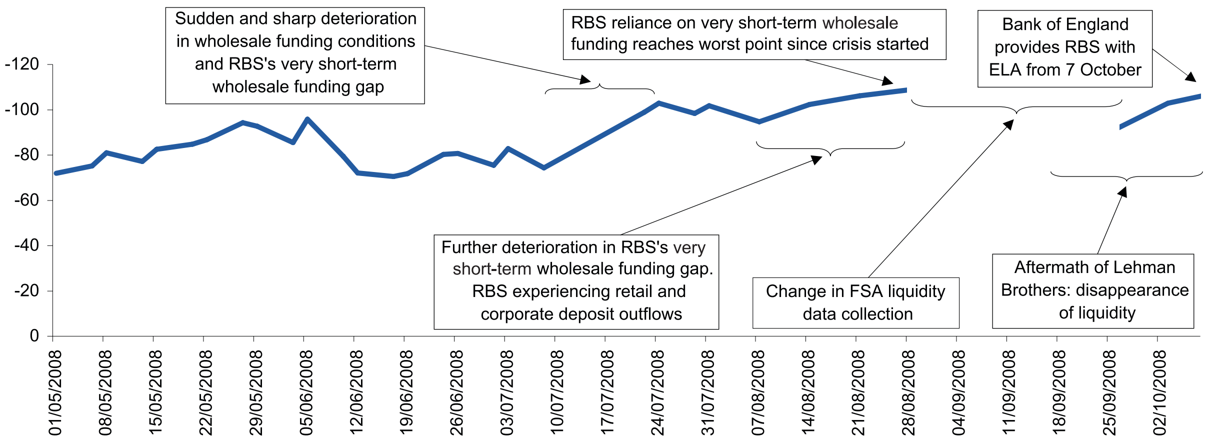
542 The peer group is the large UK banking groups. For the purposes of confidentiality, the anonymised titles are not used consistently in relation to individual peers in this graph and Section 1.2, Graphs 2.3 and 2.5 and Part 1, Graphs 1.6 and 1.7. Short-term wholesale funding is defined here as wholesale funding falling due within 25 business days. Data are taken from Current Status Indicator (CSI) reports. For an explanation of CSI reports, see Section 1.2, paragraphs 174 to 175. FSA records, June 2008.

543 The Review Team was not able to establish how much of the proceeds from the rights issue was used to pay down short-term wholesale funding although the Review Team has seen evidence which indicated that RBS proposed to use £2bn of the proceeds for this purpose, RBS records, June 2008.

544 This conclusion was based on analysis of the absolute size of RBS's and its peers' short-term wholesale funding gaps. At this date, RBS also had the largest short-term wholesale funding gap relative to liabilities within that peer group. These data are taken from CSI reports, FSA records, June 2008. Short-term wholesale funding is defined here as wholesale funding falling due within 25 business days.

545 This conclusion was based on analysis of RBS's and its peers' overnight wholesale funding gaps: on an absolute basis; relative to liabilities; and as a proportion of their short-term wholesale funding gaps. These data are taken from CSI reports, FSA records, June 2008.

Graph 2.20: RBS's very short-term wholesale funding gap, May to December 2008[546]



its peers' overnight wholesale funding as a proportion of their short-term wholesale funding gaps.

472 In mid-July, there was a sudden further deterioration in RBS's liquidity position, as indicated by the increase in its very short-term[547] wholesale funding gap. In July, RBS's very short-term wholesale funding gap increased by nearly £30bn (see Graph 2.20). This also reflected a general deterioration in market conditions.

473 During August, RBS's reliance on very short-term wholesale funding increased again. RBS began to suffer a gradual outflow of retail and corporate deposits, which put further pressure on it to source funding from the wholesale markets (see paragraph 450).

474 At end-August 2008, the size of RBS's very short-term wholesale funding gap, which continued to be predominantly US$ denominated (see Section 1.2, Graph 2.4), reached its highest level since the start of the crisis period as shown in Graph 2.20. It remained concentrated in the overnight markets and in the riskier unsecured markets.[548]

475 RBS's concentration in overnight wholesale funding meant that every day, RBS was required either to roll over existing funding arrangements with its wholesale market counterparties or find ample sources of new funding. This presents a significant risk to the ability of a firm to settle its obligations as they fall due, as stressed market conditions are characterised by, amongst other things, a lack of willing counterparties and only selective roll-overs of existing wholesale funding.

476 Therefore, the Review Team's analysis showed that by end-August 2008, RBS was more vulnerable than other peers in the event that the wholesale markets

546 Very short-term wholesale funding defined here as wholesale funding falling due within five business days. Wholesale funding gap data are taken from CSI reports and LRP reports which replaced CSI reports from end-August 2008 (during the short transitional period, liquidity data were collected by the FSA from firms, including RBS, during regular telephone calls held at that time, see Section 1.2, paragraphs 173 to 177). For the purposes of this analysis, the Review Team took the LRP Gap 1 (as this does not take collateral into account) Week 1 (five business days) figure to be conceptually the same as the very short-term wholesale funding gap calculated from the CSI reports. However, the Review Team noted that there were some definitional differences between the CSI report and LRP report as to what was included as wholesale asset and liability flows. FSA records, May to December 2008.

547 Very short-term wholesale funding defined in paragraphs 472 to 478 as funding falling due within five business days.

548 FSA records, July 2008.

closed to it, as the period that RBS could survive without access to new wholesale funding was the shortest in that peer group.[549]

477 While Graph 2.20 shows an improvement in RBS's very short-term wholesale funding gap in September, the Review Team understood that this was due to a change in the format of liquidity data collection by the FSA, (see Section 1.2, paragraphs 179 to 183).

478 In fact, in the aftermath of Lehman Brothers' collapse on 15 September 2008, RBS's reliance on very short-term and, in particular, overnight wholesale funding grew.[550] It continued to fund its growing overnight gap until 7 October when it was no longer able to fund itself and became reliant on ELA. RBS's use of ELA peaked on 17 October.[551]

Asset quality

479 In August 2008, RBS announced a first half-year statutory operating loss before tax of £692m. This was particularly influenced by its trading performance and write-downs on credit market exposures (as discussed in Section 1.4), but also incorporated increased losses on loan impairments. This is shown in Table 2.15.

Table 2.15: Credit trading losses and impairments on loans and securities recognised by RBS between mid-2007 and mid-2008[552]

£m	H1 2007	H2 2007	H1 2008
Income / loss on credit trading activities	421	(1,851)	(6,273)
Impairment charges for loans and advances	(851)	(1,255)	(1,588)

480 RBS had already announced significant losses on credit market exposures in April 2008. In August 2008, its interim results included £5.9bn of write-downs on these exposures. For some instruments, such as monoline exposures, these write-downs were greater than RBS had expected in April 2008 (when £5.9bn had been the total anticipated for the whole of the remainder of 2008). These write-downs contributed to an overall loss on credit trading of £6.3bn at end-June 2008.

481 RBS's loan impairments also increased significantly to £1,588m in the first half of 2008, almost doubling from £851m recognised in the first half of 2007. Impairment losses had grown significantly in Global Banking and Markets (GBM) and US retail and commercial banking, although there was little change in the quality of the firm's UK portfolio. However, as described in Section 1.3.4, RBS's impairment charges, impairment allowance and levels of non-performing loans remained relatively low, as a proportion of loans and advances, compared to peers.

549 The Review Team was not able to perform this analysis for earlier months as CSI reports (which were replaced by LRP reports in August 2008) did not collect the required data. RBS's shorter survival period than its peer group demonstrated its greater reliance on very short-term wholesale funding and/or that it held a lower level of available assets that could be used to raise alternative sources of cash through sale or repo relative to its peers (as analysis took all collateral into account). FSA records, August 2008.
550 FSA records, September 2008.
551 This was repaid on 16 December 2008.
552 2007 RBS interim results; 2007 RBS annual report and accounts; and 2008 RBS interim results.

1.6.4 RBS in a relatively poor position: market perceptions

482 In Section 1.6.3, it can be seen that RBS was poorly positioned relative to some of its peers in terms of its capital and liquidity positions, and asset quality. However, the factors in this weak position were not all necessarily known by market participants at that time because:

- By the prevailing tier 1 standard, RBS appeared well capitalised relative to peers. The Basel III common equity tier 1 ratio, under which definition RBS's underlying core capital position was in fact weaker than that for peers, was not announced until 2010, and will be phased in from 2013 (see Appendix 2D).
- The liquidity data collected by the FSA during this period, which highlighted RBS's significant reliance on overnight wholesale funding, were not publicly available.
- Though RBS's credit trading losses remained significant, impairments on RBS's banking book (which eventually had a greater impact on RBS's capital resources) had only started to show initial signs of deterioration (see Table 2.15).

483 The Review Team attempted, therefore, to understand market perceptions of RBS in relation to its capital and liquidity positions and its asset quality, in particular in the months leading up to its failure. The Review Team has approached this through:

- reviewing contemporaneous market analysis, including broker reports, rating agency reports, press coverage, and analysts' calls in the period following RBS's rights issue;
- analysing movements in RBS's and its peers' equity share prices and credit default swap (CDS) spreads from the initial dent in general market confidence in summer 2007 to end-2008, as well as an analysis of movements in RBS's credit ratings during 2007 and 2008; and
- meeting a sample of hedge funds, as active market investors, to discuss their views of RBS over the Review Period.

Brokers, rating agencies, analysts and press

484 A review of broker and rating agency reports, as well as press coverage and analysts' calls from that time revealed mounting concern in relation to RBS's capital position and asset quality in the months following the announcement of the rights issue in April 2008. However, the Review Team saw almost no evidence that the market saw RBS's liquidity position as a threat to its financial stability. On the day before it received ELA, Standard & Poor's believed that RBS's liquidity position did not present any particular issues for the firm.[553]

485 During May and June, market perceptions of RBS's asset quality and capital position, as well as market reactions to the rights issue, were mixed. The rating

553 Standard & Poor's Research Update, 6 October 2008.

agencies welcomed RBS's change in capital policy from its hitherto '*tight*' approach to capital management. This change was signalled by the announcement of the rights issue in April and the asset disposal plan.[554] Some market participants believed that RBS could achieve its own 6% core tier 1 capital target.[555] At the same time, there existed concerns that the rights issue would be substantially undersubscribed.[556] Despite the high take-up rate of the rights issue, which was confirmed on the 9 June,[557] concerns around capital lingered with regard to the impact of reduced income generation within GBM on RBS's earnings and capital position.[558] Furthermore, the legacy of the ABN AMRO acquisition[559] and concerns about the quality of the purchased assets persisted.[560] And anxiety continued about the potential for losses on RBS's credit market exposures[561] (including monolines[562]) and its commercial real estate portfolio.

486 Market sentiment moved further against RBS in July. Within the media, there was increasing challenge to the credibility of RBS's plans to strengthen its capital position as it became apparent that RBS was struggling to find a buyer for its non-core subsidiaries and as it ruled out the prospect of selling its £2.4bn stake in the Bank of China. Concerns over the US sub-prime mortgage market also led to increased scrutiny of Citizens, RBS's US subsidiary. These considerations, combined with ongoing concerns over RBS's asset quality, hardened opinion that its current capital position was not as secure as some had previously thought.[563] However, in contrast to these opinions, the Review Team saw one broker report that remained bullish in its assessment of RBS's future prospects.[564]

487 In August, there was further scrutiny of RBS's plans to improve its capital position. RBS failed to sell its overseas operations in Australia and New Zealand and this reinforced market opinion that it would continue to struggle to dispose of its non-core subsidiaries.[565] Uncertainty also persisted about the quality of RBS's overseas property exposures, and there was debate about ABN AMRO's asset quality.[566] On 8 August 2008 RBS reported a statutory operating loss before tax of £692m for the six-month period to end-June 2008.

488 On 15 September Lehman Brothers collapsed. As described in Box 2.4, two weeks later the governments of Belgium, the Netherlands and Luxembourg announced a €11.2bn injection to shore up Fortis's balance sheet following concerns around its solvency. Those concerns led to market speculation that RBS might have to meet Fortis's obligations under the ABN AMRO acquisition terms since the restructuring had not yet been completed.[567]

554 Standard & Poor's Report, 24 June 2008.
555 HSBC Global Research Report, 2 June 2008.
556 FT Article, 3 and 6 June 2008.
557 FT Article, 9 June 2008.
558 Standard & Poor's Report, 24 June 2008.
559 FT Articles, June 2008.
560 RBS Pre-close Trading Update Conference Call, 11 June 2008. Transcripts sourced from Thomson StreetEvents.
561 Standard & Poor's Report, 24 June 2008.
562 RBS Pre-close Trading Update Conference Call, 11 June 2008. Transcripts sourced from Thomson StreetEvents.
563 FT Articles, July 2008.
564 HSBC Global Research Report, 29 July 2008.
565 FT Articles, August 2008.
566 RBS Pre-close Trading Update Conference Call, 11 June 2008; RBS Interim 2008 conference call, 8 August 2008. Transcipts sourced from Thomson Streetevents.
567 FT Article, 30 September 2008; also highlighted in The Guardian, 29 September 2008.

489 Also during September, a broker report highlighted RBS's significant property and construction lending exposure, which it considered presented material credit quality risk.[568] Another broker report viewed RBS favourably compared to peers on account of its relatively '*aggressive*' approach to repairing its capital base and marking down its toxic assets. This report stated that RBS had de-risked or '*moved down the risk curve*' in its corporate lending in direct comparison to one of its larger UK banking group peers.[569]

490 In October there was evidence of further falls in market confidence about RBS's solvency[570], as well as concern around its liquidity position. On 3 October, the BBC News Business Editor stated that '*a big British bank was having difficulty renewing credit, which took it too close-for-comfort to the brink'*.[571] Domestic and worldwide confidence in RBS ebbed; RBS told the FSA that a Korean newspaper claimed that RBS had liquidity problems, and also that two major UK bank counterparties carried out credit checks against RBS before lending to it overnight.[572]

Equity prices, credit default swap (CDS) spreads and credit ratings

491 In addition to its review of market analysis, the Review Team considered market perceptions of RBS by analysing the equity prices and credit default swap (CDS) spreads for RBS and its large UK banking group peers during the period June 2007 to December 2008. This indicates that RBS was viewed as one of the more risky UK banks, but that it was not a clear outlier until very late in September 2008. The Review Team also analysed movements in RBS's credit ratings during 2007 and 2008.

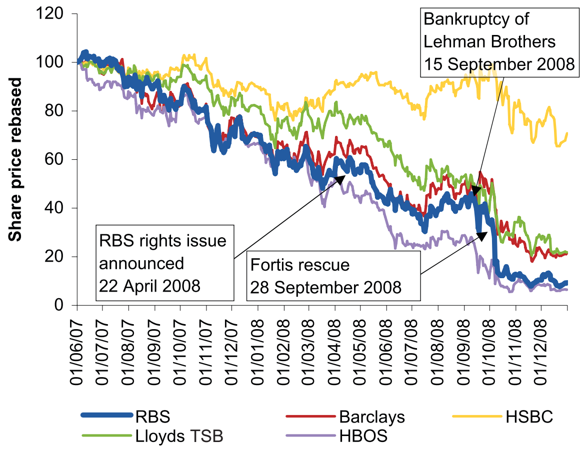
Equity prices

492 The path of RBS's equity price can be seen in Graph 2.21 and the key events provoking significant movements are presented in Box 2.5. The graph shows that the equity prices of most of the large UK banking groups fell significantly during the period from June 2007 to December 2008. But RBS's share price did not take a significantly different path from most of its peers until late September 2008.

493 From early 2008, and during the remainder of the Review Period, information was circulated internally within the FSA that indicated that RBS's share price volatility was greater than its large UK banking peers. This information was generated by the 'HARM' model (a variant of the KMV-Merton Model), to which share price volatility is an input, and which the FSA Strategy and Risk Division had been developing from mid-2007. The Review Team was informed that the output of the HARM model was circulated to Supervision and FSA senior management from the beginning of 2008 via daily spreadsheets which also contained a range of other market data. From June 2008, FSA senior

568 Deutsche Bank Global Market Research, 24 September 2008.
569 Dresdner Kleinwort, 22 September 2008
570 FT Articles, October 2008; Standard & Poor's Research Update, 6 October 2008.
571 A British newspaper subsequently reported that the RBS Chairman and CEO were to be replaced, The Daily Telegraph, 8 October 2008. Earlier, on the 1 October 2008, the same newspaper published an interview with a fund manager who raised the question as to whether banks' management should remain where the bank has lost significant shareholder value, The Daily Telegraph, 1 October 2008.
572 FSA records, October 2008.

Graph 2.21: Large UK banks' equity prices June 2007 to December 2008 rebased[573]



Source: Bloomberg Finance LP

management also received monthly '*Executive HARM Updates*' which aimed to explain how the HARM model related to underlying accounting data, equity prices and volatility, as well as information in the press in relation to firms, and to provide more in depth analysis on specific topics.[574]

494 Attempts by the FSA Strategy and Risk Division to infer market value based leverage from the share price volatility shown by the HARM model suggested that RBS required additional capital before the April 2008 rights issue and continued to immediately after.[575] The Review Team noted, however, that the HARM model was (and is) considered contentious because in more benign periods, which are often characterised by lower share price volatility (for example the period prior to the start of the crisis), it may not have indicated that RBS required additional capital. To some extent, therefore, it may tend to be an indicator of inadequate capital only once this has already become apparent from other analytical approaches.

495 The FSA did not, therefore, put in place a process to encourage Supervision to use the HARM metrics in the supervision of firms and it did not incorporate those metrics into the FSA impact and probability risk assessment framework.[576] Nor are the metrics used by the FSA now to determine a firm's regulatory capital requirements. Consistent with that, it is the Review Team's understanding that RBS's HARM metrics were not used in the supervision of RBS during the Review Period.

496 Even after the rights issue, the HARM model indicated that RBS required additional capital of £29.5bn[577]; this reflected high share price volatility. In retrospect, this was more than the £20bn the UK government announced in

573 Rebased: 100 = 1st June 2007.
574 FSA records, June 2008.
575 FSA records, April to June 2008.
576 See Section 3, paragraph 676 for more detail on the FSA impact and probability risk assessment framework.
577 FSA records, June 2008.

October 2008 it would inject to RBS.[578] The Review Team considered, however, that it was not reasonable to expect that the Supervision Team should and could have used this to determine policy in the period between the rights issue and the point of failure given that:

- The FSA had pushed RBS to raise as much capital as possible in the April 2008 rights issue and once RBS had raised £12bn, this restored its total capital ratio to 13.2%, which was initially perceived as adequate (see Section 1.1).
- RBS was trying to rebuild its capital further through its asset disposal programme.
- The HARM model was (and is) considered an imperfect indicator of capital requirements.

The Review Team was informed that the output of the HARM model was used as one of the inputs (but not the primary input) to the assessments made in October 2008 by the Tripartite authorities of the level of capital injection required to ensure RBS's solvency.

Box 2.5

RBS equity share price – key events

Rights issue announcement
Following the announcement of the rights issue on 22 April 2008, RBS's share price dropped by 5% in two days. It continued to sink over the following weeks, losing 35% of its value between 12 May and 2 June. There was continued downward pressure during June, causing the share price to dip below the rights issue offer price of 200p on 8 July. It then reduced again, falling to 165p on 16 July. Over the following weeks, there was a temporary and volatile rally and the share price reached a three month high of 249p on 9 September.

Bankruptcy of Lehman Brothers
On 15 September, the day that Lehman Brothers failed, RBS's share price plunged; it fell 23% between 15 and 18 September, the three days that also witnessed AIG's rescue and the announcement of Lloyds TSB's and HBOS's intention to merge.

The failure of RBS
On 28 September, the Benelux governments announced their rescue package for Fortis; on 29 September Bradford and Bingley was nationalised by the UK government and on the same day RBS's share price dropped a further 13%. When Standard & Poor's downgraded RBS's[579] counterparty credit rating on 6 October, RBS's share price plummeted by 39%. RBS failed the following day. Over the course of one month, the share price had fallen by 64%.

578 In 2008, RBS received a £20bn injection of capital from the UK government in exchange for ordinary shares (£15bn) and preference shares (£5bn); the preference shares were converted to ordinary shares in April 2009. In November 2009, there were subsequent increases in capital injections by the UK Government which amounted to a further £25.5bn. UKFI annual report and accounts, 2010/2011.

579 RBS Group plc, Standard & Poor's Research Update, 6 October 2008.

CDS spreads

497 The path of RBS's and peers' CDS spreads is presented in Graph 2.22 and Graph 2.23.[580] Following the financial market turmoil in autumn 2007, spreads on CDS contracts for all of the large UK banking groups widened; credit markets were thus signalling that assessments of banks' riskiness had increased but to a similar extent across RBS's peer group.

498 RBS's CDS spreads broadly tracked those of the large UK banking groups until June 2008, when credit markets began pricing higher riskiness at Barclays, HBOS and RBS compared to Lloyds TSB and HSBC (see Graph 2.22 and Graph 2.23).

499 It was only in late September 2008 that RBS's CDS spreads increased to a level clearly disconnected from most of the large UK banks. The problems at Fortis may have been the catalyst for this.

Credit ratings

500 This section examines credit ratings on RBS during the period from January 2007 to end-2008.

501 Graph 2.24 highlights a varied picture of two credit rating agencies' reactions during 2007 and 2008. For example, Standard & Poor's did not downgrade RBS's[581] counterparty credit rating until 6 October 2008, the day before RBS's failure. While previously Standard & Poor's presumably had been reassured by the rights issue, by this point it considered that RBS's weakening financial profile and capital position left it less well positioned than some of its major global peers.[582] In contrast, Moody's, having already placed on review for possible downgrade the senior debt rating for RBS[583] following the announcement of the rights issue in April 2008, downgraded this from Aa1 to Aa2 in June 2008.[584]

Hedge funds' recollections

502 In order to understand market perceptions regarding RBS at the time, the Review Team also met a sample of hedge funds to seek their views of RBS over the Review Period and, in particular, in the months leading up to RBS's failure. The Review Team requested contemporaneous research and analysis but, in most instances, the hedge funds were not able to provide this. Due to the passage of time, the Review Team acknowledged that it was possible that perceptions or views held by these market participants during the Review Period may not have been recalled in these meetings with complete accuracy and may be subject to the application of hindsight. However, the Review Team considered that the recollections of these hedge funds would assist it to understand market

580 The Review Team analysed spreads on credit default swap (CDS) contracts for both senior and subordinated debt, and across a number of contract maturities (one, two, three and ten years). This section presents a selection of CDS graphs, but the Review Team's findings were consistent across all contract types.
581 RBS Group plc.
582 Standard & Poor's Research Update, 6 October 2008.
583 RBS Group plc.
584 Moody's Global Credit Research, 22 April 2008 and 27 June 2008.

perceptions of RBS at the time. The key points from those discussions are summarised below (see also Section 1.5, paragraphs 358 and 363 to 364).

Inadequate and poor quality capital

503 Many of the hedge funds the Review Team met remembered that RBS's inadequate amount of capital was a major cause for concern at the time, as well as one of the main reasons behind its failure. In particular, a few of the hedge funds recalled that RBS had a low equity tier 1 position, with the RBS CEO focusing instead on the total tier 1 position. One hedge fund described RBS as one of the most highly leveraged banks in the world on an equity to assets basis due to the '*aggressive*' approach it had towards capital. A few of the hedge funds recollected that they had been concerned about the quality of RBS's capital, driven by the significant proportion of preference shares within RBS's tier 1 capital. Another remembered that RBS paid out 50% of its earnings in dividends, in contradiction to its purported capital rebuilding strategy at that time.

Reliance on wholesale funding

504 RBS's significant reliance on wholesale funding was cited by some of the hedge funds as a factor in its failure. However, most of them did not recall considering in detail the risk associated with RBS's liquidity position at the time.

Poor asset quality

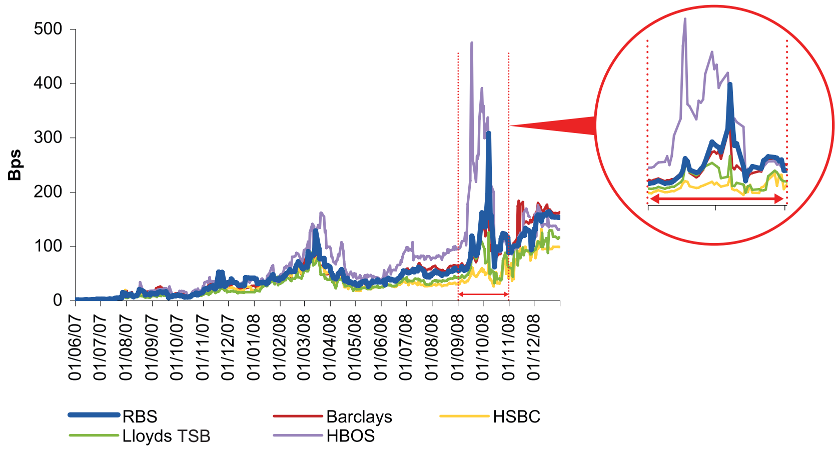
505 All of the hedge funds remembered having concern over the quality of RBS's assets.

506 The write-downs on credit market exposures taken by RBS at end-2007, as well as the further losses expected on those positions and then recognised in the H1 2008 results, were seen by a few of the hedge funds as providing some certainty as to the extent of trading book losses. However, the same hedge funds recalled being concerned about the small impairment charge and limited signs of deterioration in RBS's banking book relative to peers in its H1 2008 results, which fuelled concerns as to the extent of further losses to come from RBS's banking book assets.

507 One hedge fund in particular said that the H1 2008 £692m statutory operating loss before tax prompted it to consider in more detail how RBS would be placed if market conditions worsened further. It remembered thinking that RBS had managed to make a loss at this point in the business cycle and in the event that market conditions deteriorated further, RBS, which had low levels of capital, might be '*poorly positioned*'.

508 Many of the hedge funds recounted that their asset quality concerns had centred on the composition of RBS's loan portfolio, including exposures to the US sub-prime mortgage market, corporate and retail loans in Ireland via Ulster Bank and the rapid proliferation of commercial property loans from 2004 onwards. Another of the hedge funds also remembered RBS's large single name concentrations in its loan book, which it considered were driven, in part, by RBS's unwillingness to syndicate certain loans if the potential return was attractive

Graph 2.22: Large UK banks' one year CDS spreads on senior debt June 2007 to December 2008 (bps)



Source: Bloomberg Finance LP.

enough for it to want to retain the loan in full. The decision by RBS to retain these loans on its balance sheet was described by this hedge fund as '*mind-boggling*'. Another hedge fund considered that RBS followed an '*industrial logic*' to allocate targets for asset growth, without necessarily performing a detailed analysis of the capacity for lending growth in specific economies.

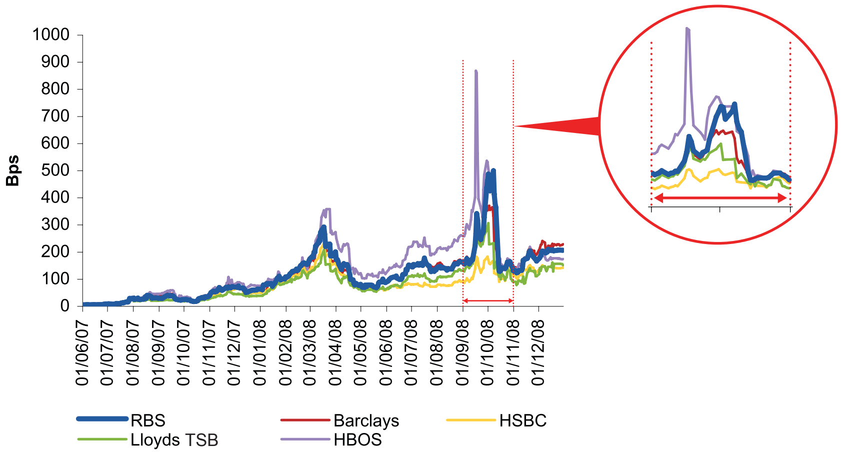
509 Other asset quality concerns recalled by the hedge funds related more to RBS's trading book assets such as leveraged finance and exposures to monolines. While peers had similar exposures, they were not exposed to the same extent or for the same duration as RBS.

510 On the factors related to RBS's failure, one of the hedge funds highlighted, in particular, the '*inextricable link*' between adverse market perceptions of RBS's asset quality and its loss of wholesale funding and deposits in the months leading up to its receipt of ELA from the Bank of England.

Impact of management, governance and culture on capital, liquidity and asset quality

511 Some of the hedge funds recounted that they had considered the RBS CEO to be dominant (he '*ran the show*'). They recalled that the he had shown limited interest in the balance sheet and, during analyst calls, steered discussion towards strategy and away from financial analysis. One hedge fund described the RBS CEO as taking a dismissive approach to further write-downs on the loan book. A few of the hedge funds remembered that, at that time, they considered that the RBS CEO ran the firm on a profit and loss basis, with a primary focus being to increase returns. These same hedge funds elaborated that, in their view, this approach resulted in poor decision-making at RBS as the risks associated with its expanding balance sheet and asset quality were not adequately considered. Another also noted the emphasis placed on earnings per share based measures in the RBS CEO's remuneration package.

Graph 2.23: Large UK banks' three-year CDS spreads on subordinated debt June 2007 to December 2008 (bps)



Source: Bloomberg Finance LP.

This hedge fund considered that this encouraged increased leverage, with the aim of maximising earnings.[585]

1.6.5 The FSA's regulation and supervision of RBS from spring to autumn 2008: improved understanding of capital, liquidity and asset quality in deteriorating market conditions

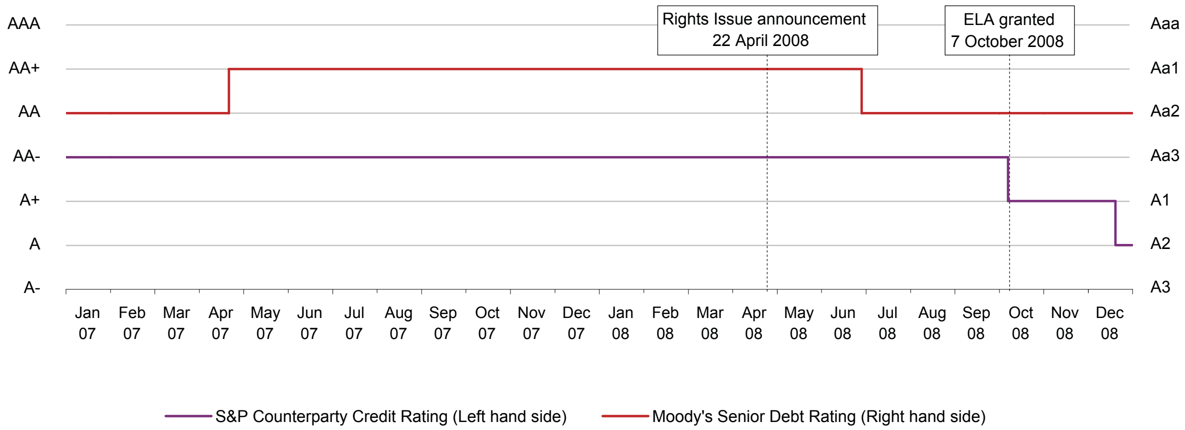
512 Sections 1.1 to 1.4 concluded that the FSA's approach to the regulation and supervision of capital, liquidity and asset quality prior to the start of the crisis period was deficient. From then on, the FSA embarked on significant changes to its approach. These included:

- A new approach to capital adequacy developed during early 2008 and formally agreed at ExCo in April 2008[586], which implemented a core capital target for major UK banks of 5%, well above the then international minimum of 2%.[587]
- Improvements to its regulatory and supervisory frameworks for liquidity risk. These had been initiated in early 2007, even before the crisis, and resulted in a Discussion Paper (DP) on future policy in December 2007.[588]
- Some increase in the intensity of the FSA's focus on asset quality issues, in particular in relation to trading books.

513 This increasing focus on the core issues of capital, liquidity and asset quality continued and was in some ways accelerated between May and October 2008. But in retrospect, the improvements in FSA regulation and supervision at that time proved to be too late to prevent the failure of RBS.

585 Review Team meetings with sample of hedge funds, June to July 2011.
586 FSA records, April 2008.
587 As discussed in Section 1.1 and Appendix 2D, at least half of the total capital resources requirement of 8% had to comprise tier 1 capital, at least half of which had to comprise core tier 1 capital, making an effective core tier 1 minimum requirement of 2%.
588 FSA Discussion Paper 07/7, *Review of the Liquidity Requirements for Banks and Building Societies*, December 2007.

Graph 2.24: RBS Group PLC credit trading history 2007 to 2008



Source: Standard & Poor's and Moodys.

Regulation and supervision of capital

514 At end-April 2008, the FSA Supervision Director presented a paper to the Tripartite Standing Committee, which set out the FSA's strategy to address the key prudential risks that faced the major UK banks at that time.[589] The paper also focused on the FSA's approach to the risks posed by individual firms, including RBS. In relation to RBS, key elements of the strategy were to:

- ensure RBS had adequate core tier 1 capital through meeting the FSA's (recently introduced) core tier 1 target of 5%, which had been introduced to underpin firms' individual capital guidance (ICG) (see Section 1.1, paragraph 91);
- require RBS to improve its capital planning; and
- require RBS to improve its ability to comply with conditions for Basel II model approval and to resolve the issues with ABN AMRO's approach to the implementation of Basel II in relation to its credit risk capital requirements.

515 In addition, as explained in Section 1.1, paragraph 76, the September 2007 ARROW Panel for RBS instructed the Supervision Team to complete a supervisory review and evaluation process (SREP)[590] for RBS and to set full ICG for the firm within six months.

516 Between May and October 2008, the Supervision Team, Supervision and FSA senior management continued to address the main priority of ensuring that RBS had adequate quality capital to absorb further losses and to maintain confidence in the firm's solvency, against a backdrop of increasing market uncertainty and market expectations that firms should hold more and better quality capital.

517 This was supported by wider FSA initiatives to improve the quality of capital at major UK banks and the data available to supervisors to assess firms' capital adequacy. However, a number of other issues (such as the work on capital planning and setting ICG) were not completed as expected during 2008. Given

589 FSA records, April 2008.
590 The FSA's supervisory review and evaluation process (SREP), by which it reviews the results of a firm's individual capital adequacy assessment process (ICAAP) and then sets individual capital guidance (ICG), is explained further in Section 1.1.4.

the very limited resources applied to the supervision of RBS at that time (as discussed in Part 2, Section 3.3) and the extra pressures on the FSA which arose as a result of the continued deterioration in market conditions, the Review Team judged that the FSA's supervision of RBS's capital position was appropriate. The Review Team did not consider that any of the issues not fully addressed during 2008 would have prevented the firm's failure in October 2008.

Capital position

518 After the rights issue, the Supervision Team and senior management in Supervision considered that RBS's capital position was strong relative to its peers.[591] At that time RBS had raised £12bn core capital and was above the FSA's new core capital target of 5%.[592] RBS had also set itself a target core tier 1 ratio of at least 6% to reach by end-2008 which it planned to achieve through its asset disposal programme announced in April[593] (see Section 1.1.5). Although some concern persisted, as indicated by the FSA Watchlist commentary in July 2008,[594] during the remainder of the Review Period, the Supervision Team and FSA senior management considered that RBS was likely to meet its core tier 1 target of 6% by end-2008.

519 Following the rights issue, the Supervision Team, Supervision and FSA senior management continued to monitor RBS's efforts to strengthen the quantity and, in particular, the quality of its capital in line with the FSA's strategy for major UK banks and its specific strategy for RBS at that time.[595] In mid-2008, FSA senior management also discussed RBS's approach to capital with the RBS CEO, in light of FSA concern that RBS had a culture of squeezing out capital.[596]

520 A key and immediate action was to ensure RBS progressed with its asset disposal programme. Consistent with that, the Supervision Team monitored RBS's progress through regular discussions with the firm and via receipt of capital planning updates from it, which the Supervision Team corroborated against regulatory capital data provided by RBS.[597]

521 In the months that followed the rights issue, RBS did not achieve all the expected disposals (such as of its insurance business) because it was not able to achieve its target prices.[598] The FSA CEO was concerned about RBS's failure to sell its insurance business due to the '*perceived lack of alternative options*' for RBS to continue to rebuild its capital position.[599] However, the Supervision Team considered that, based on the analysis it had performed, '*it is possible to see how the Group could continue to* [aim to] *meet their 6%* [core tier 1]

591 Review Team meeting with the then FSA Supervision Director, June 2011; Review Team meeting with Supervision Team, June 2011.
592 FSA records, April 2008. The 5% core capital target was in effect the fore-runner of the benchmarks used for the October 2008 recapitalisation and subsequently. Note that this is different to RBS's own core tier 1 target of 6% announced in April 2008.
593 FSA records, April 2008; RBS rights issue announcement, April 2008.
594 The July 2008 FSA Watchlist entry for RBS noted that '*whilst the successful* [rights] *issue does not answer all of our concerns, the improved capital position allows for greater focus on the effective delivery of the ABN disbandment/ integration plan*'.
595 Review Team meeting with the then FSA Supervision Director, June 2011.
596 FSA records, July and August 2008.
597 Review Team meeting with Supervision Team, July 2011; FSA records, July and August 2008.
598 Review Team analysis of press articles and rating agency reports, June to August 2008.
599 FSA records, August 2008.

target without the sale of the insurance business' and that '*this would* [still] *leave them with a significant buffer above our 5%* [core capital] *target ratio*.' The Supervision Team set out this view in a memo to the FSA CEO in August 2008.[600] The FSA CEO escalated this to the FSA Board on 21 August 2008.[601]

522 The supervision of RBS's capital position was supported by the collection and analysis of two enhanced monthly capital data forms for certain major banks with effect from end-July 2008; these forms had been approved by ExCo in July.[602] It is the Review Team's understanding that FSA specialist resource performed peer analysis of these data and provided this analysis to Supervision, including the Supervision Team, who recalled that RBS was not shown to be an outlier compared to peers. For instance, contemporaneous peer analysis based on June and July 2008 did not show RBS to be an outlier in terms of its estimated end-July 2008 core tier 1 figure, nor in forecasts for future periods.[603]

523 These capital data also included forward-looking capital projections which the Supervision Team explained it used to corroborate progress reports that it received from RBS on its asset disposal programme. The collection and use of these data were in the early stages of development at the time and the Review Team considered that the Supervision Team used these appropriately.

524 The use of these forms by FSA specialists and the Supervision Team represented a step change from the previous central analysis of regulatory returns and exception reporting to Supervision which did not, for example, include routine performance of peer analysis on capital returns (see Section 1.1, paragraph 42).

Capital planning

525 In the period following the rights issue, Supervision continued to have concerns about weaknesses in RBS's capital planning and forecasting capabilities, which had been highlighted by RBS's apparent fall below ICG at end-March 2008 (see Section 1.1, paragraphs 95 to 103). However, whilst a key element in the FSA's strategy was to ensure the firm improved its capital planning capability, the Supervision Team appropriately prioritised ensuring that RBS had adequate capital.[604]

526 Weaknesses in RBS's capital planning and forecasting capabilities were also reported to the FSA Firms and Markets Committee (FMC) on 25 April 2008 and were included on the FSA Watchlist entry for RBS in May 2008.[605] Two actions were proposed by the Supervision Team in the April FMC report to address this issue:

600 FSA records, August 2008.
601 FSA records, August 2008.
602 FSA records, June and July 2008.
603 FSA records, July and September 2008. The peers considered were Barclays, HBOS, HSBC and Lloyds TSB (and in some cases Abbey). There were some concerns about RBS's data for end-July 2008 estimates. One document also considered certain additional stresses; RBS was also not an outlier on a '*downturn sensitivity*' estimate, at 5.2% within a range of 4.8% to 6.3%.
604 FSA records, April 2008.
605 FSA records, April and May 2008.

- to perform a full on-site review of RBS's capital planning process as part of planned 2008 ARROW work, and potentially wider thematic work in this area[606], to action by 30 June 2008; and
- to consult the external auditors on their comfort with RBS's capital planning process, to action by 31 July 2008.

The Supervision Team also advised RBS in June 2008 that it intended to ascertain the details of its capital planning approach as part of the SREP (see paragraph 536).[607]

527 However, neither of these actions was carried out; the SREP was also not completed within the Review Period (see paragraphs 534 to 538).[608] In relation to the on-site review of capital planning, the Supervision Team explained to the Review Team that a decision was taken by Supervision to delay the 2008 ARROW. The Review Team considered that this was a reasonable judgement given the wider supervisory priorities of the time for the Supervision Team, Supervision and FSA senior management.

Capital models

528 As well as further work to monitor RBS's plan to strengthen its capital position following the rights issue, this period also saw significant work on capital models. The Supervision Team continued to work on RBS's internal ratings based (IRB) and expected potential exposure (EPE) model waiver applications consistent with the FSA's strategy for RBS at that time.

529 In relation to RBS's application to use its EPE model, the Supervision Team challenged RBS on several aspects of its application, including in relation to stress-testing. The EPE waiver was subsequently granted by the FSA with effect from 16 July 2008.

530 With regard to RBS's IRB model approval application, as discussed in Section 1.1 paragraph 55, in April 2008 ExCo granted RBS partial IRB approval subject to further conditions, including that RBS should obtain independent validation on the quality of its model.[609] The independent reviewers concluded that RBS's models '*were fine*', but the FSA's '*capital adequacy/governance/methodological concerns*' regarding the model were confirmed.[610] Based on this, in July 2008 ExCo decided not to grant further approval. RBS, therefore, did not obtain any further capital benefit in respect of these models. Given that serious issues raised by the FSA in relation to these models had not been fully resolved by RBS, the Review Team considered that this was an appropriate judgement.

531 In the Review Team's opinion, the supervision delivered in this period was consistent with the prevailing standards in relation to models, which are set out in Section 1.1.4.

606 The wider thematic work related to the roll-out of enhanced capital data collection which is described in paragraph 522.
607 FSA records, June 2008.
608 FSA records, July 2011; Review Team meeting with Supervision Team, July 2011.
609 FSA records, April 2008.
610 FSA records, July 2008.

ABN AMRO's approach to the implementation of Basel II in relation to its credit risk capital requirements

532 As described in Section 1.5, paragraphs 395 to 399, in spring 2008, *De Nederlandsche Bank* (DNB) and the FSA agreed that ABN AMRO would calculate its capital requirements according to a measure based on Basel I.[611] ExCo members had discussed this in April 2008 and stressed that it should not be a long-term measure.

533 From March to July 2008, the FSA carried out more detailed work to establish an appropriate level of conservatism. It concluded that ABN AMRO should calculate its capital requirements based on Basel I risk-weighted assets with an uplift of 30%. That Basel I basis produced a higher capital figure than the Basel II IRB models based approach would have done. ABN AMRO continued to operate on this basis well beyond the end of the Review Period.

Individual Capital Guidance (ICG)

534 As described in Section 1.1, paragraph 76, the 2007 ARROW Panel endorsed the Supervision Team's recommendation to provide RBS with only interim ICG (ICG being the total amount of capital the FSA believes is adequate for a firm to hold given its risk profile) at that time and set a six-month deadline for full ICG to be set by the FSA.

535 Although Supervision's focus for RBS during 2008 was on increasing the quantity and quality of capital to meet the FSA's new core 5% capital target, the Supervision Team also took steps to review the firm's individual capital adequacy assessment process (ICAAP) and undertake the SREP, which are Pillar 2 requirements of the Capital Requirements Directive.[612]

536 In May 2008, the Supervision Team initiated a discussion with RBS on the format and scope of its ICAAP and outlined the FSA's expectations for this assessment. A further letter was sent from the Supervision Team to RBS on 5 June 2008 to explain that the FSA intended to carry out the on-site SREP meetings in the second half of 2008. As part of the SREP, the Supervision Team intended to review details of RBS's capital planning approach.[613]

537 The Supervision Team received the ICAAP in early August and by October 2008 had, with FSA specialists, begun to appraise the ICAAP document and determined a proposed outline for the SREP on-site visits, which it presented to a SREP Planning Panel in October.[614] Its initial view was that there was a key weakness in the lack of supportive documentation for the ICAAP; as a result, substantial information requests were needed to support the FSA's discovery work ahead of the planned visits.[615]

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611 This measure was expressed in terms of minimum tier 1 and total capital ratios of 9% and 12.5% respectively, including the requirement to treat capital deductions in the same manner as required under Basel II. 2008 ABN AMRO annual report and accounts.
612 The Capital Requirements Directive came into force on 1 January 2007.
613 FSA records, May to June 2008.
614 FSA records, October 2008.
615 FSA records, October 2008.

538 In the Review Team's opinion, there were acceptable reasons for the Supervision Team not to complete the SREP and issue full ICG in 2007 and early 2008. Over the remainder of 2008 to the end of the Review Period, the Review Team judged that the Supervision Team made reasonable progress in advancing the setting of RBS's full ICG, while focusing appropriately on the adequacy of RBS's core tier 1, rather than total, capital.

Capital instruments

539 During the Review Period, as well as monitoring RBS's progress in improving its capital position, the Supervision Team responded to, but did not resolve, issues raised by RBS in relation to capital instruments issued by ABN AMRO. These had been included in ABN AMRO's (and, at the consolidated level, RBS's) capital resources at end-2007, immediately following the acquisition, but subsequent analysis by RBS had raised questions about whether these instruments complied with FSA rules.

540 In response, the Supervision Team sought FSA specialist advice and subsequently expressed concern about the compliance of these instruments in emails to RBS in both May and June 2008.[616] However, it is the Review Team's understanding that the matter was not resolved during the Review Period and that RBS continued to count these instruments within its capital resources after the end of the Review Period.[617]

541 It was RBS's responsibility to ensure that its capital instruments complied with the prevailing requirements at all times. The matters raised involved complex technical questions about the terms of the specific instruments and the interaction of legislation in the UK, the Netherlands, Australia and the US. Given the number of other issues that the Supervision Team had to consider during mid-2008, it was understandable that those matters received more prominence.

542 However, RBS operated with limited capital headroom prior to the completion of the rights issue in June 2008. The risk that certain capital instruments were potentially non-compliant was, therefore, significant in the context of RBS's capital position and may have been critical in determining whether or not the firm was above or below its ICG (see Section 1.1, paragraphs 95 to 103).

Regulation and supervision of liquidity

543 As discussed in detail in Section 1.2, following the onset of the crisis period, there was a step change in the FSA's, Supervision's and the Supervision Team's focus on liquidity risk, with significant improvements to both the FSA's regulatory and supervisory framework. This included, as noted in the introduction to this section, the FSA's publication in December 2007 of a DP which set out proposals for changes to the shape and content of liquidity policy in response to the recent market turbulence. But this increased focus proved too late to ensure an improvement in RBS's liquidity position sufficient to avert its failure in October 2008.

616 FSA records, May to June 2008.
617 Data provided by RBS to the Review Team in July 2011.

544 Although there was increasing Tripartite interest in liquidity regulation and the Bank of England was involved in discussions on liquidity policy during the crisis period, the FSA continued to have primary responsibility for the regulation and supervision of liquidity.

545 RBS's liquidity position was not highlighted as a priority within the FSA's strategy for RBS at end-April 2008.[618] In December 2007, the FSA Watchlist entry for RBS had been expanded to include the impact of the extreme market conditions on the firm's liquidity and capital positions. The Review Team was informed by the FSA CEO that the FSA Watchlist entry for RBS was discussed at ExCo, including its liquidity position. The minutes seen by the Review Team did not record those discussions or any agreed actions in relation to RBS's liquidity position.[619] The absence of any action points suggested that RBS's liquidity position was not considered by FSA senior management as an immediate risk. In any event, there seems little that could have been done to change the firm's liquidity position once the crisis period started.

The FSA's monitoring of RBS's liquidity position

546 Consistent with the strategy for RBS and the FSA's view that RBS's liquidity position was not an immediate risk, as well as the fact that once the crisis period started there was limited action that could be taken to improve a firm's liquidity position, during May to October 2008, the Supervision Team's overall approach to RBS's liquidity position was predominantly one of monitoring, using the enhanced qualitative and quantitative liquidity data then being collected.

547 As discussed in Section 1.2 (paragraphs 172 to 181), over the crisis period the FSA supplemented the quantitative data collected under the Sterling Stock Regime with ad hoc reporting from certain firms, including RBS. From September 2007 until August 2008, the FSA collected twice-weekly Current Status Indicator reports from RBS and other major banks and building societies. These were replaced at end-August 2008 with Liquidity Risk Profile reports.

548 These additional quantitative liquidity data were in turn complemented with quantitative and qualitative data on market and funding conditions and liquidity positions collected from firms, including RBS, by the FSA via weekly questionnaires and during regular telephone calls.

549 From these data, the Supervision Team, Supervision and FSA senior management were aware of the significant size of RBS's overnight wholesale funding gap in the months leading up to its failure.[620] The Review Team understood that the Supervision Team, together with the FSA Supervision Head of Department, raised RBS's reliance on overnight funding with the RBS

618 FSA records, April 2008.
619 FSA records, May to October 2008.
620 Review Team meeting with the then FSA Supervision Director, June 2011; Review Team meeting with the then FSA Supervision Head of Department (HoD) June 2011; FSA records September to October 2007; and FSA records, throughout 2008.

CEO during a meeting in June 2008 and that it was agreed with the RBS CEO that this needed to be reduced over time.[621] The Supervision Team was aware of RBS's initiatives to try to improve its liquidity position which are explained in more detail in Section 1.2 (paragraphs 141 and 143). But the Supervision Team understood that these improvements could only materialise over the longer term since prevailing market conditions made it difficult for RBS to improve its funding profile in the immediate term.[622]

550 Not until the bankruptcy of Lehman Brothers, did concern regarding the risks associated with RBS's significant overnight wholesale funding gap heighten within the Supervision Team, Supervision and FSA senior management[623] as confidence broke that certain institutions were too big to fail and liquidity disappeared. The FSA Supervision Director reiterated concern about RBS's overnight wholesale need in an email to the FSA CEO on 25 September 2008 and commented that RBS's overnight funding need was '*huge*' and that '*while their requirements are being met it wouldn't take much for there to be a problem*'. Concern was also expressed in this email that the FSA Supervision Director was not aware of the existence of an FSA '*contingency plan in the event that a particular bank can't fund its overnight position*' but understood that there was limited action the FSA could take.[624]

551 As discussed in Section 1.2 (paragraph 196 to 197), from September 2007, the FSA, and in particular the FSA Chairman, stressed the significance of deteriorating liquidity conditions, and raised issues relating to overall policies on public liquidity support. But following the collapse of Lehman Brothers in September 2008, from the FSA's perspective, the only realistic contingency plan for a large bank such as RBS was for the Bank of England to provide ELA and/or for a capital injection from HM Treasury.

Regulation and supervision of asset quality

552 The FSA's strategy for RBS, set out in the paper to the Tripartite Standing Committee at end-April 2008, included a next step to '*ensure downside risks to capital are fully understood*' from, for example, credit-related markdowns.[625] This section considers how the Supervision Team and wider FSA approached the supervision of RBS's credit risk in both its trading and banking books in the period following the rights issue, in line with this strategy.

621 Review Team meeting with Supervision Team, June 2011; Review Team meeting with the then FSA Supervision HoD, June 2011.
622 Review Team meeting with Supervision Team, June 2011.
623 Review Team meeting with the then FSA Supervision Director, June 2011; Review Team meeting with the then FSA Supervision HoD, June 2011; Review Team meeting with Supervision Team, June 2011.
624 FSA records, September 2008.
625 FSA records, April 2008.

Structured credit assets and monoline exposures

Structured credit assets

553 As explained in Section 1.4.3, before the onset of the market disruption in August 2007, the FSA's general approach to supervision involved limited fundamental analysis of inventory within the trading book. The FSA's regulation and supervision of RBS, with respect to structured credit and other related portfolios, was severely deficient.

554 The risks to banks from structured credit assets were identified in mid-2007, as discussed in Section 1.4.2. Given that the potential for loss was already in place, due to the exposures created by early 2007, there was little the FSA could have done at that point to reduce RBS's exposures to structured credit. It was a matter of understanding RBS's approach to the valuation of those assets and projecting additional write-downs that might need to be taken.

555 The FSA 2008 *Financial Risk Outlook* (FRO), published in January, highlighted as a priority risk the difficulties in valuing structured credit assets and the impact of those difficulties on market confidence.[626]

556 The Review Team saw evidence that, by autumn 2007, work was underway by FSA specialists to assess RBS's and other firms' sub-prime exposures and valuation approaches.[627] This included gathering and analysing data and several meetings with firms supported by Supervision Teams.[628] It also included consideration of exposures resulting from structured credit assets such as collateralised debt obligations, leveraged finance and exposures to monolines. Many of these assets were held in firms' trading books.

557 The Review Team learned that significant additional data requests were made to RBS to try to assess its structured credit exposures, its approaches to the valuation of those assets, and the likelihood of further losses, but that RBS had challenges in providing these data.[629] The FSA also continued to have '*minimal data*'[630] on ABN AMRO's structured credit portfolios, which had considerably increased RBS's exposures to these assets (see Section 1.4 paragraphs 281 to 283). Therefore, the analysis undertaken by the FSA specialist team in relation to RBS was often based upon limited data.[631]

558 It was not until late September 2008 that a comprehensive and standardised valuation benchmarking exercise was rolled out. This was designed to assess major banks' exposures to troubled asset classes, including structured credit, and to inform the FSA's view on firms' risk profiles and the potential for future losses from these portfolios in the event of continued market dislocation. This reflected the implementation of a new regular reporting framework, with data collected from firms on a quarterly or six-monthly basis.[632]

626 *Financial Risk Outlook*, FSA, January 2008.
627 With evidence of discussion with RBS in April 2007 on its exposure to sub-prime. FSA records, April 2007.
628 FSA records, November and December 2007; Review Team meeting with Supervision Team, July 2011.
629 FSA records, April 2008.
630 FSA records, April 2008.
631 FSA records, November to December 2007 and April 2008.
632 FSA records, September 2008.

559 In the Review Team's view, the FSA could have performed this benchmarking exercise earlier, given the significant valuation uncertainty on certain asset classes during 2007 and 2008. However, as well as the challenges in getting firms like RBS to produce the necessary data, the Review Team acknowledged that limited specialist resource availability within the FSA may have been a factor.

560 In the Review Team's opinion, the small FSA specialist team responsible for assisting Supervision in understanding the appropriateness of how firms, including RBS, were valuing their exposures to structured credit had the requisite skills and experience. However, the Review Team considers that the work required to understand firms' structured credit portfolios during 2008 was much greater than could be performed by a team of that size. The Review Team has been advised, therefore, that to undertake the exercise earlier would have required the FSA to hire external resource to assist in this work which could have increased the risk of market leaks.

Monoline exposures

561 From November 2007 the FSA collected data from firms on their monoline exposures and carried out peer analysis (see Section 1.4, paragraph 320).

562 Following the rights issue, the Supervision Team was concerned with immediate risks posed by RBS's trading book, in particular its significant monoline exposures.

563 Work continued on RBS's exposure to monolines during 2008. For example, in June 2008, a paper was presented to the Tripartite Standing Committee on Financial Stability which set out a comprehensive overview of the health of the major monoline insurers, and the exposures of the major banks[633] to this sector.[634] RBS was shown to have the largest monoline exposures of all the major UK banks. A subsequent FSA FMC report at end-June again highlighted RBS as being particularly exposed to monolines and suggested that RBS should take at least €1.6bn in additional write-downs against these exposures.[635] The Review Team has not been able to determine how this recommendation was taken forward by the Supervision Team.

Banking book asset quality

564 As shown in Section 1.3, paragraph 230, and Table 2.5, since its failure, RBS experienced very significant losses in its banking book.

565 The 2008 FSA *FRO* commented, in relation to banks and building societies, that '*commercial property prices have now begun to fall.....Arrears rose in 2007 and there is a risk that banks will face increased impairment charges in 2008*' and that '*there is increasing evidence that asset quality, most notably mortgage arrears, began to deteriorate in the last quarter of 2007 and this trend is likely to continue in 2008*'. However, this was not highlighted as a priority risk generally, whereas the valuation of structured credit exposures was (see

633 As well as some of the larger investment banks.
634 FSA records, June 2008.
635 FSA records 2008. RBS had already announced with the April 2008 rights issue that it would take £5.9bn in write-downs against CDS contracts with the monoline insurers for the full year. In its H1 2008 results, announced on 8 August 2008, RBS then recognised £5.9bn of write-downs on these exposures for the half year.

paragraph 555). In May 2008, the FSA Retail Banking Sector Team identified credit risk associated with higher risk lending as one of a number of issues.[636]

566 In contrast to the increased supervisory focus during 2008 on RBS's structured credit assets in its trading book, the Review Team saw limited evidence that the Supervision Team undertook work to understand the quality of RBS's loan portfolios in its banking book in order to assess the potential impairments that could materialise from an economic downturn. This was despite concern among market participants about the quality of RBS's assets (see paragraphs 484 to 489 and 505 to 510) and RBS's commercial property exposure being highlighted by the FSA and Bank of England as a cause for concern throughout the Review Period (see Section 1.3.6).[637]

567 This was consistent with the FSA's general approach to supervision which involved limited fundamental analysis of balance sheet composition and asset quality (see Section 1.3, paragraph 251) and its prioritisation at that time of the immediate risks arising from the trading book. As noted in Section 1.3, the FSA has subsequently revised its approach to the assessment of firms' underlying asset quality.

568 The Review Team did not see a record of discussion or any actions in relation to RBS's banking book asset quality in its review of the records of ExCo meetings.[638] However, it was discussed in relation to certain other firms. This supported the Review Team's view that RBS's banking book asset quality was not a key concern for FSA senior management at that time. With hindsight, this was a weakness, given the extent of impairments RBS would recognise in 2008, 2009 and 2010 (see Table 2.15).

Conclusions on what happened in RBS from spring to autumn 2008

- From a capital, liquidity and asset quality perspective, RBS was relatively poorly positioned in comparison with most of its peers even after the rights issue completed in June 2008. This made it vulnerable to a loss of confidence.
- Between May to October 2008, market participants increasingly perceived that RBS was relatively poorly positioned in terms of its capital and asset quality; there is less evidence of market understanding of RBS's poor liquidity position.
- The decline in market confidence and liquidity, which had gradually gathered pace from summer 2007, became catastrophic after the collapse of Lehman Brothers in September 2008. In this environment, any bank perceived to be (and in many cases actually) relatively poorly positioned became subject to falling confidence, with funding increasingly denied. RBS was one such bank.
- A combination of the systemic concerns and concerns about RBS's relative position resulted in RBS suffering a liquidity run as wholesale counterparties, and to a lesser extent retail and corporate depositors, increasingly declined to fund it, leaving RBS reliant on Emergency Liquidity Assistance (ELA) from 7 October 2008.

636 FSA records, May to October 2008.
637 FSA and Bank of England records, 2006, 2007 and 2008.
638 FSA records, May to October 2008.

Conclusions on the FSA's regulation and supervision from spring to autumn 2008

- The FSA responded appropriately to the onset of the crisis period. But with hindsight its actions were insufficient for RBS to withstand the additional shocks, to remain adequately capitalised and to prevent wholesale market counterparties and depositors from withdrawing their funds. This reflects the fact that once the crisis period started, there was limited action that could be taken to improve RBS's position rapidly and sufficiently to withstand failure.
- The FSA developed a new approach to capital adequacy during early 2008 which implemented a core capital target for major UK banks of 5%, well above the then international minimum of 2%.
- The FSA continued to progress its review of liquidity regulation and its plan to implement an improved liquidity regime.
- The Supervision Team, Supervision and FSA senior management focused on the main priority of ensuring that RBS had adequate quality capital to absorb further losses and to maintain confidence in the firm's solvency through monitoring RBS's progress against its asset disposal plan.
- There was a step change in the Supervision Team's, Supervision's and FSA senior management's focus on liquidity risk. But consistent with the view that RBS's liquidity position was not an immediate risk, as well as the fact that once the crisis period started there was limited action that could be taken to improve a firm's liquidity position, the supervisory approach to RBS's liquidity risk was predominantly one of monitoring.
- The FSA also enhanced the existing capital and liquidity data it received from certain firms, including RBS, with additional reporting to assist it to monitor firms' capital and liquidity positions.
- There was an increase in focus on structured credit assets as the FSA became more aware of the emerging problems associated with these exposures. However, this was hampered by data quality issues and limited specialist resource at that time.
- The Supervision Team did not assess the potential risks to RBS's future capital position arising from impairments on banking book assets. This was consistent with the FSA's prioritisation of the immediate risk arising from structured credit assets at that time.

Lessons already identified where actions have been taken

These are already covered in Sections 1.1 to 1.4.

Recommendations for further change

These are already covered in Sections 1.1 to 1.4.

2 Management, governance and culture

569 Section 2 considers the role that RBS's management, governance and culture may have played in contributing to the bank's failure. It also examines how the FSA supervised RBS's management, governance and culture during the Review Period.

570 Section 2 covers:

- in 2.1, the importance of management, governance and culture;
- in 2.2, management, governance and culture at RBS;
- in 2.3, the FSA's supervision of RBS's management, governance and culture; and
- in 2.4, key lessons and recommendations for further change.

2.1 The importance of management, governance and culture

571 As described in Part 1 and Part 2, Section 1, there were multiple factors behind RBS's failure. Some of these were generic factors which made the entire global financial system vulnerable to a crisis. These included unconstrained credit booms in several countries, inadequate global capital and liquidity requirements for banks and an inadequate regulatory response to the rapid growth of complex and opaque credit securities markets. But there were also factors specific to RBS that explain why it was among the banks that failed as the crisis developed.

572 While external factors were undoubtedly important in RBS's failure, banks are run by people and those in board and senior management positions are responsible for the decisions they make. It is only with hindsight that it is clear that there were specific decisions taken by the RBS Board and senior management which placed RBS in a more vulnerable position than other banks when the financial crisis developed between 2007 and 2008. They included:

- keeping RBS lightly capitalised in order to maintain an 'efficient' balance sheet;
- adopting a business model that was highly dependent on wholesale funding and therefore choosing to run with a high level of liquidity risk;
- expanding commercial real estate lending with inadequate monitoring and mitigation of concentration risk;
- rapidly increasing lending in a number of other sectors which subsequently gave rise to substantial losses, eroding RBS's capital resources;
- expanding the structured credit business in 2006 and early 2007 when signs of underlying deterioration in the market were already starting to emerge;
- proceeding with the ABN AMRO acquisition without a sufficient understanding of the risks involved;

- funding that acquisition primarily by debt, which in turn made RBS's capital position worse than it might otherwise have been; and
- adopting the role of lead partner in the ABN AMRO acquisition, thereby initially acquiring all the assets and risks on behalf of the consortium.

573 These decisions need to be considered in the context of what was, at the time, a widely held, but erroneous, view about the inherent stability of the global financial system. Some of the decisions appeared reasonable at the time and were not dissimilar to those taken by other banks. They turned out badly for RBS once the financial crisis hit and could therefore be considered 'poor' decisions only with the benefit of hindsight. Other decisions could, in the opinion of the Review Team, be considered 'poor' or at least questionable at the time, for example where they seem to have been based on an inadequate appreciation of the risks involved.

574 Individual poor decisions can result from imperfect analysis in particular circumstances: even well-run companies and banks can make important mistakes. But a pattern of decisions or judgements that may reasonably be considered poor, whether at the time or with hindsight, suggests the probability of more generic, underlying causes. In particular, banks may have a tendency to make poor decisions if there are deficiencies in:

- their management capabilities and approach;
- the governance arrangements, which should provide checks and balances and ensure effective oversight and challenge; or
- the culture, in particular the attitude to the balance between risk-taking and growth.

Given the series of decisions that RBS made and which contributed, to a greater or lesser extent, to its vulnerability to the financial crisis in 2008 and to its subsequent failure, the Review Team considered whether a root cause lay in aspects of its management, governance and culture. This section considers RBS's management quality, governance arrangements and culture during the Review Period.

575 Some aspects of management, governance and culture can be assessed fairly precisely. For example, it is possible to identify whether a bank has appropriate formal processes of governance by reviewing matters such as whether board agendas cover appropriate issues and management information flows to the appropriate level. However, many of the important questions about management, governance and culture cover issues such as boardroom dynamics, management style and shared values. These, by their nature, are matters of judgement and are difficult to assess precisely, even on the basis of contemporaneous documentation. For example, assessing whether key board decisions were subject to adequate monitoring and challenge is inherently difficult, as the minutes of board meetings typically record the decisions taken rather than the detail of how or why a particular decision was arrived at, or whether alternative views were expressed in the course of the debate. And assessing a firm's culture effectively is difficult even when done

contemporaneously, let alone when attempting to assess the past. Despite these difficulties, the Review Team has concluded that it is highly probable that aspects of RBS's management, governance and culture played a role in the story of RBS's failure and should be addressed in this Report.

576 The purpose of highlighting possible deficiencies in RBS's management, governance and culture here is:

- to attempt to satisfy a legitimate public interest in understanding the causes of RBS's failure; and
- so that lessons can be learned to help firms avoid similar difficulties in the future.

The information which the Review Team used to identify these possible deficiencies could quite reasonably be subject to differences in interpretation by different readers of the Report, and be subject to public debate. However, the fact that some decisions are described as poor or mistaken, either in retrospect or at the time, carries no implication that RBS or any individual was guilty of any regulatory breach.

577 In describing possible deficiencies in RBS's management, governance and culture during the Review Period, the information on which the Review Team has drawn includes:

- the FSA's supervisory records created during the Review Period, which identified some concerns about RBS's management, governance and culture;
- the reports produced for Enforcement Division in 2010, which throw some light on important management, governance and risk control issues (see Part 3);
- interviews with past and present RBS Board members and senior executives;
- material provided by RBS in connection with this Report or in response to the FSA's Enforcement investigation;
- an RBS Group Internal Audit report of 2008 on the events that led to the significant write-downs in RBS's credit market activities; and
- interviews with investors who were, at the time, attempting to assess the risks associated with their investments in RBS.

578 The Review Team used these sources to identify questions and, where possible, to reach conclusions about RBS's management, governance and culture. Where appropriate, the Review Team has also identified lessons for the future.

579 The Review Team's analysis of RBS's management, governance and culture is set out in Section 2.2. Analysis and conclusions of how effectively the FSA supervised management, governance and culture at RBS during the Review Period are in Section 2.3. Section 2.4 describes some key lessons and recommendations for further change. Details of how the FSA's approach to the supervision of

management, governance and culture has changed since the Review Period can be found in Section 3.5.

2.2 Management, governance and culture at RBS

580 The material described above raises questions about five aspects of RBS's management, governance and culture:

- the overall effectiveness of Board oversight and challenge;
- the Board's role in relation to the ABN AMRO acquisition;
- the Board's oversight of strategy;
- the Group Chief Executive (CEO)'s leadership capability and management style; and
- the quality of risk controls and management information.

581 This section does not include a separate sub-section on culture, in part because it is extremely difficult, several years after the event, accurately to assess the culture of RBS during the pre-crisis period. Culture may be defined as a set of attitudes, values, goals and practices which together determine how a firm behaves, both towards its stakeholders and internally. A particular culture can have a significant influence on the decision-making of a firm, pre-disposing it to either insufficient or excessive risk tolerance.

582 It will be seen that this section of the Report does raise a number of questions about RBS's culture, which may have had a significant influence on its decision-making. These questions relate to whether RBS became over-confident about its abilities, had too optimistic an outlook, or was too focused on revenue and profit rather than balance sheet risk.

2.2.1 The overall effectiveness of Board oversight and challenge

583 The FSA announced in December 2010 that, in the context of its enforcement work,

'*We did not identify ...... a failure of governance on the part of the Board.*'

However, it is important to note that this conclusion was reached in the context of whether there was a basis for the FSA successfully to bring an enforcement case in relation to the issues that were investigated. It should not be regarded as providing a positive assessment by the FSA of the general quality of corporate governance at RBS during the Review Period.

584 The effective functioning of a board requires both the discipline of appropriate formal process and the facilitation of critical interactive exchange among board members ahead of taking decisions, especially in relation to the strategy to be followed. These two ingredients of formal process and exchange among board members are complementary but both are required. Process alone may involve little more than a box-ticking affirmation that the formal structures required for

discussion and decision-taking exist. Equally, the animation of critical interactive exchange, while vital, is unlikely to be constructive unless harnessed into an appropriate decision-taking structure.

585 By and large, the existence and adequacy of a board's formal processes can be identified and assessed after the event by reviewing the minutes of board and committee meetings. By contrast, assessing the quality of critical interactive discussion among board members is more difficult. This is because the extent and nature of any differences of view are not typically or dependably captured in minutes. Furthermore, the take-away impressions of board members, both at the time and later, about a particular discussion may differ and may be subconsciously coloured by their knowledge of subsequent events.

586 In addition to these two critical ingredients of appropriate formal processes, as set out in company policy and in corporate governance best practice codes, and critical interactive exchange among board members, a board's effectiveness is also a function of:

- the relevant experience of the members and how well they work together under the leadership of the chairman;
- the nature and depth of challenge by non-executives to the executive; and
- the quality of the board's understanding and oversight of firm-wide risks.

587 The evidence base suggests that the RBS Board's composition and formal processes met acceptable standards. In particular:

- The Board included members with relevant experience and skills and successful track records in other fields. On paper, it looked adequately strong.
- The Chairman took steps to familiarise himself with RBS's business and conducted the business of the Board and its committees in accordance with relevant corporate governance guidelines. He took care to allow all Board members to put forward their views and participate in discussions, and provided opportunities for Board members to challenge the executive.[639]
- Board discussions covered an appropriate range of issues and the Board made formal decisions on issues for which it was legally responsible.
- The Chairman's Committee[640] – a body created to facilitate rapid convening and which *de facto* included all Board members – was appropriately constituted and followed formal processes. On becoming Chairman in April 2006, Sir Tom McKillop took steps to improve the transparency and operation of the Chairman's Committee.

639 Board members said in interview that a lot of the discussion of proposals took place at the Board dinners which regularly preceded the formal Board meetings.

640 Under Sir Tom McKillop, the Chairman's Committee was an officially constituted Committee of the Board. All Board members were also members of the Chairman's Committee and invited to attend. The Committee held a minimum of three scheduled meetings per year and ad hoc meetings as required. The main purpose of the scheduled meetings was to discuss the Group's financial results and risk issues in months when no Board meeting was scheduled. Ad hoc meetings were used to deal with emergencies or material matters that required immediate decisions, for example the acquisition of ABN AMRO. Decisions taken by the Chairman's Committee were formally communicated later to the Board.

- Although, in the pre-crisis period, RBS did not have a formal Board Risk Committee (as subsequently recommended by Sir David Walker's report[641]), risk issues were the responsibility of the Group Audit Committee (GAC). This was not out of line with standard practice at the time.

588 As described in paragraphs 632 and 644, the Supervision Team formed a positive view of RBS's high level corporate governance arrangements, and the relationship between RBS and the FSA, in the 2006 Interim ARROW and the 2007 ARROW assessments.

589 In formal terms, therefore, there is no evidence of a procedural failure of governance at RBS Board level during the Review Period. For example, as Part 3 will discuss, there was no evidence of any failing of formal governance processes in relation to the decisions on the acquisition of ABN AMRO. The Board and Chairman's Committee met frequently to discuss this acquisition throughout the process and Board members were fully aware of the limited extent of due diligence which had been conducted.

590 The RBS Chairman responded to the losses that led to the announcement of the rights issue in April 2008 by commissioning a Group Internal Audit review to '*understand the background to, and lessons learned from, the events that led to significant write-downs in RBS sub-prime, leveraged finance and other credit market activities*[642], with a focus on identifying changes that RBS should make to its processes. In the Review Team's opinion, commissioning this review was an appropriate step towards learning any lessons from those events. The review identified a number of issues, and changes for RBS to make, some of which are referred to later in this section.

591 While the Review Team found no evidence of formal governance failings, the fact remains that the RBS Board and the Chairman's Committee were ultimately responsible for a sequence of decisions and judgements that resulted in RBS being one of the banks that failed during the financial crisis. On that basis and in retrospect, the Review Team concluded that there were substantive failures of Board effectiveness at RBS, even if there were no formal failures in the governance process.

592 In particular, the evidence seen by the Review Team raised questions as to whether the RBS Board:

- Failed adequately to challenge RBS's focus on increasing revenue, assets and earnings per share (EPS) and failed to ensure that adequate attention was given to the core banking fundamentals of capital, liquidity and asset quality.
- Set incentives for the RBS CEO[643] which made it rational for him to focus on increasing revenue, profit, assets and leverage, rather than on capital, liquidity and asset quality. The CEO's annual remuneration was heavily influenced by operating profit, EPS growth and return on equity, as distinct

641 *A review of corporate governance in UK banks and other financial industry entities*, 26 November 2009.
642 RBS Group Internal Audit report, July 2008.
643 The CEO's annual incentive was '*primarily based on specific Group financial performance measures such as operating profit, earnings per share and return on equity. The remainder was based on a range of non-financial measures, which may include those relating to shareholders, customers and staff*' (RBS Annual Report and Accounts 2007).

from return on assets.[644] There was less regard to non-financial performance measures. This type of incentive package was, however, not dissimilar to those at other large banks.

- Failed adequately to identify and address the aggregation of risks across the businesses (see Section 2.2.5) and therefore properly to assess the bank's overall exposures and, ultimately, its vulnerability to a major downturn in the markets and collapse in asset prices.

- Did not adequately encourage the executives to re-examine the assumptions lying behind aspects of their strategy, especially in light of developments in global markets such as the downturn in the US sub-prime market in late 2006 and early 2007 and the severe stresses in funding markets in summer 2007. Effective challenge from a wide range of perspectives is an important board function.

593 These points in turn raise the following key questions about whether the RBS Board's mode of operation was, in practice, as effective as the preceding analysis of the Board's composition and formal process suggests:

- Whether the Board's size – there were 17 directors for most of the Review Period – made it less manageable and more difficult for individual directors to contribute, hence reducing overall effectiveness.

- Whether, despite the relevant skills and experience of individual members of the Board, it collectively lacked a critical mass of members with deep experience in both core banking and investment banking trading activities (for example structured credit) sufficient to provide regular, informed challenge to executive assumptions, explanations and proposals. This raises a more general question as to whether bank boards need significantly more industry-specific expertise than is typically considered necessary for boards in other sectors of the economy. However, it is far from certain that having more members with deeper expertise would have resulted in greater Board challenge to the assumptions which RBS made during 2006 and early 2007, given that those assumptions were shared by many banks and industry experts at the time.

- Whether the Board and executive management were, in their assessment of the ABN AMRO deal, overly influenced by a desire to make RBS a leading global bank (for example by acquiring a global payments business) and were therefore too willing to proceed with this very large and complex acquisition on the basis of an inadequate risk assessment, exacerbated by limited due diligence.

- Why the Review Team was able to identify little significant disagreement on major issues during the Review Period in a Board containing tough and experienced individuals with successful track records (see paragraph 647). Clearly constant disagreement would be debilitating for a board, but some divergence from consensus would not be unhealthy.

644 RBS had one of the lowest equity / asset ratios of any major European bank. See Section 1.1.1.

2.2.2 The Board's role in relation to the ABN AMRO acquisition

594 The decision taken in 2007 by the RBS Board to acquire ABN AMRO is now generally acknowledged to have been a critical strategic error. RBS's current Chairman has publicly stated his view that:

'I don't think there can be any doubt that the key decision that led RBS to its difficulties was the acquisition of ABN AMRO. That is the painful reality that we can now do nothing to change. With the benefit of hindsight, it can now be seen as the wrong price, the wrong way to pay, at the wrong time and the wrong deal.'[645]

595 In relation to Board effectiveness, the acquisition of ABN AMRO deserves particular focus since, while there are many aspects of a bank's strategy and operation where a board can only play an indirect role as overseer and challenger, the decision to proceed with a major acquisition is a specific responsibility of the board.

596 Four features of the ABN AMRO acquisition made it potentially very risky:

- it was an exceptionally large and complex transaction;
- the bid comprised primarily debt rather than shares, and RBS's decision to raise most of that debt on the short-term wholesale markets increased its reliance on short-term wholesale funding and its consequent vulnerability as the financial crisis developed;
- there was considerable uncertainty in the market arising from the consortium structure, under which RBS would consolidate the whole of ABN AMRO on its balance sheet before the transfer of assets to other consortium partners[646]; and
- RBS undertook extremely limited due diligence.

597 During the period of the acquisition, the RBS Board comprised 17 members. The key discussions took place in the Board, in the Chairman's Committee (in which all Board members had an opportunity to participate and most did so), and in one to one discussions between the Chairman and individual Board members. These meetings and discussions were frequent throughout the relevant period and, while the large size of the Board and the need for rapid decisions meant that much of the substantive discussion took place in the Chairman's Committee, the overall process followed by the Board was both continuous and inclusive. It is also relevant to note that, before making its initial offer for ABN AMRO in May 2007, the Board received legal advice regarding whether it had given the offer proper consideration.[647]

598 However, despite this adherence to formal process, it is now clear that the outcomes of the RBS Board's decision-making in respect of the ABN AMRO acquisition were dramatically negative. It is a matter of judgement how far these outcomes reflected the severe deterioration in the market environment, with a

645 RBS Press Release Annual General Meeting, 3 April 2009.
646 This is described in more detail in Section 1, paragraph 406.
647 RBS records, May 2007.

correspondingly negative impact on RBS business, and how far, despite the comprehensive hierarchy of formal board processes in place, they reflected an inadequate and seriously flawed assessment of relevant issues, above all in relation to risk. The Review Team noted that the unprecedented deterioration in the market environment that RBS and others experienced makes the excision of hindsight from this judgement both more necessary but also more difficult. Nevertheless, on balance the Review Team judged that the substance of decision-making by the Board in relation to ABN AMRO was defective at the time, whatever the subsequent deterioration in the market and wider financial environment.

599 With reference to the acquisition of ABN AMRO, the Review Team attached special significance to three closely related factors that may have influenced the quality of the RBS Board's decision-making:

- The first is the fact that the decision to acquire ABN AMRO was taken against the background of the firm's track record of successful acquisition and integration, particularly of NatWest, and the CEO's personal contribution to it. While this sense of confidence in past achievement may have been justified, it may also have led the Board to be overconfident in its appraisal and challenge of new proposals.

  In interview, Johnny Cameron told Enforcement Division: '*One of the things that went wrong for RBS was that, and I say this to many people, we bought NatWest as a hostile acquisition. We did no due diligence. We couldn't because it was hostile. After we bought NatWest, we had lots of surprises, but almost all of them were pleasant. And I think that lulled us into a sense of complacency around that. The fact is that the acquisition of ABN was also hostile. We got bits and pieces of information but fundamentally it was hostile. There's this issue of did we do sufficient due diligence. Absolutely not. We were not able to do due diligence…that was part of doing a hostile acquisition.*'[648]

- Second, it was not apparent to the Review Team that the Board discussed in sufficient depth the risks involved in the acquisition, including its exceptional complexity, unprecedented scale and how it was to be financed, especially as so little effective due diligence was possible. The Board drew comfort from the fact that the limited due diligence, which seems to have focused on identifying the scope for synergies and cost cutting, with less emphasis on identifying the risks and potential exposures, identified no 'show-stoppers' in particular business or functional areas. In the absence of detailed due diligence, the Board also placed reliance on the fact that ABN AMRO was regulated by the DNB and the FSA, on ABN AMRO's publicly available SEC filings, on Sarbanes-Oxley conformity, on reports by the rating agencies and on Barclays' persistence in pursuing its bid.

  The minutes of the Board meeting on 28 March 2007 record that the RBS CEO '*provided background to the project... A bid for [ABN AMRO] was not seen as a "must do" deal*'. The CEO advised the Board that '*execution risk*

648 FSA records, July 2009.

would be high' and that *'any bid for [ABN AMRO] and subsequent integration would be more difficult than previous transactions'*.[649]

However, the Review Team has not found evidence that the Board undertook any penetrating analysis of the risks on an enterprise-wide basis in respect of capital and liquidity. During interviews with the Chairman and other Board members, it was indicated that, while the assumptions and plans were discussed on a regular basis, '*...at no stage did any Board member propose that we should not proceed'*.[650] One former Board member reflected, with hindsight, that there was an element of 'group-think' in the Board's decision to acquire ABN AMRO and that, to his knowledge, no Board member ever said that he or she was worried about the deal.[651] In the opinion of the Review Team, it is very difficult to reconcile this approach with the degree of rigorous testing, questioning and challenge that would be expected in an effective board process dealing with such a large and strategic proposition.

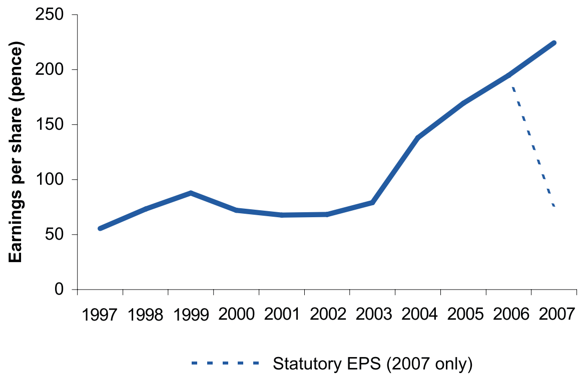
In this context, it is also relevant to note that the investment banking advice available to the Board was largely remunerated on a success fee basis. While this was common practice at the time, it meant that, as the adviser had a substantial financial interest in the successful completion of the transaction, it is difficult to regard the adviser as independent.

- Third and most significantly, the Board appears to have displayed inadequate sensitivity to the wholly exceptional and, compared with other companies, unique importance of customer and counterparty confidence in a bank and its chosen strategy. The Board was fully aware that it could undertake only extremely limited due diligence in respect of the ABN AMRO acquisition. However, it appears to have treated the fact that such constraints on due diligence are normal in any contested bid as, at least to some degree, entitling it to disregard this impediment and to attach undue weight to the assertions that, in specific business areas, no 'show-stoppers' had been identified as part of the due diligence process. The fact that the scope for rigorous due diligence is normally severely constrained for contested bids should not have justified a reliance on limited due diligence when so massive a banking transaction and associated risks were involved. The Review Team reached this conclusion in the knowledge that, had a fully adequate due diligence process been possible, the Board might still have been satisfied with the outcome and decided to proceed. Whether or not that is the case, the decision to make a bid of this scale on the basis of limited due diligence entailed a degree of risk-taking that can reasonably be criticised as a gamble.

600 In summary, the Review Team concluded that the judgement of the RBS Board in respect of the ABN AMRO acquisition was not characterised by the degree of moderation and sensitivity to strategic risk appropriate to a bank. With so much

649 RBS records, March 2007.
650 FSA records, May 2011.
651 FSA records, June 2011.

Graph 2.25: RBS basic earnings per share (EPS), 1997 to 2007, with 2007 statutory data adjusted to exclude the effects of the bonus issue in that year[652]



Source: 1997-2007 RBS annual reports and accounts.

at stake, there was a critical need for more fundamental probing, questioning and challenge by the Board.

601 The actual or possible deficiencies set out above did not justify enforcement action for the reasons set out in detail in Part 3, paragraphs 248 – 257 of this Report. However, this fact does not justify a view that governance at RBS was effective during the Review Period in relation to the ABN AMRO acquisition. In the opinion of the Review Team, it was not.

2.2.3 The Board's oversight of strategy

602 A key role of a board is to set the basic goals for a firm's strategy and to ensure that they are within the agreed risk appetite. This requires that a board assure itself that a detailed consideration of risks is part of the process of considering future strategy.

603 Until 2007, RBS was perceived as a highly successful bank. For example:

- There had been significant growth in earnings per share (EPS) in the ten years between 1997 and 2007 (Graph 2.25).
- When the 2007 results were announced in February 2008, they revealed a record Group operating profit of £10.3bn (£7.7bn after tax[653]).
- Through its acquisition of NatWest, RBS had become one of the world's largest banks. That acquisition was considered at the time to be a masterstroke of strategy and execution and a sign of the CEO's exceptional skill. Moreover, many of the post-acquisition 'surprises' in relation to RBS's initial assessment of prospective synergies had turned out to be favourable. RBS increased its assets by a multiple of 29 between 1998 and 2008 (assets grew by an average of 41% per year), and it moved from outside the top 20

652 In 2000, RBS conducted a bonus issue and issued shares to former shareholders in NatWest as part of the acquisition; this therefore had an effect on EPS from 2000. RBS also conducted a bonus issue in 2007. The graph shows an estimate of EPS assuming that the bonus issue had not taken place; the dotted line shows the statutory basic EPS in 2007 taking the bonus issue into account.

653 RBS 2007 annual results.

global banks by market capitalisation prior to its acquisition of NatWest to ninth in the world by 2007.

604 The RBS strategy which, it was believed, had delivered this apparent success, was a mixture of acquisition and organic growth. It has been described as 'opportunistic' but was also seen by some institutional investors as lacking clear direction. The Board wanted to be open to opportunities that would deliver growth away from the core UK retail business and allow expansion into other businesses and regions, such as investment banking, the US and the Far East.

605 It is difficult in retrospect to evaluate RBS's strategy or to assess whether, in the absence of the global financial crisis, it would have continued to be successful. There is nothing intrinsically wrong with an 'opportunistic' strategy. Nevertheless, the Review Team's analysis raised questions about the effectiveness of the RBS Board's role in relation to strategy. Given the scale of RBS's ambitions for growth, in particular during 2006 and into 2007, it is reasonable to expect the Board to have assured itself that the growth strategy was accompanied by a very high degree of attention to the associated risks. In retrospect, this was not clearly and demonstrably the case:

- The 'Board, Remuneration Committee and Nominations Committee Performance Evaluation 2005' report[654] said that a quarter of the Board disagreed that the Board's review and evaluation of strategic issues in relation to the Group's present and future environment was satisfactory, that directors would like more time to consider and debate strategy, and that a number of them felt that there should be a formal report or discussion of risk appetite when the budget was reviewed. The 2006 report[655] said that directors felt there was insufficient input to and review of risk appetite at Board level, that the Board needed to articulate its risk appetite and that a third of them did not appear to be satisfied with the Board's role in defining and developing strategy.
- As described in paragraphs 79 and 80 of Part 3, strategy documentation provided to the Group Board for Global Banking and Markets (GBM) did not include detailed analysis of the relevant markets to support the aspirations for growth or of the key risks involved. The risk impact was typically summarised in a bullet point for each initiative, with no information as to how the various risks identified were to be addressed or mitigated. There was no evidence of any significant challenge by the Risk function to the proposals.
- The Review Team was told of some feedback from an adviser who contributed to the RBS executive programme that RBS was unique among major banks in having many 'hill climbers' but almost no 'hill finders'.[656] The bank was seen as exceptionally strong in people who would reliably implement agreed strategy but relatively much weaker in its capacity for strategic thinking.

654 RBS records, December 2005.
655 RBS records, December 2006.
656 FSA records, July 2011.

- The RBS Group Internal Audit report[657] delivered to the Chairman in July 2008, said: '*Based on our review and meetings with Board members, discussions of strategy could be expanded to include more analysis of strategic options and their associated risks. These discussions would also be supported by appraisals of current risk levels versus risk appetite*' and '*This should include the nature and scale of the risk that the Board is prepared to take*'.

- A memorandum dated 15 July 2008 from RBS's Head of Group Internal Audit to the RBS Chairman, which was the cover letter to the report, went further, saying: '*You will see observations in our Group report regarding the role of the Board in relation to strategy determination and acceptance of risk. The report does not convey the depth of feeling expressed by Board members regarding their ability to discuss, challenge and influence the decision-making on these key areas*'.[658]

  It is the Review Team's understanding that the purpose of this memorandum was, at the request of the Chairman, to capture views expressed by interviewees (including five non-executive directors). These included interviewees' reflections on individuals, which were more subjective than the content of the main report.

606 A number of those interviewed by the Review Team described RBS as being much more focused on revenue and profit than on the size of the balance sheet. This, together with the factors described above and the optimism described elsewhere in this section, with the benefit of hindsight raise the following questions about the RBS Board's oversight of strategy:

- whether the Board and executive management actively assured themselves that they were receiving adequate information to consider the risks associated with strategy proposals, and were sufficiently disciplined in questioning and challenging what was presented to them;

- whether the main consideration in setting strategy was to accelerate growth in revenue and profit rather than assessing the impact of the chosen strategy on balance sheet exposures; and

- whether the Group Risk function was given adequate authority or support to ensure that the Board was fully aware of and gave priority to the risks inherent in the strategy.[659]

2.2.4 The CEO's leadership capability and management style

607 The success of RBS described in the previous section had been achieved under the leadership of Sir Fred Goodwin as CEO and was perceived to be the result of an overt and highly effective management philosophy, based on:

- tight cost control and centralisation of processing functions;

- superior ability to achieve cost synergies after acquisitions;

657 RBS Group Internal Audit report, July 2008. See Section 2.2.1.
658 RBS Group Internal Audit report, July 2008.
659 The position on this began to change following the appointment of a new Group Chief Risk Officer in January 2007.

- a strong focus on growth, driven by clear targets and incentives; and
- an overt focus on capital 'efficiency', i.e. on high leverage.

608 During 2003 and 2004, prior to the Review Period, the FSA had identified a risk created by the perceived dominance of RBS's CEO. While it was recognised that the CEOs of large firms tended to be assertive, robust individuals, the FSA's view was that, in the case of RBS, the 'challenging management culture led by the CEO'[660] raised particular risks that had to be addressed.

609 The risks that can emerge where there is a dominant CEO are not merely ones of difficult relationships between the CEO and the board, staff, shareholders and regulators. More seriously they can also result in a lack of effective challenge by the board and senior managers to the CEO's proposals, resulting in risks being overlooked and strategic mistakes being made.

610 During interviews with the Review Team, RBS Board members did not provide evidence to support assertions (referred to in some press reports) that they felt 'bullied' or unable to challenge the CEO.[661] And their assessments of the CEO's style varied considerably. The Review Team heard that the CEO showed skill in his handling of Board relationships, intervened infrequently in Board discussions and reliably followed up on points raised by Board members. Interviewees said that the CEO could be courteous and professional in meetings but also that he could come across as somewhat cold, analytical and unsympathetic. The picture that emerged was clearly more complex than the one-dimensional 'dominant CEO' sometimes suggested in the media.

611 The Review Team has been made aware that the senior management team at RBS received positive scores in employee opinion surveys. In 2007, 66% of employees were recorded as agreeing with the statement '*GEMC*[662] *provides good leadership*'.[663] Some additional detail about the operation and culture of the RBS senior management team as a whole was reported in the 15 July 2008 memorandum from RBS's Head of Group Internal Audit to the RBS Chairman, as follows:

'*Most of the members of GEMC we met with criticised the way the Committee operates. Our report describes a lack of meaningful discussion of strategy and risk. However GEMC members also described dysfunctional working in relation to:*

- *GEMC are not operating as a team.*
- *Conversations are typically bilateral.*
- *Performance targets consume too much of the agenda.*
- *Discussions often seem bullying in nature.*
- *The atmosphere is often negative and is at a low point currently.*'[664]

660 FSA records, March 2005.
661 See paragraphs 251-253 of Part 3 for RBS non-executive director responses to Enforcement Division on this issue.
662 RBS's Group Executive Management Committee.
663 RBS records, November 2008.
664 RBS Group Internal Audit report, July 2008.

It is the Review Team's understanding that these comments related to the operation of GEMC during the period in which market conditions and results deteriorated. In addition, it needs to be recognised that the observations about the GEMC in general might not relate to the CEO in particular. In the same document, RBS's Head of Group Internal Audit also wrote, in relation to the separation of management responsibilities, '*There have been a number of observations made during this review that the Group CEO tends to operate too often in the CFO role and that [the CFO] should be more independent in his decision making*'.

612 This, alongside other information from the Review Team's interviews and other sources raises the following questions about the CEO's capability and style and its impact on the business:

- Whether his management style may have discouraged robust and effective challenge from the Board and senior management team:
  - A number of RBS's non-executive directors (NEDs) told the Review Team during interviews that they had been able and prepared to challenge the executive. However, when asked, they gave few clear examples of proposals from the CEO or executive management during the Review Period which were substantially amended as a result of Board challenge. The main examples given were that the NEDs pushed the executive to change the scale of the investment in Bank of China in 2005, and the Remuneration Committee's reduction of some proposed bonuses.
  - Some of those interviewed said that, given the CEO's excellent grasp of detail and skill in forensic analysis, it was sometimes difficult to raise more general questions or concerns that were not readily supported by detailed, objective facts and evidence.
- Whether the levels of remuneration paid to RBS executive directors during the Review Period, which were among the highest for major UK banks, may have played any part in discouraging robust and effective challenge of the CEO by his direct reports.
- Whether the CEO was overly focused on revenue and profit growth targets at the expense of giving sufficient attention to balance sheet risk, particularly in relation to:
  - the growth of assets in many sectors, such as commercial real estate and structured credit, over the period 2004 to 2007[665]; and
  - the desire to proceed with the ABN AMRO deal in order both to achieve further earnings growth away from the mature UK market, and maintain and strengthen RBS's competitive position against peers.
- Whether his response to the emerging losses in structured credit, monoline insurance and leveraged finance in 2007 and 2008, both in respect of the decisions[666] on whether to hedge and on the recognition of losses in the accounts, reflected a bias towards optimism. In interview, Johnny Cameron

665 Although RBS was not necessarily an outlier in these respects.
666 Some of these decisions were the responsibility of the GBM Board and management.

told Enforcement Division that the CEO '*is and was an optimist and he tended to take an optimistic view of what was likely to happen and had often in his life been proved right*'[667]. There was a view among some shareholders that the CEO did not fully appreciate:

– the large, single name risks arising from RBS's rapidly growing exposures in the syndicated and leveraged loans markets; and

– the growing accumulation of risks across the Group.

These factors were among those that ultimately contributed to RBS's vulnerability to the market stresses and the collapse in market confidence in RBS in 2008.

613 In addition, while noting that the FSA concluded that it was not appropriate to take disciplinary action against the CEO regarding delegation of senior management roles in GBM[668], the Review Team considered that there was an issue as to whether the CEO achieved the right balance between maintaining his own detailed understanding and oversight of the GBM business and delegating some of the management of that business to others. An important part of a CEO's responsibilities, as set out in the APER section of the FSA handbook,[669] is to ensure that those to whom he or she delegates responsibility have 'the necessary capacity, competence, knowledge, seniority or skill' to deal with the issues that are likely to arise. A CEO is required to 'take reasonable steps to maintain an appropriate level of understanding' of parts of the business delegated to others. While the Board was entitled to rely on assurances from the CEO that the GBM business was being properly managed, including adequate oversight of risks, and while there was no basis for enforcement action, in retrospect there remains an important question about the quality of the CEO's judgement in his delegation of the responsibility for management and oversight of GBM.

2.2.5 The quality of risk controls and management information

614 Analysis of the information reports which flowed to the RBS Board revealed that many of the key features that the FSA would have expected to see in an appropriate management information system were in place at RBS during the Review Period. The processes for debating and agreeing budgets and for monitoring performance against monthly revenue and cost targets were reasonably designed and executed.

615 The issue of whether RBS's management controls and risk assessment systems, in particular those within GBM, were deficient to such a degree as to amount to a breach of FSA principles and rules, was covered in Enforcement Division's investigations. For the reasons described in Part 3, the FSA concluded that they did not amount to a breach. But, as Part 3 also sets out, there were important deficiencies with respect to:

667 FSA records, November 2009.
668 See Part 3, paragraphs 184 – 189.
669 See http://fsahandbook.info/FSA/html/handbook/APER *Statements of Principle and Code of Practice for Approved Persons*.

- the assessment, monitoring and reporting of risks associated with the expansion of the collateralised debt obligation (CDO) business and the retention of super senior CDOs on the balance sheet;
- the key management information that GBM reported to RBS senior management and to the Board, which may have restricted the Board's oversight of the growing GBM business;
- RBS's stress-testing, together with inherent limitations in the widely used value-at-risk (VaR) measure;
- the production and timely reporting of a regular and complete balance sheet, disaggregated into the major exposures carried by GBM; and
- the processes for independent price verification and a bias towards optimism in its approach to CDO valuation issues by RBS senior management, together with an acceptance of that optimism by RBS's auditors and the RBS Group Audit Committee.[670]

616 The Review Team identified a number of other issues relating to RBS's risk controls and management information, in particular:

- The adequacy of the process for proposing and agreeing a risk appetite.[671]
- The RBS Board did not formally approve a Group Liquidity Policy.[672]
- The Board received a monthly risk report, which was enhanced during the Review Period. However the Review Team was told that, at the beginning of 2007, this reported past and current risks, rather than being forward-looking. The RBS Group Internal Audit report 2008 referred to an external review of the monthly risk reporting to the Board, which said that it was '*relatively light on predictive or leading indicators*' and that '*in places, the report is complex for non-technical readers*'.[673] In February 2009, RBS's new CEO told the Treasury Select Committee that '*risk management systems at RBS need a lot of change*' and that areas which could be improved included '*rules on size and concentration, types of risk and amounts of risk*'.[674]
- While the evidence is inconclusive, the risk reports presented to the Board and the minutes of meetings suggest that the Board was not adequately sighted on the aggregation of risks across the Group and, as the financial crisis developed, the bank's increasing vulnerability.
- At the start of the Review Period, the RBS Group Chief Risk Officer did not sit on the GEMC or routinely attend the CEO's morning meetings. It is the Review Team's understanding that there was some reluctance on the part of the CEO to agree to his participation in these meetings, on the grounds that he reported to the Group Finance Director, who did attend. This situation

670 The valuation of the CDO positions for the 2007 annual reports and accounts is covered in Part 2, Section 1.4.2 and Part 3, Section 1.9.2.
671 RBS was not necessarily an outlier in this respect during the Review Period.
672 This was confirmed in interview by the Group Finance Director and one of the NEDs. Other NEDs could not recall seeing or approving it. See also paragraph 128 of Section 1.2.
673 RBS Group Internal Audit report, July 2008.
674 Evidence to the Treasury Select Committee 11 February 2009, pages 259 and 266.

changed following the appointment in January 2007 of a new Group Chief Risk Officer, who did attend the GEMC and the morning meetings, and had a direct reporting line to the Chairman of the Group Audit Committee. However, it was not until 1 April 2008 that the Group Chief Risk Officer was appointed as a full member of the GEMC.

- The RBS Group Internal Audit report 2008 found that the Group Risk Committee[675] was not well-attended between January 2006 and April 2008, including by GEMC members. It became a forum where the bias of discussion was to approve policies and look at historical data, rather than to ensure that emerging risks were understood and addressed. Where risks were identified, Group Internal Audit could not find evidence of their escalation in the GEMC minutes.

- The Head of Group Internal Audit's memorandum of 15 July 2008 referred to a Financial Times article on the degree of control exercised by some executive management teams over the information provided to boards, arguing that too much control can reduce the ability of board NEDs to play a meaningful role.[676] In relation to RBS, the memorandum to the Chairman states: '*It is clear your colleagues feel this happens too often with 'good news' reporting and decisions presented as a fait accompli. They contrasted this with positive experiences at other companies' Boards on which they serve*'.[677]

- Elsewhere, the memorandum referred to a report that the Board received from the responsible executive in October 2007 about the Citizens business, which stated that, overall, it was anticipated that Citizens would meet its budget for 2007. The memorandum suggested that a number of Board members had interpreted this as giving a positive picture[678], but that:

  '*There were however a number of indicators of deterioration prior to October within Citizens. Non-performing loans in the SBO portfolio*[679] *had been steadily rising, new purchases had been stopped and the portfolio had been transferred to Treasury for attention. Given these circumstances, and the previous close attention paid to the portfolio by the former Citizens CEO, it seems that making any reassuring statements, at the September Board and in October to the Group CEO, would be incautious at best.*'

617 The Review Team's assessment of RBS's management information and risk control systems has therefore, with hindsight, raised questions about:

- whether there was adequate focus at Board level on the core banking fundamentals of capital, liquidity, asset quality and risk, both on an aggregated, group-wide basis and within individual businesses;

675 As explained in Section 2.2.1 the Group Risk Committee was not a Committee of the Board.
676 FT Article, 26 June 2008.
677 RBS Group Internal Audit report, July 2008.
678 Group Internal Audit was, however, not able to confirm the NEDs' recollection from the limited detail in the Board minutes.
679 With an SBO (Serviced By Others) portfolio, an originator undertook a credit assessment and property valuation for a home equity loan application by reference to the originator's underwriting criteria. If approved the funds were advanced by the originator and the loan was sold to another party (in this case, Citizens Financial Group). The originator performed the back office functions for these loans, charging the purchaser a fee for these services.

- whether the risk management information enabled the Board adequately to monitor and mitigate the aggregation of risks across the Group, and whether the information was sufficiently forward-looking to give early warning of emerging risks;
- whether the status accorded to the Group Risk function within RBS hindered the development of high-quality predictive risk management and risk management information;
- the completeness of the management information provided to the Board by the executive; and
- whether the optimism, confidence and focus on revenue described elsewhere in this section were a factor in the above.

2.3 The FSA's supervision of RBS's management, governance and culture

618 The FSA's pre-crisis supervisory approach included an explicit focus on management, governance and culture.[680] Indeed, in some ways a key failing of this approach, apparent with hindsight, was that the FSA placed too much reliance on its ability to assess whether good processes, systems and controls were in place. By contrast, while considerable resources were devoted to the implementation of Basel II, there was insufficient focus on analysing, in substantive quantitative terms, the core prudential issues of capital, liquidity and asset quality.

619 The supervisory records contain evidence of how the FSA assessed issues related to management, governance and culture at RBS during the Review Period. Overall, FSA the Supervision Team responsible for RBS demonstrated a professional application of the then standard supervisory approach to these issues.

620 In some key respects, however, the FSA's pre-crisis approach was, in retrospect, insufficiently robust. Crucially, it entailed the flawed concept of a 'regulatory dividend' – a less intensive supervisory approach, whether or not justified by substantively lower risk, in return for a firm demonstrating effective controls and displaying cooperation with the FSA. Dropping the concept of a 'regulatory dividend' is one among a number of important changes which the FSA has since made to its supervisory approach to management, governance and culture.

621 This sub-section describes both the significant extent to which the FSA did identify some important management, governance and culture issues at RBS and its ineffectiveness in securing substantive change. It covers in turn:

- the FSA's regulatory relationship with RBS, including the 'regulatory dividend'; and

680 See *The FSA's risk-assessment framework*, August 2006, www.fsa.gov.uk/pubs/policy/bnr_firm-framework.pdf. The FSA's post-crisis approach to supervision retains an explicit focus on management, governance and culture (see Section 3.5 and Box 2.7).

- how the FSA assessed and supervised:
  - whether the RBS CEO was dominant and any associated risks;
  - RBS's Board effectiveness;
  - RBS's key risk control systems; and
  - RBS's culture.

2.3.1 The FSA's overall relationship with RBS: the flawed concept of a 'regulatory dividend'

622 FSA Principle 11 states that 'a firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice'.[681]

623 Until the financial crisis began in August 2007, the FSA had an overt supervisory philosophy that it should, wherever possible, rely on a firm's senior management to ensure that risks were well-controlled.[682] It checked whether this was likely to be possible by asking questions about the processes, systems and organisational structures in place. These 'systems and controls' and 'principles based' approaches (the drivers for which are described in Section 3.1.3) tended to be at the expense of focused, detailed and quantitative attention to the core prudential issues.

624 In attempting to assess whether it could rely on senior management to identify any deficiencies in systems and controls and then to correct them, the FSA also placed importance on achieving an open and positive relationship with firms.[683] Where this was judged to be the case, firms could benefit from the 'regulatory dividend' described in Box 2.6 of Section 3.1.1.

625 The danger of this approach, however, was that it could result in a firm being rewarded for meeting the minimum standards of cooperation, which should be non-negotiable. This in turn created the danger that supervision might not only fail to address substantive risks and issues, but also fail to identify and ensure the mitigation of important management, governance, cultural and control issues. The history of the FSA's overall supervisory relationship with RBS during the Review Period illustrates these dangers.

626 The Supervision Team had expressed concerns about the relationship with RBS in the 2003 Interim ARROW assessment, well before the start of the Review Period. By the second half of 2004, the relationship had deteriorated further and there were indications that RBS was not keeping the FSA regularly informed of important developments nor responding to information requests in a timely manner.[684] Another point of difference was RBS's refusal to allow the

681 FSA Handbook: Principles for Business (PRIN) Section 2.1 – http://fsahandbook.info/FSA/html/handbookl/PRIN/2/1
682 See *Principles-based regulation: focusing on the outcomes that matter*, April 2007, www.fsa.gov.uk/pubs/other/principles.pdf. See also: Speech by John Tiner, FSA CEO, *Better regulation: objective or oxymoron*, 9 May 2006, www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0509_jt.shtml and Section 3.1.1 of this Report.
683 See 'Principles-based regulation: Focusing on the outcomes that matter', April 2007, Section 3.2, www.fsa.gov.uk/pubs/other/principles.pdf.
684 FSA records, September 2004.

Supervision Team to meet the RBS NEDs on an individual, one-to-one basis[685], arguing that the Board was a unitary body and that individual NEDs should not be 'picked off', although it should be noted that such meetings were not routinely taking place at other major banks at that time.

627 Overall, FSA supervisory records from 2004 suggest that RBS management, and in particular the RBS CEO, had been resistant to what they saw as unnecessary FSA interference.[686] RBS stood out among its peers in terms of the regularity and vigour of pushback against FSA policy initiatives and resistance to enquiries with which it felt uncomfortable.

628 Faced with this situation, Supervision believed that improving the FSA's relationship with RBS was a priority. Its strategy to achieve this included:

- A 'clear the air' meeting in October 2004 between the FSA Supervision Director and RBS's CEO, which secured a commitment from both parties to repair the relationship. It is not clear whether the FSA demanded that RBS improve the relationship, but the 2005 ARROW letter refers to 'constructive dialogue between the FSA and RBS evident in recent months'.[687] An early objective given to the Supervision Team Manager, who assumed responsibility for RBS in August 2005, was to improve the relationship.

- A meeting in November 2004 between the CEOs of the FSA and RBS. The FSA's meeting note[688] records that the RBS CEO felt the relationship was back on the right basis and that RBS had been too defensive, with an acknowledgement that it could have handled the FSA's request for one-to-one meetings with NEDs better. While RBS firmly believed one-to-one meetings were inappropriate in the context of a unitary board, the RBS CEO said he wanted to find a way to meet the FSA's requirements.

- Regular meetings and telephone calls between the Supervision Team (sometimes with the Supervision Head of Department) and key RBS executives.

- Preparation of a paper for RBS setting out the FSA's expectations of how the close and continuous relationship should work in practice, which was discussed with the RBS CEO.[689]

629 It is evident from the records that the relationship improved during 2005 and 2006. For example:

- RBS started to notify the FSA more consistently and at an earlier stage about significant events such as staff changes.

- The Supervision Team secured RBS's agreement to meet the RBS NEDs, albeit collectively rather than individually, and in the presence of executive representatives from the firm.[690]

685 FSA records, January 2005.
686 FSA records, July 2004.
687 FSA records, March 2005.
688 FSA records, November 2004.
689 FSA records, March 2005, August 2005 and January 2006.
690 FSA records, April 2005.

- RBS shared with the FSA the outcome of an independent review of its Group Internal Audit, commissioned by RBS following supervisory concerns.[691] The results of this review were considered by the Supervision Team to be satisfactory.
- RBS's CEO started to make regular telephone calls to the Supervision Head of Department (HoD).
- Meetings at various levels between the FSA and the firm were judged by the Supervision Team to be productive.

630 The Supervision Team was also aware that the RBS Chairman had decided during 2006 to include in the RBS CEO's formal performance objectives a requirement to improve the firm's relationship with the FSA. This was seen as a positive sign that RBS had accepted that improving its relationship with the FSA was a priority.

631 However, despite this improvement, problems remained. For example:

- The Supervision Team told the Review Team that RBS remained reluctant to provide the FSA with full Board management information (MI)[692], and, at that time, provided only quarterly financial MI. In response to requests from the Supervision Team, RBS did share increasing amounts of MI during the Review Period. However, the FSA did not receive the full Board pack at any time during the Review Period.
- In line with common practice, the Supervision Team sent the draft 2005 ARROW letter to the RBS CEO before finalising it to send to the RBS Board. The RBS CEO proposed changes to the draft letter. The Review Team's view was that Supervision should not have accepted two of the changes. The effect of the first of these may have been to obscure from the Board of RBS that the FSA had not always regarded the dialogue with RBS's executive management as constructive. The effect of the second, described in Section 1.3.6, may have been that RBS's Board did not appreciate the extent of the FSA's concern about RBS's management of the risks associated with its corporate lending, in particular its commercial property portfolios.

It is the Review Team's understanding that the changes were made in the context of Supervision being encouraged to improve the relationship with the firm. Indeed, in the first case, Supervision added to the letter a statement emphasising the importance of sufficient challenge, including of the RBS CEO, at both RBS Board level and from the RBS executive team. The acceptance of these changes was a matter of judgement and not an exception to the FSA's prevailing practice at the time.

632 Supervision concluded in October 2006 that the relationship had improved to a sufficient extent that the action relating to corporate governance set out in the 2005 Risk Mitigation Programme (RMP) could be considered closed[693] and that

691 FSA records, December 2004.
692 This was not materially out of line with other large banks at the time. The Review Team has been told by a former RBS Board member that the FSA did not formally request the full Board MI pack. In his view, RBS would have provided the pack in response to such a request, provided that the bank had understood the reasons for the request.
693 FSA records, October 2006.

the firm could start to benefit from a ‘regulatory dividend’. This decision may have reflected, at least in part, a need for the Supervision Team to manage competing pressures within its limited resources.[694] The Supervision Team affirmed its positive view of the relationship in its presentation to the RBS Board following the 2007 ARROW assessment, which noted ‘*We believe we have a constructive and open relationship with the Group which we value*’.[695]

633 The Review Team concluded that the Supervision Team’s overall approach to the relationship with RBS, and its award of a ‘regulatory dividend’, were not out of line with the FSA’s then standard supervisory approach. However, in retrospect, the decision to close the RMP action in 2006 was premature and the whole concept of the ‘regulatory dividend’ was flawed and potentially dangerous. Furthermore, the FSA’s overall approach to assessing whether management skills, effective governance and appropriate culture were in place relied too much on high-level indicators, such as the degree of cooperation by the firm with the FSA supervisors, rather than on detailed enquiry into key potential areas of concern.

2.3.2 FSA assessment and supervision of CEO leadership and management style

634 As early as 2003, the Supervision Team had identified that the RBS CEO’s assertive and robust style might create a risk. Between then and 2006, the Supervision Team raised the issue of ‘CEO dominance’ during meetings with the RBS Chairman, and sought to ensure that specific actions were in place to mitigate any risks. The FSA’s response to this issue reflected its prevailing supervisory approach, which is described in this section. Within the limitations of that approach, the FSA’s response was reasonable. However, although there was engagement by the Supervision Head of Department and Supervision Director, with the benefit of hindsight the Review Team would have expected to see greater involvement of the FSA’s most senior executives (Managing Director of Retail Markets and CEO) in considering how best to respond to this important risk.

635 Starting in 2004 and continuing into the Review Period, the Supervision Team’s approach to assessing the risk of CEO dominance in RBS was to review:

- the quality of internal reporting to the RBS Board;
- the strength and consistency of RBS Board challenge to the CEO; and
- the effectiveness of RBS’s Group Internal Audit.

636 In an October 2004 briefing note[696], the Supervision Team recorded that, as a result of the poor regulatory relationship and lack of access to NEDs, it had ‘felt it necessary to consider’ requiring RBS to commission a Section 166[697] review of

694 See Section 3.3 for a discussion of the limited resources applied to supervision of RBS at the time.
695 FSA records, October 2007.
696 FSA records, October 2004.
697 This is a review by an independent skilled person into one or more aspects of a firm’s business carried out under powers set out in Section 166 of the Financial Services and Markets Act 2000.

high level controls.[698] In the event, the FSA did not take this action, partly because, in December 2004, the Supervision Team met a group of RBS executive and non-executive directors who described the nature of challenge at Board level, gave an example of Board challenge to the CEO (an e-banking proposal that had not been taken forward after NED push-back[699]), and confirmed that, in their view, they provided adequate challenge to the CEO.

637 The Review Team's view was that commissioning a Section 166 review would have sent a strong message to RBS, including its Board, and might have provided the FSA with more information on the effectiveness of governance, particularly around the potential dominance of the CEO.

638 In the March 2005 ARROW letter[700], RBS was informed that the FSA would continue its supervisory work on governance, in view of 'the Group's scale, business growth and robust management culture, led by the Group CEO and the senior executive team'. The Supervision Team followed this up by raising the issue of CEO dominance and the mitigation of associated risks in meetings with successive RBS Chairmen in 2005 and 2006.[701]

639 Following this work, Supervision concluded, as part of the October 2006 Interim ARROW assessment, that the risks associated with CEO dominance and challenge to him had been mitigated sufficiently that the issue could be closed. This was based on:

- Meetings with the NEDs and Chairman that provided examples of Board challenge to the executive.
- The presence of a new Chairman and new Group Finance Director, who had taken up their posts earlier in the year. The Supervision Team judged both to be providing appropriate challenge to the CEO and to be committed to working cooperatively with the FSA.
- The track record and broad range of experience of the NEDs who, individually, were recognised by the FSA as competent and resilient individuals.
- An oral report from RBS that the results of its Board Effectiveness Review were positive, with no material issues identified.
- The absence of any reports to the FSA of major issues at the firm that might suggest weaknesses in governance.

640 With hindsight, however, a key missing element in the FSA's decision to close the RMP issue was engagement at the most senior FSA executive level. We have not seen evidence that the Supervision Team asked FSA senior executives for support with key issues, such as securing RBS's agreement to bilateral meetings with NEDs. Nor have we seen evidence of the FSA's CEO or Managing Director of Retail Markets seeking to play an active role in ensuring the effectiveness of

698 High level controls comprise the firm's control functions (internal audit, compliance and risk management), its senior management, corporate governance arrangements and overall culture. See *The FSA's risk-assessment framework*, August 2006, www.fsa.gov.uk/pubs/policy/bnr_firm-framework.pdf.
699 FSA records, December 2004.
700 FSA records, March 2005.
701 FSA records, June 2005 and June 2006.

governance, other than in a discussion in January 2007 about new governance arrangements for RBS's US business.[702] This reflects a more general tendency in the FSA's pre-crisis supervisory approach for key supervisory decisions and responsibilities to be delegated several layers below the FSA's CEO.[703] In future it is important that the prudential supervision of the largest UK banks includes significant direct involvement of the most senior PRA and FCA executives. This is particularly important for addressing sensitive management, governance and culture issues.

2.3.3 FSA assessment and supervision of Board effectiveness

641 In considering the FSA's assessment of the effectiveness of RBS's Board, it is useful to distinguish between:

- the period from January 2005 until early 2008, during which governance was supervised in accordance with the FSA's pre-crisis approach; and
- the period from the beginning of 2008 onwards, during which the FSA's supervisory approach began to change in response to deteriorating market conditions.

Assessment of Board effectiveness between January 2005 and March 2008

642 Following the 2005 ARROW assessment, the FSA Supervision Team sought to form a view on the effectiveness of RBS's overall corporate governance. It considered, for example:

- the adequacy of Board discussions and the quality of the (limited) management information it received;
- the challenge the Board provided to the CEO and senior executives;
- the quality and effectiveness of senior management and the internal audit, risk management and compliance functions; and
- the Board's use of the firm's control functions in its oversight of the business.

643 The Supervision Team approached this through:

- a series of regular meetings with the RBS Chairman, a group of NEDs, the Chairman of the Group Audit Committee, senior executives and the control functions of internal audit, risk management and compliance; and
- requesting RBS to provide regular risk and financial management information.

644 Having reviewed these issues using the available evidence during 2005 and 2006, the Supervision Team concluded, as part of the 2006 Interim ARROW, that '*Our work over the course of the year has provided us with increased*

702 The Managing Director of Retail Markets discussed the need for improvements in US risk management and RBS's progress on 'Treating Customers Fairly' (TCF) with the RBS CEO in 2006. The FSA set out its plans for the TCF initiative in *Treating customers fairly – progress and next steps*, July 2004 (www.fsa.gov.uk/pubs/other/tcf_27072004.pdf).

703 Section 3.1.2 describes the implications of the FSA's overall structure, size and span of responsibilities, for the involvement of the most senior levels of FSA management in such issues.

assurance on the effectiveness of the Group's high level corporate governance arrangements such that we now feel able to close the specific RMP issue'. The following year, the 2007 ARROW letter stated that the FSA judged that many of the improvements in corporate governance noted during the 2006 Interim ARROW assessment had been maintained.[704] An FSA internal document noted that the Board composition was strong with a wide range of skills.[705] And the FSA concluded that the Board was increasing its use of quantitative information to review the risks facing the firm.

645 However, it is not clear that the Supervision Team had access to all the information needed to reach such a positive conclusion. As mentioned in Section 2.3.1, the Supervision Team did not have full RBS Board MI packs in order to ascertain whether flows of information to the Board were adequate. And its ability to gain insight into the quality of Board challenge was hampered by difficulties in gaining access to RBS NEDs on a confidential, one-to-one basis.

646 From 2004 until 2007, the Supervision Team sought the bilateral private meetings with RBS NEDs (without executives present) referred to in Section 2.3.1, but was unsuccessful in obtaining them, other than with the RBS Board Chairman and the Chairman of the Group Audit Committee. Holding one-to-one meetings was identified as a potentially important part of assessing Board effectiveness, but RBS actively resisted these meetings, which were not routinely taking place at other major banks. A meeting with a group of NEDs, without executives present was, however, held in January 2006 and again in March 2007.

647 The FSA considered that the RBS Board contained some tough and experienced individuals and expected them to challenge the RBS executive. The Supervision Team was given assurances that the NEDs provided adequate challenge to the RBS CEO and senior management, the example given being a reorganisation of UK Retail which the Supervision Team was told had been driven largely by NED challenge on the underperformance of this business and on the general strategy for it.[706] However it was inherently difficult for the Supervision Team, from the outside, to judge the effectiveness of the challenge that the NEDs were providing to the executive.

648 The real effectiveness of Board challenge to RBS executive management therefore remains uncertain and with the benefit of hindsight it seems likely that the Supervision Team had, at best, an imperfect basis on which to reach its assessment, set out in the 2006 and 2007 ARROW letters, that RBS's corporate governance arrangements were effective. Nevertheless the Supervision Team did identify the issue and sought to address it as far as possible within the limitations of the pre-crisis supervisory approach. Moreover, its ability to insist on private one-to-one meetings with RBS's NEDs, which may have provided more evidence, was limited by the fact that such meetings were not taking place routinely at other major banks (where, however, the same risk of a dominant CEO may not have been identified).

704 FSA records, October 2007.
705 FSA records, September 2007.
706 FSA records, January 2006.

649 In relation to other potentially important issues of Board/Committee effectiveness, however, the Supervision Team's approach appeared reasonable at the time. In particular:

- There was no evidence available to the Supervision Team that the formal board processes for discussion and approval of the ABN AMRO deal (described in Section 2.1.1 of Part 3) fell below appropriate standards. For example, as mentioned in Section 2.2.2 of Part 2 (above), the Board and Chairman's Committee held many meetings about the proposed transaction, engaged investment banking advisers, sought and were given the appropriate assurances and were presented with the results of the due diligence.
- When reviewing RBS's governance, the Supervision Team looked at the reporting lines of the Group Risk Committee. During the Review Period, this was not a Board level committee with non-executive members[707]; it reported to the Group Executive Management Committee. This point was recognised by the Supervision Team but it did not press the issue. This was because RBS argued that its existing structure, under which the Group Audit Committee also covered risk, provided sufficient Board oversight and was in line with practice at other firms.
- The Supervision Team considered the reporting arrangements for RBS Group Internal Audit, which reported directly to the Board's Group Audit Committee, to be in line with good practice. Group Internal Audit also reported to the Group Finance Director for 'pay and rations' purposes, but this arrangement is by no means uncommon, although it might under some circumstances undermine the real or perceived independence of internal audit. In the case of RBS, the issue was recognised by the Supervision Team, which kept it under review. The effectiveness of Group Internal Audit was part of the regular agenda for meetings with the external auditors and the Chairman of the Group Audit Committee.

650 Having considered the FSA's approach to assessing the effectiveness of the RBS Board and its top level governance from the beginning of 2005 until early 2008, the Review Team concluded that the Supervision Team was aware of the risks and issues and took steps to address them. With hindsight, however, hampered by an insufficiently robust FSA approach to ensuring direct access to NEDs (which might have provided it with more information or evidence) and by a lack of effective engagement by FSA senior management, the Supervision Team's approach was insufficient to establish whether there was a problem of inadequate challenge by the Board, of the executive, which could have existed even within the context of acceptable formal governance arrangements.

707 See also Section 2.2.1. RBS adopted a Board level Risk Committee in 2009, following recommendations of the Walker Review (*A review of corporate governance in UK banks and other financial industry entities*, 26 November 2009).

Assessment of Board effectiveness between March 2008 and October 2008

651 Section 1.1 describes the action taken by the FSA in April 2008 in response to the sudden deterioration in RBS's capital position. The FSA recognised that this deterioration, and the need for the rights issue in April 2008, might also indicate weaknesses in governance. In response:

- The FSA took reassurance from the fact that, in May 2008, the RBS Chairman commissioned a review[708] by RBS Group Internal Audit into the events that led to significant write-downs in RBS's credit market activities, including, among other things, governance and business strategy. The FSA was given a copy of the findings after the end of the Review Period.
- FSA senior management pushed RBS to strengthen the Board by appointing NEDs with banking experience who would also improve the Board's challenge to the executive. RBS decided, following the announcement of the rights issue, to accelerate its plan to bring in new NEDs. On 27 August 2008, it announced the appointment of three new NEDs[709]: Stephen Hester, Arthur Ryan and John McFarlane.[710] In September 2008, the Chairmen and CEOs of the FSA and RBS discussed further changes planned for non-executive representation on the RBS Board.[711]

2.3.4 FSA assessment and supervision of management quality, organisational structure and control systems

652 As discussed in Part 3 of this Report, Enforcement Division's investigation considered whether the scale of losses in GBM was in part driven by deficiencies in its management capability, structure and control systems. For the reasons explained in Part 3, the FSA believes that, while there were undoubtedly important deficiencies, these were not of a nature or severity that could be the subject of an enforcement case with a reasonable chance of success. However the inadequacies identified raise the issue of how effectively the FSA assessed management competence and control systems in the Review Period. The Review Team's assessment was that, in retrospect, the FSA's supervision of these issues at RBS, while in line with the prevailing approach, lacked the necessary intensity and rigour to identify key problems and secure mitigating actions.

653 The Supervision Team, at the time, did not express any general concerns about the competence of the RBS senior management team. It formed relatively informal views on certain key individuals, notably when someone new joined the firm, through, for example, speaking to FSA senior managers who knew the individual concerned through prior professional contacts. The Supervision Team also developed its views of individuals during routine supervisory meetings with RBS senior management, based to a large extent on how well they engaged with the FSA's priorities at the time ('Treating Customers Fairly' and Basel II) and the

708 For further details of the Review, see Section 2.2.1.
709 Royal Bank of Scotland Group plc Press Release 27 August 2008: *Board Appointments and Board changes*.
710 Stephen Hester was a former Chief Operating Officer of Abbey National plc, Arthur Ryan was a former Chief Executive Officer of Prudential Financial Inc and John McFarlane was a former Chief Executive Officer of Australia and New Zealand Banking Group Limited.
711 FSA records, September 2008.

commitment they showed to improving the regulatory relationship. Individuals who were seen to perform well in these areas were likely to be considered helpful and competent.

654 While this approach fell well short of a systemic, critical and evidence-based assessment of competence or experience, it was in line with prevailing practice for all large banks. With hindsight, the Review Team judged that this approach had the potential to provide false reassurance. The more formal and rigorous approach the FSA now uses to assess the competence of those in, or applying for, Significant Influence Functions described in Section 3.5 has a much greater chance of reaching a reliable assessment.

655 Management stretch in RBS was identified as an issue throughout the Review Period. The Supervision Team highlighted it in the 2005 ARROW letter, where the concern was primarily focused on the Citizens business in the US. It was, however, also expressed as a concern across the US businesses and the wider group. There were also questions about how far the management and control infrastructure was keeping pace with the growth of the business.

656 The Supervision Team identified that, as far as the US businesses were concerned, neither strategy nor management responsibilities were clearly articulated. These concerns were shared by the US regulators. RBS accepted the need for change and, in June 2007, appointed a single CEO responsible for all of the firm's US businesses, including GBM and retail banking.[712] The Supervision Team had questions about the role of the new US CEO, including how it would interface with the existing functional management lines and how the effectiveness of the new appointment would be assessed. These points were still under review in late 2007 as the financial crisis started to impact the firm.

657 Notably, however, while the Supervision Team raised questions about the overall structure of the US business, it did not focus on issues relating to the appropriateness of management delegation to and oversight of GBM's business, its organisational structure and the management skills within it. These are areas where, with hindsight, the Review Team's view is that there were important questions to be asked.

658 Nor did the Supervision Team identify the significant imperfections in the GBM balance sheet and risk reporting systems, its stress-testing approaches and price verification systems described in Section 2.2.5 and in more detail in Part 3. This lack of focus on detailed risk control systems was illustrated by the fact that, in April 2007, the ARROW Planning Panel concluded that risk management was not a high priority for the ARROW discovery work.[713] As a result, the ARROW letter produced in October 2007 referred to the generic risks created by the rapid growth of RBS's US businesses (including GBM), rather than focusing on specific weaknesses in oversight and control.

659 Overall, therefore, while the Supervision Team during the Review Period did consider issues relating to appropriate organisational structure and control

712 RBS announced on 23 March 2007 that Ellen Alemany would become CEO of RBS America (see RBS Press Release dated 23 March 2007 *RBS announces management appointments in US*).

713 The ARROW Planning Panel's consideration of the approach to the 2007 ARROW assessment is covered in Section 3.2.4.

systems, the approach was not sufficiently intensive to identify the specific problems (for instance within GBM) which the Review Team believed were important. Given that Supervision and specialist support resources were far more limited than the FSA now deploys (see Section 3.3), supervisors were not able to carry out detailed reviews of control functions other than by exception, when triggered by specific evidence of particular problems. During the Review Period, prior to the onset of the financial crisis, the Supervision Team did not become aware of specific material failures in RBS's internal controls which would have alerted them to the need for more intensive analysis.

660 Finally, it should be noted that, alongside a focus on management competence and risk controls, and maintaining oversight of key prudential issues, the Supervision Team was also required to address priority conduct issues, such as Treating Customers Fairly (TCF). This created the danger that the strong focus on the conduct theme of TCF, which had been defined as a key FSA supervisory priority in the period 2004-2008[714], could have been at the expense of an adequate focus on core prudential risks.

2.3.5 The FSA's assessment and supervision of culture

661 The assessment of a firm's 'culture' and its possible implications for regulatory risk are inherently difficult. Even within the context of the FSA's now more intensive post-crisis approach to supervision, we remain cautious about believing that there are rigorous mechanisms that can accurately assess a firm's culture and its implications for compliance and the business.

662 The FSA's view of culture during the Review Period was partly informed by a firm's approach to TCF. Supervision teams attempted to assess whether firms were embedding the delivery of fair outcomes for consumers in their business and culture. RBS showed sufficient commitment to this initiative during the Review Period to provide the Supervision Team with some comfort concerning its culture in relation to the fair treatment of retail customers. Whether that approach was truly effective as a means for the FSA to assess a firm's culture more generally remains uncertain.

663 The crucial cultural questions relevant to RBS's failure, however, relate not to the fair treatment of customers, but to whether RBS was over-confident about its abilities, had too optimistic an outlook, and was too focused on revenue and profit at the expense of balance sheet risk. In each of the three ARROW reviews during the Review Period, the Supervision Team identified significant growth in RBS's business, and was rightly concerned that this might not be balanced by a recognition that control systems needed to keep pace. The FSA communicated this to RBS in the ARROW letter of 4 March 2005 and, while acknowledging progress made by RBS, reiterated the importance of this in the ARROW letters of 5 October 2006 and 23 October 2007.

714 The FSA set out its plans for the TCF initiative in *Treating customers fairly – progress and next steps*, July 2004 (www.fsa.gov.uk/pubs/other/tcf_27072004.pdf). Firms were required to demonstrate that they were consistently treating their customers fairly by 31 December 2008 (see *Treating Customers Fairly initiative: progress report*, May 2007 – www.fsa.gov.uk/pubs/other/tcf_implementation.pdf).

664 At a high level, therefore, the Supervision Team during the Review Period did identify relevant issues relating to the relationship between RBS's overall strategy, and its control systems and culture. In retrospect what was lacking was an approach sufficiently detailed to identify specific deficiencies or sufficiently robust to ensure that risks were mitigated by appropriate action.

2.4 Key lessons and recommendations for further change

2.4.1 Issues for boards to consider

665 While the above analysis of management, governance and culture at RBS has largely led us to pose questions, rather than draw firm conclusions, it illustrates issues which should inform the thinking of the boards of banks and other financial services firms going forward. These are whether:

- The board has the right size, composition (including its non-executive component), skills, experience, external advice (where appropriate) and ability to 'step back' to assist executive management by challenging the assumptions underlying: strategy; strategic initiatives (such as acquisitions); risk appetite and exposures; and the key areas of the firm's focus.
- The board considers and gives sufficient weight to the risk implications of strategic initiatives for depositors (policy-holders in the case of an insurer) and the financial stability of the wider economy. The NEDs have an important role in assisting the executive to do this.
- The board ensures that the drive, energy and willingness to challenge subordinates, required in a CEO, do not discourage robust and effective challenge, and teamwork, among the executive team.
- The board considers the appropriateness of delegation by its CEO.
- The board sets executive incentives which encourage adequate attention to the core banking fundamentals of capital, liquidity and asset quality.
- The board ensures that, while rightly encouraging positive thinking, a 'can do' attitude and confidence in executives, these do not result in over-optimism that either leads to significant risks not being recognised or exposes the firm to excessive risk.
- The board has a risk committee, separate from its audit committee, which is able to identify and bring to the board's attention the major risks facing the firm, including in aggregate.
- The chief risk officer participates in the risk management and oversight processes at the highest level within the firm.

Many of these issues are covered in the Walker Review.[715] In addition to these, the Review Team makes some additional recommendations for boards:

715 *A review of corporate governance in UK banks and other financial industry entities*, 26 November 2009.

- The chairman or, if appropriate, the senior independent director, should discuss with their FSA supervisor the outcome of the externally facilitated effectiveness review of the board which should be undertaken at least every two to three years, and the action they propose to address any issues identified.

- In order that boards, whether of authorised firms or of the FSA[716], can demonstrate that they have subjected proposals from the executive to appropriate discussion and challenge, the board secretary should ensure that minutes of board and sub-committee meetings set out the substance of the views expressed and record key elements of the debate and challenge provided, as well as the conclusions for each agenda item. This need not be a verbatim record nor, unless requested at the time by a board member, include individual comments. In the case of all authorised firms, these minutes would then be available to supervisors when assessing board effectiveness. The issue as to the appropriate standards relating to company secretaries, in order to ensure they can achieve this, should be considered in relation to the UK Corporate Governance Code.

2.4.2 Lessons for the FSA

666 Several of the potential areas of concern about RBS's management, governance and culture discussed in Section 2.2 were identified by the FSA Supervision Team during the Review Period. However, the degree of supervisory intensity applied to these issues, while consistent with the FSA's prevailing practices and approach, was less than the FSA would now consider appropriate.

667 Section 3.5 describes changes that the FSA has already made, or is implementing, to its supervision of management, governance and culture. The executive management of the FSA has agreed that these further recommendations will be taken into account in the design, in collaboration with the Bank of England, of the Prudential Regulation Authority and, as appropriate, of the Financial Conduct Authority:

- where concerns arise, the FSA should make greater use of formal Significant Influence Function (SIF)[717] interviews to assess the competence of senior managers already in post;

- the FSA should highlight, by means of the SIF process and its regular supervision, the substantive and specific responsibility of the CEO to ensure that those they appoint to senior roles or to whom significant powers are delegated, have the appropriate qualifications, skills and experience, in line with the requirements set out in APER principles 5 and 6; and

716 See coverage of FSA Board minutes in Section 3.1.3. The executive management of the FSA has agreed that this recommendation will be taken into account in the design, in collaboration with the Bank of England, of the Prudential Regulation Authority and, as appropriate, of the Financial Conduct Authority.

717 'Significant Influence Functions' are the most senior controlled functions within FSA authorised firms, including for example the chairman, executive and non-executive directors, the CEO and the Head of Compliance.

- the FSA should consider whether and how boards of regulated firms considering major acquisitions should obtain independent advice on the proposed acquisition, to assist assessment and challenge of the proposal, from an adviser whose remuneration is not linked to successful completion of the acquisition.

3 Supervisory approach, priorities and resources

668 Section 1 of Part 2 covered specific aspects of the FSA's regulation and supervision where they related directly to the causes of failure set out in Part 1. Section 2 covered the FSA's regulation and supervision of management, governance and culture at RBS, considered to be an additional contributory factor in its failure. But behind these particular aspects of the FSA's regulation and supervision lay an overall philosophy and approach which shaped both the intensity of the FSA's supervision of RBS and the resources devoted to it. This section steps back to describe that supervisory philosophy and approach, the FSA's processes and its resources, and highlights the overall deficiencies which had implications for the FSA's effectiveness in many specific areas. It does not repeat the conclusions made in Sections 1 and 2, except when needed to illustrate a significant point.

669 Section 3 covers:

- in 3.1, the FSA's philosophy and approach to the supervision of high impact firms[718] during the Review Period;
- in 3.2, major areas on which the FSA's supervision of RBS focused from 2005 to 2008;
- in 3.3, the resources applied to the supervision of RBS;
- in 3.4, how the FSA supervised RBS's Global Banking and Markets (GBM) business unit; and
- in 3.5, improvements already made to the FSA's approach to supervision and the resources allocated.

670 Overall, the conclusions reported in this section confirm the findings of both the *Northern Rock Report* of March 2008[719] (*NR Report*) and *The Turner Review* of March 2009[720] that the prevailing supervisory approach was deficient. In particular, that approach resulted in:

- inadequate resources devoted to large systemically important banks;
- a risk-assessment process that was too reactive and placed too much reliance on the senior management and control functions of firms;
- inadequate consideration of the strategic and business model related risks;
- inadequate focus on the core prudential risk areas of capital adequacy, liquidity, asset quality, balance sheet composition, and leverage; and
- inadequate focus on investment banking activities.

718 See the Glossary of ARROW terms at the end of this section for further details.

719 The FSA's Internal Audit Report, *The Supervision of Northern Rock: a lessons learned review* was published in March 2008. See the FSA Press Release dated 26 March 2008, www.fsa.gov.uk/pages/Library/Communication/PR/2008/028.shtml.

720 Further comments on the FSA's approach to Supervision can be found in *The Turner Review: a regulatory response to the global banking crisis*, March 2009 at Chapter 2, Section 2.7: The FSA's supervisory approach, www.fsa.gov.uk/pubs/other/turner_review.pdf.

671 Unlike in the case of Northern Rock, however, the Review Team has not found that the way in which the Supervision Team[721] implemented the FSA's defined supervisory approach was materially deficient. With one specific exception, relating to not confirming the capital position of the firm at end-March 2008, the Supervision Team was, in the RBS case, largely doing what was expected of it, according to the priorities, processes, practices and approach set by FSA senior management, and working within the constraints of the resources allocated to it. There were, though, a number of judgements made by the Supervision Team, Supervision[722] or the FSA that the Review Team has questioned.

672 The fact that the Supervision Team was largely doing what was expected of it but was following a deficient supervisory approach, in turn clearly implies however, that the senior management of the FSA who determined those resources, processes and practices must have made design decisions which were, in retrospect, seriously mistaken. The senior management of the FSA were in turn subject to the oversight of the FSA Board, whose role is considered in Section 3.1.3. It is important to recognise, however, that they made those decisions within the context of a widely held, but erroneous, view about the inherent stability of the global financial system, and of political pressure to maintain a 'light touch'[723] regulatory regime to support the competitiveness of the UK financial sector.

673 The lessons learned from the failure of RBS and from the FSA's deficient supervisory approach are set out at the end of this section. These lessons have already been reflected in the complete transformation of the FSA's approach to the supervision of the largest high impact firms, on which both the Prudential Regulation Authority and Financial Conduct Authority will build.

3.1 The FSA's philosophy and approach to supervision[724]

674 Before turning to aspects of how RBS was supervised in the context of the FSA's prevailing approach, this section discusses:

- in 3.1.1, the FSA's philosophy and approach to the supervision of high impact firms prior to the start of the market crisis in August 2007;
- in 3.1.2, the deficiencies in that approach; and
- in 3.1.3, who designed that deficient approach and the context in which they did so.

721 See the Glossary of ARROW terms at the end of this section for further details.
722 See the Glossary of ARROW terms at the end of this section for further details.
723 The description of the FSA's approach as 'light touch' was primarily used by politicians rather than by the FSA itself. However, it was representative of the political environment at the time and the development of the supervisory approach.
724 In January 2000, the FSA set out its proposed approach to regulation in *A new regulator for the new millennium*. This explained the framework the FSA intended to put in place to enable it to deliver its statutory objectives. Further updates were issued in December 2000, February 2002 and October 2002 describing the progress the FSA had made. In February 2003 the FSA published *The Firm Risk Assessment Framework*. In August 2006, *The FSA's risk-assessment framework*, explained changes made to ARROW under the name 'ARROW II' www.fsa.gov.uk/pubs/policy/bnr_firm-framework.pdf and further information was provided on the FSA website: www.fsa.gov.uk/pages/Doing/Regulated/supervise/index.shtml, and *The FSA's Risk-Based Approach, A guide for Non-Executive Directors*, November 2006, www.fsa.gov.uk/pubs/other/arrowguide.pdf.

3.1.1 The FSA's pre-crisis philosophy and approach to supervision

675 The FSA's approach to the supervision of high impact firms such as RBS during the Review Period reflected (i) a philosophy as to what good supervision should entail, (ii) some specific process features, and (iii) the organisation structure of the FSA at the time. We describe these in turn below.

676 The overall *philosophy* was that good supervision should entail:

- A 'risk-based' approach, which was designed to:
  - identify the main risks to the FSA's statutory objectives as they arose;
  - measure the importance of those risks; and
  - mitigate those risks where their significance justified this.

  In assessing individual firms, the scale of risks was quantified as the product of their impact (the potential harm that could be caused by particular events) and probability (the likelihood of the events occurring).[725] This was used to provide a measure of the overall risk to the FSA's achievement of its statutory objectives. The nature and extent of the FSA's supervisory relationship with a firm depended on how much of a risk the firm was considered to pose.

- A 'principles-based' approach: during the Review Period, the FSA increasingly focused on achieving desired regulatory outcomes more through principles than through detailed rules.[726] The expectation was that firms' behaviour would improve with this shift in emphasis.[727] An example of how the principles-based approach was used was in the FSA's Treating Customers Fairly (TCF) initiative.

- The potential for firms to earn a 'regulatory dividend'[728]: this entailed a less intensive approach for firms which cooperated with the FSA and which maintained an effective governance and control framework (see Box 2.6).

- Reliance on senior management and control functions: Supervision would allocate actions from the Risk Mitigation Programme (RMP)[729] to the firm, in line with the degree of reliance it felt it could place on the firm's management and control functions. Supervision would request confirmation that the actions had been undertaken or rely on the firm to address issues and concerns without specifying the detailed remedial action needed.

677 Four key aspects of the *process* by which the FSA sought to implement this philosophical approach were:

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725 Impact was primarily calculated using numerical data from a firm's regulatory returns. Probability was assessed through consideration of the gross risks inherent within a particular product, line of business, sector or firm before separately considering the quality of controls in place to deal with those risks. The effectiveness of the control functions and management, governance and culture at the firm were also assessed, as well as other specific mitigants such as the amount and quality of available capital and liquidity at a firm. For further information see *The FSA's risk-assessment framework*, August 2006, www.fsa.gov.uk/pubs/policy/bnr_firm-framework.pdf.

726 Under FSMA 2000 the principles also had the status of rules and could be enforced against.

727 For further information see *Principles-based regulation, Focusing on the outcomes that matter*, April 2007, www.fsa.gov.uk/pubs/other/principles.pdf and the FSA Handbook *Principles for Business (PRIN)*, http://fsahandbook.info/FSA/html/handbook/PRIN.

728 Speech by the then FSA CEO, *Better regulation: objective or oxymoron*, 9 May 2006, www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0509_jt.shtml.

729 See the Glossary of ARROW terms at the end of this section for further details.

- The ARROW framework – this was based on a periodic detailed assessment of the risks which a firm posed, resulting in an 'ARROW letter'[730] to the firm which set out the FSA's view of those risks.
- The RMP – a document which accompanied the ARROW letter and which detailed the actions required to reduce the identified risks, primarily through management actions.
- 'Close and continuous' supervision – this phrase was used to describe the approach to the supervision of high impact firms. It included a planned schedule of meetings with the firm's senior management, in order to assess progress in addressing the risks identified during the ARROW process, and to identify newly emerging risks.
- 'Baseline monitoring' – prior to the Review Period, monitoring of regulatory returns, including those relating to capital and liquidity, had been centralised in the Contact Revenue and Information Management Department (CRIM) within the FSA and this remained the case throughout the Review Period. Breaches and other indicators of risk were reported to supervisors who were responsible for pursuing them. Further details of baseline monitoring are provided in Sections 1.1 and 1.2.

678 Three key aspects of the FSA's organisation *structure* which had implications for the way in which supervision was conducted were:

- The integration of prudential and conduct supervision, with the same Supervision Team (and indeed in some cases the same individuals within the team) responsible for assessing and supervising both the prudential soundness of firms (for example, their capital, liquidity, and asset quality) and their interaction with customers (for example, the fairness of the sales processes through which products were sold to retail consumers).
- The separation of the Wholesale Business Unit from the Retail Business Unit, with the former responsible for markets regulation and for firms entirely focused on wholesale activities, (for example, US investment banking operations in London) and the latter responsible for firms which had a significant interface with UK retail customers. RBS, like the other major UK banks, was supervised in the Retail Business Unit.
- The existence of sector teams, including one for banking, which were intended to identify cross-sectoral issues and trends, which might not be apparent at a firm-specific level.

730 See the Glossary of ARROW terms at the end of this section for further details.

Box 2.6

The 'Regulatory Dividend'

The concept of a 'regulatory dividend' was introduced in 2006. It was part of the FSA's commitment to 'better regulation'[731] and its move towards a more principles-based approach to the regulation of the financial sector. These initiatives sought to improve the regulatory architecture, which was at that point seen as '*an unhappy alliance of high level principles and detailed rules and guidance*'[732], which added unnecessarily to the complexity and costs of financial regulation both for firms and for the FSA.

The improvement in architecture was to be achieved by:

- moving away from detailed, prescriptive rules and supervisory actions targeted at how firms should operate their businesses;
- placing greater reliance on principles and outcome-focused, high-level rules as a means to drive regulatory compliance; and
- focusing more on the outcomes that the FSA wanted to achieve, leaving more of the judgement of how to achieve those outcomes to the senior management of firms.[733]

The regulatory dividend was intended as an incentive for firms: in return for '*doing the right thing*', they would experience less intensive regulation. During 2006, the FSA set out the concept of the regulatory dividend as follows:

'Well-controlled and managed firms that engage positively and openly with us should expect to experience real benefits from our more principles-based approach in the form of a regulatory dividend, for example relatively lower levels of regulatory capital, less frequent risk assessments, greater reliance on firms' senior management or a less intensive risk mitigation programme'.[734]

The regulatory dividend was available to a firm when, in the FSA's opinion, it had demonstrated that it was well managed, had effective control systems and had dealt openly with the FSA. From mid-2006 onwards, Supervision assessed firms against these criteria and decided whether, and to what extent, they could benefit from a regulatory dividend. RBS was given a regulatory dividend as part of its 2006 interim, and 2007 full, ARROW risk assessments.

The regulatory dividend is no longer part of the FSA's approach to supervision.

3.1.2 Deficiencies in the FSA's approach to supervision

679 The FSA's approach to supervision, and in particular its focus on being 'risk-based' and 'principles-based', together with its explicit reliance on senior management and control functions was widely applauded before the crisis (see Section 3.1.3). It was seen as appropriate for the regulation of the UK financial system, whose 'international competitiveness' was a key concern to

731 See the FSA's *Better Regulation Action Plan, What we have done and what we are doing*, December 2006, www.fsa.gov.uk/pubs/other/better_regulation.pdf.

732 From *Better regulation: objective or oxymoron*, speech by the then FSA CEO, at the Securities and Investment Institute Annual Conference, 9 May 2006, www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0509_jt.shtml.

733 See *Principles-based regulation Focusing on the outcomes that matter*, April 2007, Section 2.2, www.fsa.gov.uk/pubs/other/principles.pdf.

734 From *Principles-based regulation Focusing on the outcomes that matter*, April 2007, Section 3.2, www.fsa.gov.uk/pubs/other/principles.pdf. See also: Speech by the then FSA CEO, *Better regulation: objective or oxymoron*, 9 May 2006, www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0509_jt.shtml; and speech by the then FSA Chairman, *Principles-based regulation, what does it mean for the industry?*, 31 October 2006, www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/1031_cm.shtml.

which the FSA was required to have regard. But, in retrospect, this overall approach suffered from severe deficiencies. Many specific examples of these deficiencies have been covered in Sections 1 and 2. Here we describe the overall nature and root causes of the deficiencies.

680 The *philosophy* set out in Section 3.1.1 resulted in an approach which:

- Relied too much on a relatively high-level risk assessment of the key issues affecting a high impact firm and the FSA's statutory objectives, and did not require the FSA itself to carry out sufficient detailed review and direct testing to inform supervisory judgements in key risk areas.
- Was too reactive in the absence of indicators of heightened risk. As a result, the approach encouraged a culture where supervisors placed undue reliance on:
  - assurances from firms' senior management and boards about governance, strategy, business model and key business decisions; and
  - the firm's control functions (Internal Audit, Compliance and Risk Management) to identify and address issues.
- Did not define it as part of Supervision's role to question the overall business strategy.[735] As a result supervisors did not always reach their own judgements on the key business challenges and strategic risks in firms' business models, based on in-depth, rigorous review involving specialists where appropriate.
- Included the flawed concept of a 'regulatory dividend' which was potentially dangerous and which, as described in Section 2.3.1 and Box 2.6, could result in a firm being rewarded with a less intensive supervisory approach simply for levels of cooperation and adequate controls, which should have been seen as the non-negotiable minimum acceptable standard.

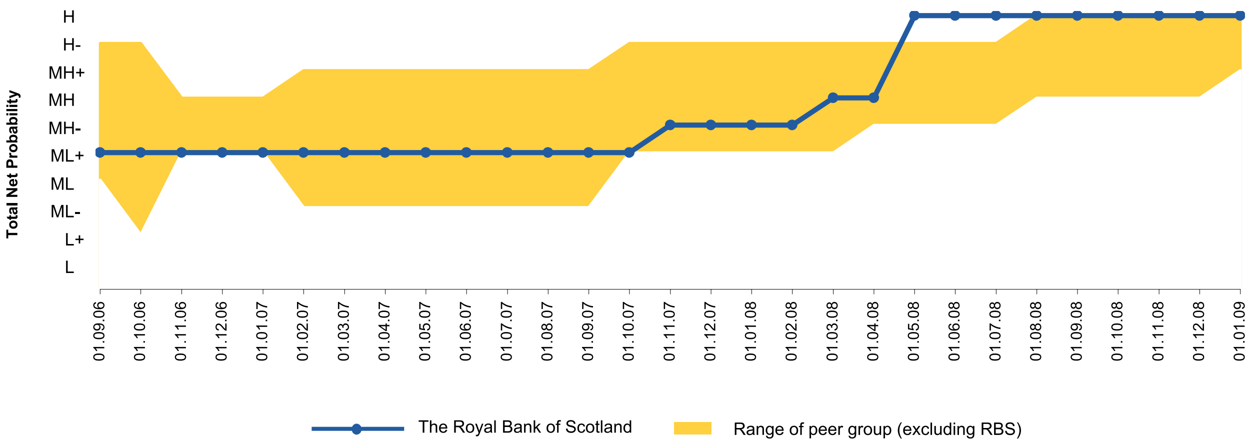
681 Within the *process* design, the system of 'baseline monitoring' of key regulatory returns was also flawed. The 'by exception' reporting by CRIM to Supervision of any breaches of capital or liquidity rules reduced the intensity of supervisory focus on the quality and quantity of a firm's capital and liquidity. This approach, together with the fact that liquidity risk was assigned a relatively low priority (see Section 1.2) and the deficient global standard for capital (see Section 1.1) resulted in a reactive and ineffective approach to the supervision of capital and liquidity until the first onset of the financial crisis in the summer of 2007.

682 The FSA's organisation *structure* had four adverse consequences for supervisory effectiveness:

- The integrated approach to prudential and conduct supervision, combined with the small total resource allocated (see Section 3.3 below) meant that:
  - the FSA failed to develop, within front line supervisory teams (as against specialist support teams), adequately high levels of skill and/or experience to focus on the core prudential issues of capital, liquidity, asset quality and trading risk; and

735 See sections 11-14 of Discussion Paper 09/2 – *A regulatory response to the global banking crisis*, March 2009, www.fsa.gov.uk/pubs/discussion/dp09_02.pdf.

Graph 2.26: Movement of RBS total net probability score tracked against the peer group range[736]



– there was a danger that a priority focus on conduct issues (such as TCF) could result in the diversion of supervision team attention away from these core prudential issues.

- The allocation of major UK banks to the Retail Business Unit, on account of their large retail customer bases within the UK, created the danger that there might be inadequate focus on risks created by their international and wholesale activities (for example, by RBS's activities within GBM). As discussed in Section 3.3, the RBS Supervision Team had only minimal resources devoted to investment banking issues.

- As described in the *NR Report*, the sector team concept as actually implemented did not result in effective flows of information and insight between the sector teams and the supervision teams, with insufficient focus on emerging risks, trend analysis and peer group comparisons.[737] Better information of this type might have identified earlier the relatively exposed nature of RBS when compared to its peers (for example, in respect of capital adequacy).

- Finally, the overall structure, size and span of responsibilities of the FSA meant that the direct involvement of the most senior levels of FSA management (for example, the Chairman, CEO and managing directors) in the consideration of risks in individual major banks was significantly less than we now consider appropriate.

683 Together, these deficiencies, combined with the widespread intellectual delusion that the global economy and financial system had become more stable as a result of financial innovation, made it less likely that the FSA would spot emerging prudential risks, either within individual high impact firms or at the level of the overall system. This failure to understand emerging risks was reflected in the fact that none of the largest UK banks, despite their size relative to the UK economy, were ranked as 'High' risk (measured as total net probability) within the FSA's ARROW framework, until as late as May 2008 (see Graph 2.26, showing the risk

736 Prior to the summer of 2006 and the introduction of the ARROW II methodology, the scoring system related directly to the risks to the FSA's statutory objectives rather than a measure of total probability. At the start of the Review Period, RBS was in line with its peers, positioned towards the lower end of the peer group range. The scoring system changed in the summer of 2006 and these data were not available until September 2006.

737 The weaknesses in this area were identified and discussed within the *NR Report* at Chapter D5, page 97.

scores of RBS against its peer group range from September 2006 to end-2008). RBS was ranked as Medium High minus (MH-) until as late as February 2008. This in part, however, reflected a delay between the point at which Supervision became focused on the increasing risk posed by RBS and the adjustment of the formal risk measure: RBS had been placed on the Watchlist[738] in November 2007 with a Watchlist focus on capital, in particular, after December 2007.

3.1.3 Responsibility for, and explanations of, a deficient approach

684 At several points in Section 1, and again in this section, the conclusion is reached that the Supervision Team's supervision of RBS was generally 'in line with the prevailing practices and approach of the time', i.e. that the Supervision Team was largely doing what was expected of it, according to the priorities, processes and approach set by FSA senior management and working within the constraints of the resources allocated to it.

685 Clearly, however, the overall decisions on those priorities and processes, and on resource allocation, were made by the senior management of the FSA[739] which must therefore have been responsible for the design of an overall approach which, with the benefit of hindsight was, in several crucial ways, deficient.

686 It is important to note, however, that those decisions were made within a context which included:

- A global approach to capital adequacy, agreed by regulators and central bankers from all major authorities across the world, which was in retrospect severely deficient, but which was believed at the time to be sophisticated and appropriate.

- A consensus among practitioners and policy-makers across the world, which confidently assumed that the financial system had been made more stable as a result of the very financial innovation and complexity which we now understand played a significant role in the failure both of the overall system and of RBS within it. In this climate, very few people in positions of responsibility in major regulatory authorities or central banks appreciated the growing risks, and several argued authoritatively that the risks to the financial system and to the banking system in particular had reduced.[740] In addition, most shareholders in banks in the UK and elsewhere in the developed world appeared to share in this view of the financial system. Many investors and supply-side analysts accepted the growth in leverage as enhancing 'balance sheet efficiency'.

- A set of responsibilities, handed by Parliament to the FSA, which extended from the prudential oversight of large complex banks to the regulation and supervision of the conduct of tens of thousands of retail firms and intermediaries. As a result, FSA senior management attention could be, and was in fact, diverted towards a number of current and legacy issues related

738 Further details of the FSA's Watchlist are provided on the FSA's website: www.fsa.gov.uk/pubs/other/watchlist.pdf and in the *NR Report* at 5.4, page 103.
739 Organograms of the FSA structure showing senior management in the Review Period together with a list of FSA Board members and ExCo members are shown in Appendix 2I.
740 See IMF *Global Financial Stability Review* April 2006.

to firms' treatment of consumers which at the time were perceived as more pressing and important (for example, split capital investment trusts, the Retail Distribution Review and Equitable Life and earlier, the pensions, mortgage endowment and precipice bond mis-selling episodes, which explained the priority given to TCF by the FSA).

- A general belief, reinforced by external assessments, that the FSA's philosophical approach was appropriate, and indeed a global model of good regulation. This sanguine view was reflected in a National Audit Office review of the FSA in April 2007. At the time of its publication, the then Economic Secretary to the Treasury, Ed Balls MP, stated that '*The independent NAO report shows that the FSA is working well, and is a world leader in a number of areas – which can only be good for the competitiveness of the UK financial services sector*'.[741] And later in 2008, the Hampton Review had found that '*to a high degree*'[742] the FSA regulated in accordance with Hampton principles[743] and Macrory characteristics.[744]

- A sustained political emphasis on the need for the FSA to be 'light touch' in its approach and mindful of London's competitive position. The then Chancellor, Gordon Brown, on several occasions in 2005 and 2006, made it clear that there was a strong public policy focus on fostering the 'competitiveness' of the UK financial services sector, and a belief that unnecessarily restrictive and intrusive regulation could impair that competitiveness. For example, in a Treasury press release dated 24 May 2005, at the launch of the Better Regulation Action Plan[745], Gordon Brown said '*…the new model we propose is quite different. In a risk based approach there is no inspection without justification, no form filling without justification, and no information requirements without justification.*

741 See the HM Treasury Press Notice dated 30 April 2007, http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/press_50_07.htm (incorrectly dated as 2008). In addition, the then CEO of the FSA in his report to the FSA Board for May 2007, stated that he had attended the Chancellor's High Level Group meeting on 30 April 2007 and reported that the Head of the National Audit Office had talked about '*the FSA being an institution the UK can be proud of*' and '*the FSA being trusted and seen as honest – which meant its reputation was very strong*'.

742 See the National Audit Office Reports: *Effective inspection and enforcement: implementing the Hampton vision for the Financial Services Authority*, March 2008; and *Regulatory quality: How regulators are implementing the Hampton vision*, July 2008.

743 Sir Philip Hampton's 2005 report, *Reducing administrative burdens: effective inspection and enforcement*, set out principles to guide effective inspection and enforcement which the Government expected all UK regulators to embed. In 2006 the Chancellor of the Exchequer invited the National Audit Office to work with the Better Regulation Executive to develop a process of external review of regulatory performance focusing on regulators' adherence to the Hampton principles and encouraging continuous improvement.

744 The 'Macrory characteristics' were set out in *Regulatory Justice: making sanctions effective, Final report,* Professor Richard B Macrory, November 2006. The review led to a government initiative to strengthen the powers available to regulators, which was put into effect by the *Regulatory Enforcement and Sanctions Bill 2007-08*.

745 The Better Regulation Action Plan was part of the government's Better Regulation Agenda drawing together and building on reforms recommended by the Hampton Review and the Better Regulation Task Force reports published in March 2005. In response, the FSA published its own action plan, with subsequent updates, and was mindful of the government's agenda in the design and implementation of its approach to regulation.
See the FSA's *Better Regulation Action Plan, What we have done and what we are doing*, December 2006, www.fsa.gov.uk/pubs/other/better_regulation.pdf.

Not just a light touch but a limited touch'.[746] In response to this focus and belief, FSA senior leaders were conscious of the need to reassure political leaders that the supervisory approach being pursued was not heavy-handed. Thus, for instance, in response to a speech by Prime Minister Tony Blair, also in May 2005[747], which expressed concerns that heavy-handed supervision by the FSA was impeding innovation and business expansion, the then Chairman of the FSA sought to correct this view by replying in a letter that the FSA was efficient and proportionate and, by way of example, noted that the FSA devoted only six staff to the supervision team responsible for HSBC. This allocation was similar to that for RBS (see Section 3.3) and a level of resource that we now consider severely deficient.

687 Within this context, if senior leaders of the FSA had proposed, before the first signs of the crisis (for example, before summer 2007), a supervisory approach which entailed higher capital and liquidity requirements, supervisory caps on rapid bank balance sheet growth, or intensive analysis of asset quality, it is almost certain that their proposals would have been met by extensive complaints that the FSA was pursuing a heavy-handed, gold-plating approach which would harm London's competitiveness.

688 The executive responsibility for designing (or failing to redesign) this in-retrospect deficient approach lay with the FSA senior executives. But those executives were subject to the oversight of the FSA Board. The focus of FSA Board agendas and discussion was significantly influenced by the decisions made by senior management and the Chairman. However, the FSA Board is, and was in the Review Period, responsible for ensuring, via oversight of and challenge to the executive, and via the approval of budgets and operating plans, that the FSA's senior management was putting in place appropriate processes and resources to ensure the achievement of the FSA's statutory objectives. The Review Team has therefore considered the role of the FSA Board in relation to the supervision of high impact banks such as RBS in the Review Period.

689 Key aspects of the role of the FSA Board which need to be noted in this respect are that:

- The FSA Board did not play any operational role in decisions relating to the supervision of specific firms, though it did receive briefing on current issues from the executive and was therefore in a position to ask questions and challenge assumptions. It was, for example, not involved in decisions about whether a firm met the threshold conditions. And indeed, if that had been defined as part of its role (somewhat akin to the role of the Board of Banking

746 The full speech can be found at: http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/better_regulation_action_plan.htm. In the following year, during a speech on 14 June 2006 at Bloomberg, the then Economic Secretary to the Treasury, Ed Balls MP, said '*…we must keep the UK's regulatory system at the cutting edge – the best in the world… at all times we will apply a principled system of risk-based regulation, without unnecessary administration burdens… nothing should be done to put at risk a light-touch, risk-based regulatory regime*'. The full speech can be found at: http://webarchive.nationalarchives.gov.uk/20100407010852/http:/www.hm-treasury.gov.uk/speech_est_140606.htm. And on 26 October 2006, in response to oral questions in the House of Commons, Gordon Brown, said that '*…with the new City task force we will continue to found our policy for competitiveness on thinking globally, investing in skills, a competitive business and light-touch regulatory environment and, most of all, doing nothing to put economic stability as risk*'. The full speech can be found at: www.publications.parliament.uk/pa/cm200506/cmhansrd/vo061026/debtext/61026-0001.htm#06102646001425.

747 See speech by Tony Blair, Prime Minister, dated 26 May 2005 on *Compensation Culture* to the Institute of Public Policy Research.

Supervision when the Bank of England had responsibility for banking supervision), a very different composition of the FSA Board would have been required, involving members with no potential conflicts arising from current financial sector roles as well as technical expertise in the relevant areas.

- The FSA Board did not then, and does not now, input in any substantive way to decisions on prudential standards, such as those relating to capital and liquidity. While it was required at times formally to approve the transposition of such standards into the FSA rulebook, capital standards are, and were, actually developed at global level via the Basel Committee process, and become European law via capital requirements directives. And in relation to quantitative liquidity standards, there were, during the Review Period, no global or European standards.
- Neither the FSA Board nor its Risk Committee had been defined as responsible for an assessment of evolving macro financial stability risks, in the way that the Financial Policy Committee of the Bank of England will now have responsibility. The FSA's precise statutory role in relation to financial stability was in retrospect unclear. No specific statutory objective was defined during the Review Period[748], but a Memorandum of Understanding between the Tripartite authorities established a framework[749] for cooperation in which the FSA's responsibility for micro financial stability was an input. In addition the FSA, in considering its market confidence statutory objective, did consider issues relating to financial stability[750], but in retrospect did not consider macro financial stability factors in the way it now considers appropriate.
- Much of the attention of the FSA Board in the pre-crisis period, as of senior executives, was devoted to considering a number of major legacy and current conduct issues that required focus – such as Equitable Life, the Retail Distribution Review and TCF. Attention was also devoted to issues relating to the development of consumer financial capability. This reflected the wide spread of the FSA's responsibilities which, as stressed elsewhere in this report, increased the danger that prudential issues would be accorded low priority in periods when economic and financial stability conditions appeared to be benign.

690 The FSA Board and Risk Committee agendas and minutes for the pre-crisis period were analysed. It is important to note that FSA Board and Committee minutes did not provide a verbatim account of all director contributions, but

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748 The FSA did not have a separate statutory objective in respect of financial stability until it was added by the Financial Services Act 2010.

749 The framework for cooperation between the Bank of England, HM Treasury and the Financial Services Authority in the field of financial stability was established in the Memorandum of Understanding (MOU) of 28 October 1997, following the formation of the Financial Services Authority. The MOU was revised in March 2006 to reflect developments including responding to a crisis threatening financial stability. Further details on the terms of engagement under the Tripartite MOU issued in March 2006 are on the FSA website:
www.fsa.gov.uk/pages/Library/Communication/PR/2006/025.shtml and www.fsa.gov.uk/pubs/mou/fsa_hmt_boe.pdf.

750 From September 2007 the FSA, and in particular the Chairman, stressed the significance of deteriorating liquidity conditions, and raised issues relating to overall policies on public liquidity support. These issues were discussed in detail at the September 2007 meeting of the FSA Board and the FSA Chairman made the other Tripartite authorities aware of his concerns (see Section 1.2.5).

were focused on recording the items discussed and key conclusions reached.[751] As a result it is possible that points may have been made which are not revealed by the minutes. NEDs have reported that, in 2006 and 2007, in addition to discussions apparent in formal minutes (see paragraph 692), the Board did informally discuss the prudential risks to the financial and banking system but, along with most other commentators and authorities, believed they were manageable. But the agenda and minutes together provide an accurate indication of the primary focus of the meetings. They reveal a strong skew towards conduct related issues.

691 Looking at the FSA Board minutes, it is noticeable that during the period between January 2006 and July 2007:

- Of the 'major topics' discussed at the FSA Board, one out of 61 related in some way to bank prudential risks and issues.
- Of items reported to the FSA Board within the CEO's report, one out of 110 related to bank prudential issues either in general or in relation to specific banks.
- Of 229 items reported by the Managing Director of Retail Markets (who was responsible for the supervision of major banking groups such as RBS), there were five items which in some way concerned bank prudential issues. Three of these related to European regulatory initiatives, and two related to the proposed Barclays and RBS bids for ABN AMRO. The issues discussed in relation to the ABN AMRO bids, however, did not touch on the prudential risks involved in any acquisition, but rather focused on the relative responsibilities of the FSA and *De Nederlandsche Bank* (DNB).[752]

Until the summer of 2007, therefore, FSA Board agendas reflected the judgement that bank prudential issues were, at that time, a low priority, since the market conditions were benign.

692 Analysis of Risk Committee minutes from the pre-crisis period reveals a broadly similar pattern, with a strong skew of attention towards conduct or internal FSA issues, and with only limited focus on the emerging risks which in retrospect we now know were developing:

- Discussion of 'key priority risks' or of 'key risks to FSA's objectives' were strongly skewed towards conduct issues, or to non-financial external risks. At the November 2005 Risk Committee, for instance, the six issues considered in detail were: small firm supervision; consumer financial capability; firms which were not treating customers fairly; potential mis-selling relating to the State second pension; the impact of natural disasters on the insurance industry; and market resilience to external shocks such as terrorist attacks or avian flu.

751 This style of minutes was introduced by the then Chairman, in 2005, replacing a more detailed discursive account previously used. The style is a common one in company boards but, in the Review Team's opinion, board minutes of authorised firms and the FSA should be enhanced (see Section 2.4 and Appendix 2A).
752 The National Bank of the Netherlands and home state regulator of ABN AMRO.

- While there were occasional discussions of credit risks, these appear from the minutes to have been skewed towards household lending in the UK and to have been focused as much on conduct issues (for example, aggressive marketing to consumers) as on any potential consequences for bank soundness and financial stability.
- Discussion of the developments which we now know, with hindsight, were forward indicators of future problems was limited and did not result in a greatly heightened level of concern. Thus for instance:
  - A discussion in October 2006 of the failure of the hedge fund Amaranth '*suggested that the market was more resilient now than in the past*'.
  - While the first apparent discussion of developments in the US sub-prime market (at the April 2007 meeting) prompted the question '*was this a risk reappraisal situation*' and the observation that '*markets could suddenly change*', it was also noted that '*the US authorities have been fairly optimistic*' and '*the US authorities were not expecting a knock-on effect on prime [household] and commercial mortgage markets*'. It is not apparent from the minutes whether there was any discussion of possible consequences of problems in sub-prime mortgages in the US, for the structured credit activities of UK banks such as RBS.
  - There was no apparent discussion of the increasing reliance of UK and other banks on wholesale funds and the resulting funding and liquidity risks that this could create.
- The focus of the Committee changed radically, however, from summer/autumn 2007. At the July 2007 risk meeting, for instance, while the pre-set formal agenda was still dominated by internal and conduct issues (Payment Protection Insurance, financial crime, information security standards, consumer driven frauds and anti-money laundering), the 'Items from committee members' focused on risks in sub-prime mortgages and hedge funds, and those arising from implicit bank liabilities to support sponsored funds.

693 The balance of the FSA Board and Board Committee attention was inevitably somewhat determined by the agendas prepared by the executive and the Chairman and by the items on which the Executive chose to focus in their reports to the FSA Board. But the FSA Board and Board Committees clearly had the ability to challenge and propose an alternative focus. As mentioned in paragraph 690, the minutes of meetings may not record all points made. But it is clear that the net effect of any challenge did not result in major pre-crisis changes to the FSA's supervisory approach or to those aspects of bank regulation (e.g. those relating to liquidity) which the FSA could itself have changed even without global agreement.

694 Interviews with NEDs who were members of the FSA Board and Risk Committee in the pre-crisis period suggested that this failure to challenge fundamentally the FSA's approach to the prudential regulation and supervision of banks did not reflect a failure to appreciate the importance of the FSA's prudential role, but

rather the fact that FSA Board members tended to share, explicitly or implicitly, the predominant assumption of the time that the financial system had become more stable, and that the crucial risks to FSA objectives did not, at that time, lie in the area of bank financial soundness. Global initiatives such as Basel II were assumed to be sophisticated, effective and sufficient responses to global banking system risks. Emerging risks, such as sub-prime losses in the US, were not ignored but were judged to be manageable. And the possibility that liquidity in inter bank markets would dry up was considered of such low probability that it was not explicitly addressed. In this environment, FSA Board members largely accepted the predominant focus of the FSA on conduct-related issues, and the political constraints within which it would have been unacceptable for the FSA to 'gold plate' global or European regulatory standards. The FSA Board was shown a copy of the FSA Chairman's letter to the Prime Minister referred to in paragraph 686, and did not demur from the line it set out.

695 As a result, prior to the early stages of the crisis in summer 2007, while the FSA was at times involved in important debates about new approaches to the regulation and supervision of firms, these did not include any detailed review of the approach to bank prudential regulation and supervision:

- There was explicit focus on the regulation and supervision of insurance companies. This reflected the problems arising from Equitable Life, and led to the 2001 *Tiner Report*[753], from which followed significant changes in insurance regulation.
- Attention was given to the challenges of supervising small firms; this resulted in the FSA's strategy on Small Firm Supervision issued in 2005.
- The FSA Board was also involved in considering the FSA's supervisory philosophy at a high level (for example, the importance of a 'principles based' approach and the ARROW II initiative), but this did not involve detailed discussion of the appropriate design of the supervisory approach to bank prudential issues, nor of the appropriate level of supervision team resource devoted to such issues.

696 From summer 2007 onwards, in contrast, the FSA Board was closely involved in the oversight of the FSA's response to the crisis. Thus for instance:

- In September 2007, it discussed in detail the severe liquidity strains which had emerged in bank funding in general, and in relation to specific banks. It expressed strong support for the proposal that the Chairman should convey to the other Tripartite authorities the FSA's belief that solutions would have to involve cross system liquidity support (see Section 1.2.5).
- It was extensively involved in satisfying itself that the programme of reforms introduced in response to the crisis – for example, the Supervisory Enhancement Programme (SEP) and the Core Prudential Programme (CPP) (see Section 3.5 and Box 2.7) were well designed and effectively implemented. Following the issue of the *NR Report* in March 2008, the FSA Board became still more involved. In the view of some FSA Board members,

753 *The Future Regulation of Insurance: a report to the Economic Secretary to the Treasury*, November 2001.

the production of the *NR Report* allowed a step-change in the FSA Board's ability to exert influence on issues related to prudential supervision.

- And the intensity of its involvement subsequently increased further; for instance in autumn 2009 it devoted an AwayDay to the detailed review of core supervisory processes.

697 In addition, the FSA Board considered in detail during 2009 the challenges created by the breadth of its responsibilities. It agreed that if the FSA were to continue to exist in its integrated form, it would be desirable to make major changes to the Board governance, with the creation of sub-boards responsible for prudential and conduct issues in order to facilitate more detailed attention to key risks and challenges. It also agreed, however, that it was not sensible to proceed with radical change ahead of the general election. Following the new government's decision in June 2010 to proceed with the more fundamental separation of conduct and prudential responsibilities, and the break-up of the FSA, these changes were no longer applicable. In particular, the responsibility for the identification of emerging systemic risks and of the appropriate regulatory and supervisory response, which under the new statutory arrangements will reside with the Financial Policy Committee (FPC), is already being discharged by the interim FPC of which both the Chairman and CEO of the FSA are members.

3.2 The supervision of RBS: 2005 to 2008

698 The FSA's supervision of RBS reflected the general approach described in Section 3.1. This section considers key aspects of how the FSA applied that approach to RBS during the Review Period. It covers:

- in 3.2.1, the timing of the formal ARROW risk assessments[754] and the evolution of the FSA's risk assessment of RBS from 2005 to 2008;
- in 3.2.2, FSA-wide supervisory priorities and the impact of reactive work which had implications for the staffing of the Supervision Team and specialist support resources;
- in 3.2.3, a description of the key issues on which the Supervision Team focused in each of the three formal ARROW assessments (2005, 2006 and 2007), and in the period after the 2007 ARROW assessment and before RBS's failure in autumn 2008; and
- in 3.2.4, the Review Team's assessment of the supervision of RBS in the Review Period, and a comparison of how this assessment compares with that reached in the Northern Rock case.

3.2.1 ARROW assessments of RBS 2005 to 2008

699 During the Review Period the ARROW framework was applied to RBS on the basis of a two-year cycle. There were full ARROW risk assessments in 2005 and 2007, with an interim desk-based review in 2006 (see Table 2.16). Following the ARROW letter of October 2007, the intention was that the next full ARROW

754 See the Glossary of ARROW terms at the end of this section for further details.

review would be in 2008. In fact, 2008 saw a continuous rise in the intensity of supervisory activity relating to RBS, but this remained outside a formal ARROW review process.

Table 2.16: Timelines of RBS ARROW risk assessments

	2005 (Full)	2006 (Interim[755])**	2007 (Full)
Planning Panel[756]*	N/A	N/A	30 April 2007
Visits	Q4 2004	N/A	Q3 2007
Final Validation Panel[757]	28 January 2005	N/A	10 September 2007
ARROW letter issued	4 March 2005	5 October 2006	25 October 2007
Presentation to RBS Board of Directors	30 March 2005	13 December 2006	31 October 2007

* Planning Panels were introduced in 2006 under the ARROW II methodology.
** Interim assessments were desk-based reviews.

700 An important part of the ARROW panel process was to benchmark the firm against its peer group. The risk profile of RBS was scored similarly to that of its peer group for the majority of the Review Period. While its impact score remained at High over the Review Period, its overall total net probability score moved in accordance with the FSA's judgement of the probability of particular events occurring or risks crystallising. RBS's total net probability score moved from Medium Low risk to Medium High risk and then to High risk after the start of the crisis period, by which time it had (for a brief period) a higher risk profile than its peers (see Graph 2.26).

701 Another indirect measure of the FSA's assessment of a firm's riskiness, which applied in the Review Period (but no longer does) was whether it was deemed to be worthy of a 'regulatory dividend' (see Box 2.6). On this measure the Supervision Team assessed RBS's risk as having reduced between 2005 and 2007. After the concerns about the degree of firm cooperation, which the Supervision Team expressed in 2005 (see Section 2.3.1), the 2006 Interim Risk Assessment letter noted that the RMP was shorter than for the previous year because the Team felt able to place more reliance on RBS to handle issues as and when they arose. A year later the 2007 ARROW letter included a specific statement that RBS was being given a regulatory dividend based on Supervision's judgement that it could now place greater reliance on RBS's governance and controls.

702 A further indicator of FSA supervisory concern about a firm was whether the firm was placed on 'the Watchlist'. Placing a firm on the Watchlist did not necessarily signal a heightened concern about prudential soundness: firms could be placed on the Watchlist for instance because of important conduct issues or technical compliance issues. RBS was not on the FSA Watchlist during the Review Period prior to November 2007 when it was placed on it because of integration risks associated with the ABN AMRO acquisition.

755 See the Glossary of ARROW terms at the end of this section for further details.
756 See the Glossary of ARROW terms at the end of this section for further details.
757 See the Glossary of ARROW terms at the end of this section for further details.

703 Overall, therefore, these different direct or implicit risk measures indicate that until late 2007, while the FSA at times had specific concerns about particular aspects of RBS's business growth, risk controls or degree of cooperation, it did not see RBS as a particularly high risk bank. Only from December 2007 was RBS's capital adequacy identified as a Watchlist issue. Thereafter, and in particular by March 2008, there was increasing FSA involvement at the most senior level, with the FSA pressing RBS to acknowledge the need for a large rights issue.

3.2.2 The FSA's priorities and the impact of reactive work

704 The ARROW process aimed to ensure that key risks were assessed in a comprehensive fashion, and that supervisory team resources were focused on identified priorities specific to each firm. The actual allocation of supervisory resources (and of specialist support) was also, however, affected by:

- FSA-wide priorities, which applied to all firms (or to all firms within a particular category); and
- supervisory issues specific to individual firms which arose because of events such as acquisitions.

705 During the Review Period there were two FSA priorities which had a very major effect on the allocation of bank supervisor and specialist support resource: the implementation of Basel II and the FSA's TCF initiative.

706 The Basel II capital adequacy regime applied to RBS from 1 January 2008. While the Basel I regime required capital support for particular lending activities on the basis of simple category-specific weights (for example, 100% for corporate loans and 50% for residential mortgages), Basel II allowed banks (and indeed expected large and sophisticated banks), subject to regulatory approval, to calculate appropriate risk weights on the basis of detailed assessments of the riskiness of specific asset categories, using complex models and drawing on historic databases of past losses. The number of specific asset categories and models could, for a bank the size of RBS, exceed a hundred. Banks therefore had to develop such models in the years running up to 2007, and the FSA supervisory staff and specialists then needed to review them and assess whether they were adequate to meet the Basel II standards. Banks whose models met the standard were given 'waivers', which allowed them to calculate risk weights on the modelled basis; where waivers were not granted, banks had to use less granular 'standardised' risk weights.

707 The process of assessing and validating Basel II models absorbed a very significant proportion of the FSA's specialist prudential risk resource during 2006 and 2007. In the long run some benefits might have resulted from this new bank capital adequacy regime, which requires more detailed assessment of asset-specific risks. But it is now clear that the Basel II capital regime, introduced on the eve of the financial crisis, failed entirely to identify and address the issue of inadequate overall capital resources. As a result, the devotion of significant FSA resources to Basel II implementation failed to make any significant contribution to making RBS or any other major bank more robust in the face of the financial crisis.

708 The second priority was the FSA's TCF initiative, which was launched in late 2003 and had key deadlines of 31 March and 31 December 2008.[758] TCF was an important FSA priority and firms were required to demonstrate via extensive internal documentation and through actual examples that they had processes and structures in place to ensure that the approach adopted at each stage of the product lifecycle placed appropriate focus on fair treatment.[759] Reviewing the material and undertaking on-site visits to assess compliance with the principle in turn absorbed significant work by Supervision and by Conduct of Business specialists. In retrospect, this initiative took up a lot of Supervision Team resource and management attention at a time when prudential risks were rapidly intensifying.

709 In addition to these FSA-wide priorities, the Supervision Team also had to respond to RBS specific events. These included the strategic investment in Bank of China in 2005 and the integration of the Sempra Energy joint venture into GBM in 2007 as well as the ongoing integration from previous acquisitions. While supervisory oversight of these investments was appropriate, the small resources devoted to RBS supervision in total (see Section 3.3) meant that attention to them could be at the expense of other activities which were, in retrospect, far more important.

710 The largest RBS specific event, during the Review Period, was of course the ABN AMRO acquisition. FSA supervisory activity relating to this has already been described in Section 1.5. What is striking is that despite the resources devoted to considering both the consortium's (lead by RBS) and Barclays' bids, the FSA's supervisory response did not entail adequate assessment of the risks which RBS was taking in: launching a huge contested bid on the basis of limited due diligence; acting as consortium leader; and choosing to finance with debt rather than equity and, within that, short-term debt. Conversely, there was significant focus by the FSA on issues relating to which would be the lead regulator in the event that the Barclays bid was successful.

711 As Section 1.5 described, the FSA's supervisory response in relation to RBS's bid for ABN AMRO reflected the fact that:

- FSA approval was not required for the acquisition and the FSA did not consider that it had a major responsibility in respect of it;
- at the time, Supervision lacked a defined approach to major takeovers (contested or otherwise); and
- the prevailing FSA philosophy and approach were that strategy and risk appetite were matters for a firm's board.

712 As Section 1.5 stated however, irrespective of the formal position and prevailing supervisory approach, the FSA should have acknowledged early in the process that the unprecedented scale of the proposed acquisition required a judgement

758 By 31 March 2008, firms were required to have appropriate management information or measures in place to test whether they were treating their customers fairly; and by 31 December 2008 firms were required to demonstrate to themselves and the FSA that they were consistently treating their customers fairly. For further information see, *Treating Customers Fairly initiative: progress report*, May 2007, www.fsa.gov.uk/pubs/other/tcf_implementation.pdf.

759 This covered, among other things, product design, marketing, sales and post sale administration.

to be made on the appropriate supervisory response in order to determine whether the risks RBS was taking were acceptable. This should have included the FSA Board questioning whether the prevailing supervisory approach to acquisitions was appropriate, even though the FSA Board's remit meant that, in the normal course of events, it did not comment on firm-specific matters.

3.2.3 ARROW risk assessments – key issues identified

713 The results of each ARROW assessment of RBS were set out in a letter to the firm's Board of Directors. The paragraphs that follow summarise the key issues from the ARROW letters. Actions to mitigate risks, and other matters arising, were set out in RMPs which had a section covering each material business unit. For example, there was a separate section for GBM throughout the Review Period.

2005 ARROW

714 Key issues from the 2005 ARROW letter included: the stretch in RBS's control framework due to rapid business growth; concentration risk in corporate lending and the potential impact of market deterioration together with the need for more developed macroeconomic stress-testing; the need for effective Board challenge of the CEO and executive; TCF; and the integration and growth of the insurance entities.

715 The assessment identified as a key risk the absolute size, market share, concentration and rate of growth of RBS's commercial property portfolio. A significant proportion of this exposure was within the UK business of GBM (see Section 3.4.3). Supervision considered, among other forms of regulatory intervention, imposing a cap on RBS's wider commercial lending activities, but concluded in line with the philosophy of the time that growth targets, and the associated risks, were more properly questions for the RBS executive and Board. As discussed in Section 1.3, the approach taken by Supervision was therefore to highlight to RBS the need for it to have best practice risk management systems including, in particular, to make improvements in stress-testing to show that it would be able to withstand a severe economic downturn; and for the RBS Board specifically to consider and debate its risk appetite and establish appropriate limits.

2006 ARROW

716 Key issues from the 2006 interim assessment letter included: the need for continued development of the macroeconomic stress-testing methodology based on an articulation of the firm's risk appetite; regulatory and operational risk in the US businesses; the need for the control and support functions to keep pace with the growth of the business; the need for further development of the Group Risk Management function; and feedback from visits the FSA had undertaken as part of a Basel II assessment.

717 Supervision concluded that progress had been made since the 2005 ARROW, not least with improving the regulatory relationship and with the degree of

reliance it could place on RBS's control functions. Partly as a result, fewer RMP actions were set.

2007 ARROW

718 As shown in Table 2.16, the 2007 ARROW process began with the Planning Panel in April and the visits took place in Q3 2007. During that period the bid for ABN AMRO was being progressed. The Planning Panel recognised the stretch for the Supervision Team of both undertaking the ARROW and reviewing the bid (see comments in Section 3.2.4 and Section 1.5).

719 As part of the 2007 ARROW, Supervision undertook a review of the firm's internal capital adequacy assessment process (ICAAP). This formed a key input into the FSA's supervisory review and evaluation process (SREP), which was performed by the Supervision Team with support from FSA specialists. This was the first submission by RBS under the new Pillar 2 part of the Basel II regime.[760] Both RBS's approach to producing its ICAAP and the FSA's approach to conducting its SREP were still developing. The detailed review work and conclusions relating to the ICAAP are set out in Section 1.1.

720 The Supervision Team sent the 2007 ARROW letter on 25 October 2007, just after the bid for ABN AMRO completed. The key issues included in the letter were: follow-up work to the Basel II capital assessment (see Section 1.1); TCF; governance of the US operations; the challenge for RBS's Risk function due to the increasing range of products and jurisdictions; restructuring of RBS's Risk function; the growth in products new to the firm as a result of the Sempra Joint Venture and the need to have adequate controls in place; control of Asian and Middle Eastern operations following rapid growth; RBS's intention to use a model to assess operational risk under Basel II; and the need for the firm to resolve certain high-priority issues before the Basel II credit model approval could be granted (on the latter, see Section 1.1).

721 In the Supervision Team's view, there was evidence of an improved relationship and control framework, as in 2006. The 2007 ARROW letter noted that the attached RMP was significantly shorter (16 RMP issues compared with 42 in 2005), as Supervision felt able to be less intensive, place more reliance on the firm and its own governance and control procedures to mitigate the risks identified and to handle issues as and when they arose (see Section 3.2.4 for an assessment of this approach).

722 The 2007 ARROW letter specifically excluded consideration of the risks associated with the ABN AMRO bid, but noted that the acquisition would accentuate a number of the key issues identified in the letter. It concluded by stating that, in the absence of the ABN AMRO transaction, the next full ARROW would be in 24 months. However, in light of the risks and regulatory arrangements associated with the transaction, Supervision would consider the timing of an assessment of those risks, emphasising that it might undertake further work at any time or require the firm to undertake additional work.

760 Under Pillar 2, a firm must, amongst other things, regularly assess the amount of capital it considers adequate to cover all of the risks to which it is, or is likely to be, exposed including those risks not covered or adequately captured by Pillar 1.

The supervision of RBS in the period between the 2007 ARROW letter and its failure on 7 October 2008

723 The Supervision Team added RBS to the FSA's Watchlist in November 2007 due to concerns over the integration risk associated with RBS's lead role within the consortium which acquired ABN AMRO. In December, the Watchlist commentary was expanded to include: the impact of the extreme market conditions on the firm's capital and liquidity positions; and the impact of Basel II. RBS was still on the Watchlist at the end of the Review Period, and work to address the Supervision Team's concerns continued along with other supervisory activity in response to the worsening financial crisis in the market and later at RBS.

724 While the intention, as outlined in the 2007 ARROW letter, was to adopt a less intensive supervisory approach to RBS, in fact by end-October 2007, the market crisis was worsening and the Supervision Team was increasingly responding to the crisis and its effect on RBS. By way of illustration, from February 2008 until the successful completion of the rights issue, the Supervision Team and FSA senior management worked intensively to assess the capital position of RBS.

725 Despite the wholly exceptional and unprecedented scale and nature of the ABN AMRO acquisition, the 2007 ARROW letter did not attempt to set out the key risks associated with a successful bid. In order to assess these risks, Supervision planned to carry out a follow-on ARROW assessment at a much later stage, in the second half of 2008. The Supervision Team also planned to make an assessment of RBS's capital planning process, given the issues that crystallised in that area just prior to the rights issue in April 2008. In the event, both the follow-on ARROW assessment and the work on capital planning were overtaken by events. Both FSA and Supervision senior management became intensively engaged in managing the crisis.

726 At end-April 2008 Supervision, in response to the continuing crisis, set out a strategy for UK banks, both systemic and non-systemic. The aim of this strategy was to ensure that the systemic banks, such as RBS, were adequately capitalised. A key feature of the strategy was its emphasis on quality of capital, with a focus on the adequacy of core equity capital rather than total capital. At that time it was the FSA's view that achieving a core capital target of 5% by end-2008 (together with improved liquidity provided by the Bank of England Special Liquidity Scheme (SLS)) should have been sufficient for the systemic banks to weather the crisis and retain the confidence of the market. Ongoing market confidence in the solvency of all the major banks was considered key to safeguarding the wholesale debt markets that provided the short-term funding on which RBS and other systemic banks were reliant.

727 Following the completion of its £12bn rights issue in April 2008, RBS ceased to be a priority within Supervision's capital-focused banking strategy.[761] In May and June 2008, the Supervision Team's attention then turned to Barclays.[762]

728 The main areas of focus of the Supervision Team in relation to RBS from May 2008 to the end of the Review Period were:

761 For further details of RBS's capital position and the FSA's focus on it in the run up to the right issue, see Section 1.1.5.
762 The Supervision Teams for RBS and Barclays had been merged under one Manager since February 2007 (see Section 3.3).

- monitoring the firm's asset disposal and de-leveraging plans, which had been agreed in conjunction with the rights issue (FSA senior management was also involved in 'keeping the pressure on' the firm to meet disposal deadlines);
- monitoring the transfer of ABN AMRO's assets as they were reallocated in accordance with the consortium agreement to the different consortium members; in addition to ad hoc discussions this involved two regulatory colleges organised by the DNB in this period; and
- reacting to a number of other issues relating to RBS.

729 As explained in Sections 1.2 and 1.6, following the onset of the crisis period, RBS's significant reliance on short-term and, in particular, overnight wholesale funding was recognised by the Supervision Team, Supervision and FSA senior management, but was not considered an immediate risk. It was also recognised that RBS's dependence on short-term wholesale funding could not be addressed quickly, particularly given the market conditions. The agreed approach for RBS was gradually to improve its liquidity position (as the firm was attempting to do as market conditions allowed) and to monitor that position using the enhanced qualitative and quantitative liquidity data then being collected by the FSA. At that time, the FSA's main focus was on HBOS, Alliance & Leicester and Bradford & Bingley but the risk profile of all banks was being monitored. Until the failure of Lehman Brothers on 15 September 2008, the FSA did not foresee the failure of a large systemic global bank.

730 The approach for RBS reflected the FSA's view that RBS's liquidity position was not an immediate risk, as well as the fact that once the crisis period started, there was limited action, in the period from May to October 2008, that could be taken to change a firm's liquidity position.

731 The Lehmans' failure was a game-changing event that triggered a domino effect, with the market rapidly losing confidence in a number of institutions which were perceived to be vulnerable. RBS's overnight wholesale funding gap rapidly worsened until, in early October, it became clear that it would not be able to continue to fund itself. The only feasible contingencies in response to the failure of a bank of its size were for either the government to provide a capital injection or for the Bank of England to provide Emergency Liquidity Assistance (ELA). On 7 October 2008, RBS received ELA from the Bank of England.

3.2.4 Was the supervision of RBS in line with the prevailing practices and approach?

The ARROW risk assessments

732 In summary, although the Review Team has not found all of the individual records of ARROW risk assessment meetings for the Review Period, it has reviewed the Planning and Validation Panel packs, including the discovery plans for the onsite visits and the ARROW letters. The Review Team's conclusion is that for 2005 and 2006 the RBS ARROW risk assessments were carried out in accordance with the prevailing practices and approach. In a narrow sense it is possible to conclude that

the 2007 assessment was also undertaken in accordance with the prevailing practices and approach as set by FSA senior management. However, the Review Team's judgement is that the acquisition of ABN AMRO was of such significance to the risk profile of RBS that in 2007 the FSA should have called into question whether the prevailing practices and approach, including ARROW, were adequate for that acquisition or whether they should have been set aside in favour of a more intensive approach. Moreover, the failure of Northern Rock and the ongoing liquidity pressures within the market should have caused Supervision to reconsider its intention to take a less intensive approach.

733 In following the ARROW risk model and the prevailing supervisory approach, Supervision focused on:

- assessing RBS's management, governance and culture;
- assessing the control functions (Internal Audit, Compliance and Risk Management) and the extent to which the Supervision Team felt able to place reliance on them;
- the characteristics of RBS's customers, products and the markets in which it operated; and
- the extent to which RBS's capital and liquidity position could act as a mitigant to its overall risk profile.

734 Considering each of these areas in turn:

- Management, governance and culture: the importance of clear and effective governance arrangements and the risks associated with the on-going rapid growth of RBS were repeatedly flagged in the ARROW letters (see Section 2 for detailed conclusions).
- Control functions: the ARROW letters also flagged the need for RBS's controls to keep pace with the rapid growth. The Supervision Team devoted significant time to its regular close and continuous meetings with senior representatives of RBS's control functions and, for example, in respect of group Internal Audit, regularly received copies of its group-wide control environment assessments.
- Characteristics of customers, products and markets: one of the ways in which a firm's customers, products and markets were considered was as part of TCF, which was an FSA priority throughout the Review Period. As a result TCF was a principal area of focus within the RBS ARROW risk assessments.
- Capital: the Supervision Team reviewed capital through the SREP and this constituted a significant part of the 2007 ARROW risk assessment. With the benefit of hindsight, the FSA has since recognised that the capital regime at the time had significant deficiencies (see Section 1.1 for detailed conclusions on the FSA's regulation and supervision of capital).

- Liquidity: before the start of the crisis period, the liquidity regime in place for major retail banks such as RBS, the Sterling Stock Regime, was severely flawed, and the supervision of liquidity risk was assigned a low priority by the FSA. As noted in Section 1.2, this was a major policy mistake. As a result, the supervision of liquidity risk in relation to RBS was limited and it was not an area of focus during the ARROW risk assessments (see Section 1.2 for detailed conclusions on the FSA's regulation and supervision of liquidity).

735 As already set out at Section 1.5, the Review Team considered that the FSA's approach to the ABN AMRO bid was inadequate in that the prudential risks were not assessed in sufficient detail at an early stage. The 2007 ARROW Planning Panel decided that the ARROW assessment should proceed, but with a 'focused approach'. However, focusing the approach could never have produced sufficient capacity for the Supervision Team to undertake a detailed assessment of the ABN AMRO bid. In the Review Team's opinion, a dedicated team should have been set up to assess the bid and relieve the stretch on the Supervision Team. That approach would have allowed the FSA better to assess and highlight, to the RBS Board, its view of the key risks associated with a successful bid and the required mitigating actions.[763]

736 The Planning Panel further directed the Supervision Team, particularly if there were more activity with the bid, to proceed with the ARROW but to cut back on the number of areas covered, in favour of looking at some in more detail. In the Review Team's view, the priorities for the Supervision Team should have been set more clearly by Supervision senior management once it became clear that the bid for ABN AMRO would proceed and was likely to be successful.

737 On the basis of this analysis, in the Review Team's opinion, the Supervision Team adequately applied the ARROW risk assessment framework to RBS, in line with the prevailing approach and practices. But the FSA's failure to recognise that the magnitude of the ABN AMRO bid warranted a wholesale reconsideration of the prevailing approach in 2007 was a serious one.

Comparison to the Northern Rock Report findings on supervision

738 In the Review Team's view, the overall position on supervision contrasted significantly with that found in the case of Northern Rock. In the *NR Report*, the FSA's Internal Audit division identified important failings in the day-to-day supervision against the FSA's practices and approach of the time.[764] In reviewing the supervision of RBS, the Review Team did not, in general, find evidence of failings to anything like the same extent. In particular:

- The supervision of Northern Rock was very reliant on close and continuous supervision as no RMP had been issued[765], but only eight close and continuous meetings were held with Northern Rock in the review period (1 January 2005 to 9 August 2007). For RBS, the Supervision Team issued a

763 Since the bids for ABN AMRO, the FSA has changed its approach to acquisitions; for example, the Review Team saw evidence in a more recent proposed major acquisition by a high impact firm that the supervision team led a multi-disciplinary team which undertook detailed work to assess the impact of the deal on the firm.
764 See the *NR Report* Executive Summary for further details.
765 Following the Northern Rock February 2006 ARROW assessment.

RMP and held 119 close and continuous meetings and 511 meetings in total over the Review Period. As seen in Table 2.17, this was higher than the peer group average.

Table 2.17: Supervision meetings[766] – estimates made by staff based on various sources for the five largest UK retail banking groups

	2005 Meetings	2006 Meetings	2007 Meetings	2008 Meetings (to 7 October)	Review period total
RBS close and continuous	**25**	**25**	**33**	**36**	**119**
Peer group average close and continuous	41	59	62	42	204
RBS other	**117**	**57**	**96**	**122**	**392**
Peer group average other	50	44	92	82	268
RBS total	**142**	**82**	**129**	**158**	**511**
Peer group average total	91	103	154	124	472

- The supervision of Northern Rock in the period reviewed was transferred between three different departments and Heads of Department, whereas RBS was supervised within the same department (which included most of its immediate peers), albeit under two different Heads of Department, during the Review Period.

- The Regulatory Period[767] for Northern Rock was increased at its 2006 ARROW Panel to 36 months, whereas the RBS regulatory period was set at 24 months in both the 2005 and 2007 ARROW Panels. The 2007 ARROW assessment was delayed by approximately seven months in order to align the ARROW with the ICAAP assessment. This delay was authorised by the Head of Department.

Overall assessment of the supervision of RBS

739 In the Review Team's opinion, taking all of the above into account, the FSA's supervision of RBS generally met the prevailing practices and approach. There was one notable exception to this finding:

- As explained in Section 1.1, the Supervision Team did not definitively establish RBS's final end-March 2008 capital position. Given the vulnerabilities in the firm's capital planning at this time, the Review Team considered this to be a considerable weakness in the approach taken. However, during the second quarter of 2008, Supervision and FSA senior management addressed the key priority, which was to ensure that the firm was adequately capitalised.

740 As well as this exception, there were a number of points on which, while agreeing that the decision taken was in line with the prevailing practices or, in

766 The table distinguishes between close and continuous meetings i.e. those that were part of a formal schedule of meetings with, for example, the firm's senior management and heads of control functions, from all other meetings.
767 See Glossary of ARROW Terms at the end of this section.

the case of the acquisition of ABN AMRO, that there was no precedent, the Review Team questioned the judgements made during the Review Period.

- The overall approach taken to considering RBS's bid for ABN AMRO involved making a set of significant judgements. The Review Team concluded that the FSA's overall approach was an inadequate response to the major risks inherent in the acquisition. This conclusion is based on the following:

  – As noted in Section 1.5, while in its opinion the decision by the FSA CEO and Chairman not to intervene in the acquisition in September/October 2007 was reasonable, the Review Team considered that supervisory attention, under FSA senior management direction, should have been more actively engaged from April 2007 when the FSA was informed of the consortium's intention to make a bid. This attention should have had particular focus on analysing in detail the key prudential implications of the acquisition for RBS. However, the FSA appeared to have taken limited account of the very substantial uncertainties and risks associated with the acquisition, which were compounded by the limited due diligence that could be performed.

  This led the Review Team further to question:

  – Whether the 2007 ARROW risk assessment and communication to the RBS Board via the ARROW letter of 25 October 2007 was appropriately focused without such analysis, as noted in Section 3.2.3. However, despite this lack of detailed work, the Review Team's opinion was that the key high-level risks, from the FSA's point of view, should have been highlighted to the RBS Board. This should have been either in the 2007 ARROW letter and RMP, or in an immediate follow-up letter.

- Other noteworthy, but less important, judgements were:

  – As noted in Section 1.2, for most of the Review Period, Supervision did not implement guidance in the FSA's Handbook that supervisors should consider monitoring the risk arising from the foreign currency business of banks under the Sterling Stock Regime (SSR). As RBS had a significant reliance on non-sterling denominated wholesale funding, and the limitations of the SSR were well known, the Review Team considered this a weakness in Supervision's approach to the assessment of RBS's liquidity risk.

  – As noted in Section 2.3, whether the Supervision Team had access to all the information needed to reach a conclusion to close the issue on governance within RBS in 2006. Although the Supervision Team made a reasoned decision based on the evidence it had, with the benefit of hindsight and accepting that the prevailing approach to the assessment of governance was under-developed, the Review Team's view was that more should have been done to address concerns that the CEO was dominant and that he received insufficient challenge from the RBS Board. In seeking to do more, greater consideration should have been given to escalating the concern and making use of the FSA's senior management to help address it.

– As noted in Section 2.3.1, in line with common practice, the Supervision Team sent the draft 2005 ARROW letter to the then RBS CEO before finalising it to send to the RBS Board. The RBS CEO proposed changes to the draft letter. The Review Team's view was that Supervision should not have accepted two of the changes. The effect of the first of these may have been to obscure from the RBS Board that the FSA had not always regarded the dialogue with RBS's executive management as constructive. The effect of the second, described in Section 1.3, may have been to reduce the force of the message to the RBS Board about the extent of Supervision's concern about the sufficiency, at the time, of RBS's risk management of its corporate lending portfolio.

– As noted in Section 1.3, the Supervision Team was concerned about the apparent lack of progress by RBS's Board and senior management to engage with macroeconomic stress-testing as an effective risk management tool. It is arguable that the Supervision Team should have done more to ensure that the RBS Board had adequately engaged in stress-testing. Moreover, as the development of RBS's macroeconomic stress-testing had been defined by the Supervision Team as the alternative that justified rejecting the options of specific caps on commercial real estate lending or an increase in RBS's capital requirements, the Review Team considered that Supervision should have revisited the judgement that stress-testing was an effective approach to mitigating commercial property lending risks (although in other respects the Supervision Team's work on stress-testing went beyond what was expected at the time).

3.3 Resources

741 This section assesses whether the level of resource supervising RBS was adequate at the key points of the ARROW assessments, and discusses how the resources on the Supervision Team changed when it merged with the team supervising Barclays in February 2007.

742 RBS operated on a global basis across different financial services sectors including retail and corporate banking, insurance, and wealth management. Across these sectors, RBS operated a multi-brand approach including: The Royal Bank of Scotland; NatWest; Ulster Bank; Direct Line; Churchill; Privilege, Green Flag; Citizens; Charter One; Lombard; Greenwich Capital; and Coutts. It was active in the UK, the US, Europe and Asia Pacific.[768] As a consequence, the challenge of supervising RBS during the Review Period was significant.

743 Overall, the Review Team concluded that, although it was in line with prevailing practice, the approach to resourcing the supervision of the largest banks was fundamentally flawed and, critically, the resources applied were far too low

768 By end-2007, RBS had a presence in over 50 countries and employed 226,400 people. See RBS Annual Results for the year ended 31 December 2007 for further details.

adequately to meet the challenges of supervising RBS.[769] The Supervision Team was seriously under-resourced compared to what the FSA now considers to be appropriate. At the start of the Review Period, it was less than a third of its size in June 2011 and the supporting specialist resource was also about a third of the present size.

Table 2.18: RBS Supervision Team resources over time

	2005 ARROW[770]	2006 ARROW[771]	2007 ARROW[772]	2007 October[773]	2008 October[774]	2011 June
Managers[775]	1	1	0.5	0.5	0.5	3
Team members	6	6.5	4.5	4	6.5	20
Total	**7**	**7.5**	**5**	**4.5**	**7**	**23**

744 As can be seen in Table 2.18, at the start of the Review Period, the RBS Supervision Team comprised one manager and six team members. This was in line with its peers. An additional team member, a technical prudential specialist who concentrated on Basel II implementation, had joined the team on a permanent basis from the Risk Review Department by the time of the 2006 Interim ARROW assessment. The specialist worked on both RBS and Barclays.

745 The Supervision Team acted as the main contact point between the FSA and the firm, and the focal point for coordinating the use of specialists from other areas of the FSA in order to achieve desired supervisory outcomes. Resource available to support the Supervision Team included: market/traded risk, credit and operational risk specialists; capital and liquidity policy specialists; actuaries to support insurance related work; specialists supporting the roll-out of particular FSA priorities, for example the TCF initiative and Basel II implementation; and sector specialists, for example, on financial crime.

746 In 2006, the FSA senior management decided to embark on a strategy of 'fewer, better staff'. This included introducing a more senior grade of manager for the teams that supervised the highest impact firms. This change was in recognition that the complexity of such firms needed skilled and experienced supervisory managers with more clout and impact managing their relationship. For budgetary purposes there was some consequential reduction in staff numbers and increase in management spans of control. The RBS and Barclays Supervision Teams were merged under one, more senior manager with effect from February 2007 with 12 staff.[776] Another perceived benefit of combining teams in this way was to allow a more flexible approach to resources and more peer comparison.

769 As noted in *The Turner Review*, at section 2.7(iii), supervisory resourcing at this level was dramatically lower than that employed in some other countries.
770 As at the Validation Panel on 28 January 2005.
771 As at 5 October 2006, the date of the ARROW letter.
772 As at the Validation Panel on 10 September 2007 – represents half of the combined RBS/Barclays Supervision Team.
773 As at 1 October 2007 – represents half of the combined RBS/Barclays Supervision Team.
774 The end of the Review Period – represents half of the combined RBS/Barclays Supervision Team.
775 The Team Manager of the RBS Supervision Team changed in August 2005.
776 For the purposes of Table 2.18 above, the Review Team has assumed that the Supervision Team was split equally between the firms.

747 In the Review Team's view, while the decision to improve the quality of resource was correct, it had the effect of moving to an even lower resource model and accentuated the problem of having too few staff adequately to supervise large and complex firms such as RBS. Combining the supervision teams for both RBS and Barclays in February 2007, although partly designed to allow more flexible allocation of resources, in practice meant that the Supervision Team became more stretched in places. For example, the manager's time was split between RBS and Barclays, and one team member became responsible for the investment banking activities of both banks. However, this change coincided with the FSA senior management decision to emphasise the focus on principles-based regulation, placing greater reliance on firms and their senior management, and offering firms a 'regulatory dividend'. Therefore, the Supervision Team was able to supervise RBS in line with the FSA's then supervisory philosophy and priorities, but was severely limited in the level of proactive supervision that it could undertake. To compensate, the approach necessitated placing reliance on the firm where appropriate.

748 Between the second half of 2007 and end-April 2008, the Supervision Team numbers reduced because of the refocusing of resources to deal with the ongoing wider market crisis. This reduction in resource took place at a time of increased supervisory intensity, with both the RBS and Barclays bids for ABN AMRO as well as the Barclays ARROW assessment. The expectation by Supervision and FSA senior management that the Supervision Team would be able to resource the assessment of the ABN AMRO acquisition on top of its day-to-day duties exacerbated the pressure on the Supervision Team. Following the completion of the ABN AMRO acquisition, with the financial crisis on-going, the level of supervisory stretch became acute. By October 2007, the resource on the Supervision Team had dropped to four and a half as Team members were deployed to work on the FSA's response to the ongoing market crisis.

749 As a result of the Supervisory Enhancement Programme (SEP)[777], towards the end of the Review Period, the resources increased to seven, which included an additional technical specialist to supervise GBM and Barclays Capital. As a result of further changes to the resourcing model for supervision to reflect the more intensive and intrusive approach the Supervision Team subsequently increased to 23 (see Table 2.18).

750 Additional specialist resource was used less in the supervision of RBS than on peers during the Review Period, but the Review Team saw no indication that requests for such resources by the Supervision Team were not met. In general, the degree to which specialist resource was used on firms depended on many factors, including: the nature of the issues identified; the resource within the Supervision Team and its priorities; and the availability of the specialist resource. As noted earlier, the Supervision Team had technical expertise assigned to the team on a permanent basis and so, to an extent, had less need for outside specialist support.

751 In terms of the quality of the Supervision Team, Supervision senior management confirmed during meetings with the Review Team that the Supervision Team, while stretched, was considered a strong and experienced team throughout.

777 Which included implementing the *NR Report* recommendations.

752 Throughout the Review Period, the Supervision Team was seriously under-resourced compared to what the FSA now considers appropriate. At the start of the Review Period, the RBS Supervision Team was less than one-third of its current size and it only moderately increased until the implementation of the FSA's Supervisory Enhancement Programme.

3.4 Supervision of Global Banking and Markets Division

753 As explained in Section 1.3, concern about poor asset quality was one of the factors in RBS's failure. Many of those assets were originated within the GBM business.[778] Detailed consideration of the assets of GBM and their impact on RBS has already been covered in Section 1. In order to provide an example of how the supervisory approach was carried out in practice, the Review Team looked in more detail at the supervision of GBM during the Review Period. This section considers:

- in 3.4.1, the FSA's approach to the supervision of GBM;
- in 3.4.2, key supervisory findings; and
- in 3.4.3, whether the supervision of GBM was in line with the prevailing practices and approach.

754 What this section explains is that there was very limited supervisory resource applied to GBM (at one point just one person, who also had responsibility for Barclays Capital) although market risk specialists supported the Supervision Team with visits and Capital Adequacy Directive (CAD) model assessments. The prevailing approach was to look at systems and controls rather than focus on underlying business risks.

3.4.1 Supervisory approach taken to GBM

755 As already noted in Section 3.3, the supervisory approach to GBM was constrained by the very limited resources applied to it during the Review Period. Since then, significant increases in the resourcing of the Supervision Team have resulted in a greater focus on GBM.

756 As noted in *The Turner Review* and in Sections 1.1 and 1.4, the capital regime for trading books led supervisors and specialists to focus on market value-at-risk (VaR) models and internal ratings based (IRB) credit risk models and their performance rather than on underlying balance sheet composition and asset quality. Although the focus on models did provide insight into RBS's portfolios and capital management, with hindsight that focus appears to have been too narrow and at the expense of examining risk in other ways.

757 In the Review Team's opinion, the factors in the two preceding paragraphs limited the Supervision Team's ability to carry out a detailed assessment of the risks associated with the rapid growth of GBM within the Review Period.

778 When RBS acquired ABN AMRO in late 2007, its exposures in many of these asset classes increased further (see Section 1.4).

758 At the start of the Review Period, based on the January 2005 risk assessment and discussions with US regulators in April 2005, the Supervision Team concluded that the controls within GBM had improved since visits in 2004. As time went on the Supervision Team concluded that there had been improvements in the wider group's control functions and, as a result, felt able to place more reliance than before on RBS's own controls to identify and mitigate risks in GBM.

759 These conclusions set the foundation for the supervisory approach to GBM that was adopted for the rest of the Review Period prior to the start of the crisis. The main elements of that approach, as reflected in the GBM RMP in the 2005, 2006 and 2007 ARROW letters, were:

- To rely on senior management to ensure that controls were keeping pace with the growth and complexity of the business. The Supervision Team received regular updates through close and continuous meetings with key members of GBM senior management in which emerging risks and RBS's response to them were discussed.

- To seek evidence that controls remained adequate where a new acquisition or joint venture was entered into, such as with Sempra Energy[779] (which was integrated into the GBM control and reporting framework in the US and UK), by requiring reviews by RBS's risk management and group internal audit functions.

- To receive copies of the quarterly reports produced by RBS's group internal audit summarising its view of the status of controls within each of the business units (including GBM); and ad hoc reports from other control functions.

- To meet Deloitte, RBS's external auditor, annually to discuss the key findings of its statutory audit and other significant work, for example the Sarbanes Oxley requirements. Following the SEP, meeting the external auditors at least annually became a requirement from October 2008.

- To establish regular dialogue with the US regulators of GBM's US subsidiary, RBS Greenwich Capital (including receiving copies of their periodic supervision visit reports).

- To carry out periodic visits to the US to gain a more detailed understanding of RBS Greenwich Capital and the adequacy of its controls (visits took place in: June 2005, supported by traded risk specialists, to review market risk management, product control and the business unit that provided derivative based solutions to hedge fund clients; February 2007 to consider regional governance and business developments including meeting the senior management of Sempra Energy; and March 2008 to obtain an update on the US operations, including the implementation of new governance structures).

- Regularly to monitor changes to VaR models designed to assess the market risk exposures within both RBS Greenwich Capital and GBM's trading

779 A proposed Joint Venture partner with which RBS later set up RBS Sempra Commodities LLP.

activities in London. A considerable amount of work was conducted by Supervision on VaR models used under the market risk capital regime (see Section 1.1.4 and Section 1.4.3).

760 Each ARROW letter highlighted the risks associated with RBS's growth (much of which was within GBM) and, in particular, the risk of management stretch. The need to clarify and strengthen the governance and control framework in the US, in order to keep pace with the expansion, was also emphasised.

761 The approach to the supervision of GBM also reflected:

- The resource available. As described in Section 3.3, one team member worked on GBM until the merger of the Supervision Teams in February 2007, and then one team member covered the investment banking activities of both RBS and Barclays. That associate left the FSA in September 2007 and was not replaced until end-April 2008 and, as a result, another member of the Supervision Team, experienced in supervising investment banks, covered GBM in addition to existing responsibilities. This was clearly inadequate.
- The very significant workload of the Supervision Team in 2007 including RBS's and Barclays' bids for ABN AMRO; ARROW risk assessments; TCF work; implementation of Basel II; the setting of individual capital guidance; and RBS's proposed investment in Sempra.

762 From the start of the crisis period in August 2007 onwards, the planned supervisory approach was increasingly overtaken by the need to respond to the extreme events that were then unfolding.

3.4.2 Key supervisory findings on GBM

763 The following bullet points set out the key issues relating to GBM that Supervision identified during the Review Period:

- In relation to GBM's US business, Supervision identified: the need for the management and control infrastructure to keep pace with the size and complexity of RBS's US activities (not only in GBM but also in Citizens Financial Group, as noted in the 2005 ARROW and 2006 Interim ARROW); and the need for a regional governance structure appropriate to the continued growth and complexity of RBS's US operations.
- The Supervision Team included actions in the 2007 GBM RMP, following the ARROW assessment, relating to: the governance of the US activities; business growth and management stretch; valuation of illiquid assets; the integration of the commodities joint venture with Sempra Energy; and conflicts of interest.
- Supervision noted the decisions to appoint a US Chief Risk Officer (in 2006) and to set up a US regional governance structure, including the appointment of a regional CEO (in 2007). Supervision concluded in 2007 that RBS had mitigated many of the FSA's concerns about the management of operational and regulatory risk in the US. The Supervision Team's view was updated in

early 2008 when it carried out a visit to RBS's US operations and concluded that there had been clear progress with establishing the governance structure.

- The Supervision Team's work on credit trading exposures (asset-backed securities, collateralised debt obligations, monolines and leveraged finance), which ultimately led to significant losses, formed an important part of the key supervisory findings in respect of GBM (see Section 1.4).

3.4.3 Was the supervision of GBM in line with the prevailing practices and approach?

764 Based on the details set out in Sections 3.4.1 and 3.4.2, the Review Team concluded that, overall, the supervision of GBM was in line with the prevailing practices and approach. This conclusion was informed by the following:

- Supervision correctly identified within the 2005 ARROW letter that a key risk for RBS was the amount and concentration of its corporate lending, and its commercial real estate portfolio in particular. While this issue applied to the wider RBS group and not just GBM, it remained an important factor in the supervision of the latter. As noted in Section 1.3, Supervision chose not to intervene directly to limit RBS's commercial property exposure nor to increase its capital requirements, but tried instead to ensure that the RBS Board adequately considered its risk appetite and developed a stress-testing approach that considered the impact of a sustained economic slowdown. As noted in Section 1.3, the Review Team concluded that, overall, the supervision of RBS in relation to stress-testing met prevailing practices, but it is arguable that the Supervision Team should have done more to try to ensure that the RBS Board had adequately engaged in stress-testing.

- The level of supervisory resource applied to GBM was broadly in line with its relative impact score, under the ARROW framework, when compared to RBS's other significant business units. With hindsight the FSA has concluded that the level of supervision resource applied to RBS was clearly inadequate.

- Given the level of dedicated FSA resource and the degree of reliance on RBS's senior management considered appropriate at the time, the work carried out by Supervision, in respect of the market risk capital regime that covered the credit trading activities of GBM, met the prevailing practices (see Sections 1.1 and 1.4).

- Similarly, the reliance on RBS's senior management and control functions; annual meetings with external auditors; the periodic visits to, and meetings with, US regulators; and the periodic visits to the relevant business units supported by traded risk specialists, were in line with the general approach set out in Section 3.1.

765 However, with hindsight it is now clear that the prevailing practices and approach applied in relation to the supervision of GBM were inadequate fully to assess the risks posed by that business.

3.5 Improvements made to the FSA's supervisory approach and resourcing[780]

Supervisory approach

766 Since the publication of the *NR Report*, the FSA's supervisory approach for high impact firms has changed significantly, including through the implementation of the SEP.[781] The more proactive, intensive and intrusive manner, and 'outcomes focused' style of supervision[782], has been enabled by significantly increased resources, in particular in the numbers of specialists. Many of the features of the new supervisory approach to the assessment of capital adequacy and liquidity have already been set out in Sections 1.1 and 1.2.

767 The SEP also introduced minimum requirements for the type and frequency of MI which supervisors should receive from firms and the frequency of close and continuous meetings with firms' senior management, heads of control functions and external auditors. For example, supervisors of high impact firms now meet the firm's external auditors at least annually to hear, at first hand, issues that the auditors have identified and ensure that the auditors are aware of the FSA's views of relevant risks and issues.[783]

768 Supervision of high impact firms now places much greater emphasis on the FSA reaching its own judgement, through detailed investigation, of the risk in firms' strategies and business models, governance (including the size and composition of the board and the challenge it provides), risk management, capital and liquidity. Supervision of the largest high impact firms now requires a rolling in-depth review of these key risk areas through the application of the Core Prudential Programme (CPP) (see Box 2.7). This approach is a significant change in the way the FSA interacts with the largest banks and has been made possible, at least in part, by a significant increase in the number of technical specialists available to support Supervision within the FSA's Risk Specialist Division (see section on Resourcing, paragraphs 775–777).

769 There is now considerably more engagement by FSA senior management, including the CEO and managing directors, with the senior executives, with individual non-executive directors (NEDs) (in particular the chairs of the risk, audit and remuneration committees and the senior independent directors) and with the boards of high impact firms. This has enabled the FSA to gain a better understanding of firms' management and governance and, where necessary, to provide challenge to any aspects that seem likely to give rise to inappropriate risks.

780 In addition, Sections 1.1 – 1.6 set out the details of other changes already made which are relevant to those sections. See also Appendix 2D *Summary of the main changes prudential policy*.

781 See the FSA Press Release dated 26 March 2008 which set out details of the SEP, www.fsa.gov.uk/pages/Library/Communication/PR/2008/028.shtml.

782 Speech by FSA CEO, *Delivering intensive supervision and credible deterrence*, 12 March 2009, www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0312_hs.shtml.

783 More recently, the FSA has, in conjunction with the Financial Reporting Council (FRC) published a joint discussion paper and feedback statement regarding the interaction between the FSA and auditors (see FSA Press Release found on the FSA website: www.fsa.gov.uk/pages/Library/Communication/PR/2011/028.shtml). Since then, a draft code of practice has been developed to enhance dialogue between auditors and supervisors (see the FSA website: www.fsa.gov.uk/pubs/guidance/gc11_05.pdf). Dialogue has increased, as has the use of Section 166 skilled persons reports. In addition, formal cooperation arrangements between the FSA and the FRC's Audit Inspection Unit have been set out in a memorandum of understanding.

770 The FSA has also adopted a more formal and rigorous approach to the assessment of those in, or applying for, Significant Influence Functions, which provides opportunities to assess: the quality of executive capability and experience, for example in respect of new business or risk areas; the risks inherent in the leadership and management style of potential chief executives and executive management more generally; and the degree of independent challenge provided by NEDs.

771 The approach to assessing governance and the Boards of firms has been enhanced. For example, the CPP module on governance assesses the design and effectiveness of the structure, systems and processes. In doing so, the size of the board, its composition and ways of working are considered alongside the size and complexity of the firm. The CPP also assesses reporting lines and information provided to the board as well as the terms of reference for the board and its committees. A further development has involved supervisors and specialists attending board meetings as observers to look at culture, behaviours, interactions with the executive and the level of challenge from the NEDs. More generally, in order to assess in more depth a firm's governance, board effectiveness and the quality of senior management, the FSA now also makes greater use of reports by skilled persons under Section 166 of the Financial Services and Markets Act 2000.

772 As also discussed in Section 2.2, the culture of a firm has a significant impact on the way it operates. The FSA has also been developing its approach to assessing culture[784] which has a significant impact on a firm's strategy, risk appetite and approach to compliance. The objective is to identify and intervene where a poor culture and associated behaviours might lead to poor regulatory outcomes. However, the FSA remains cautious about believing that there are rigorous mechanisms that can accurately assess a firm's culture and its implications.

773 As discussed in Section 2.2, the way in which a firm remunerates its executives may make it rational for them to focus on increasing revenue, profit, assets and leverage rather than on capital, liquidity and asset quality. The FSA's Remuneration Code[785] now requires firms to ensure that their remuneration policies are consistent with sound and effective risk management, do not encourage risk-taking that exceeds the firm's level of tolerated risk[786], and are in line with the firm's long-term interests.[787] The Remuneration Code includes guidance that, in designing their long-term incentive plans, firms should take account of the potential for any links to earnings per share that create an incentive to increase leverage to the detriment of the longer-term health of the firm.[788]

774 These changes represent a radical change aimed to ensure sufficient focus on these key risks posed by high impact firms. Before the crisis, the supervisory approach failed to ensure that focus.

784 See the speeches by the FSA CEO, *Should regulators judge culture*, 17 June 2010, www.fsa.gov.uk/pages/Library/Communication/PR/2010/101.shtml and *Values and Trust*, 4 Oct 2010, www.fsa.gov.uk/pages/Library/Communication/Speeches/2010/1004_hs.shtml.
785 See Chapter 19A of the Senior Management Arrangements, Systems and Controls (SYSC) Sourcebook of the FSA Handbook, http://fsahandbook.info/FSA/html/handbook/SYSC/19A.
786 SYSC 19A.3.7R.
787 SYSC 19A.3.8R.
788 SYSC 19A.3.24G.

Resourcing

775 In terms of resources, Table 2.18 shows that, as at end-June 2011, the Supervision Team for RBS alone (having de-merged from the Barclays Team) comprised three managers and 20 team members, which is in line with its peers.

776 In addition, front-line supervisors are now supported by greatly increased specialist resources. Most notably, within the FSA's Risk Specialists Division, specialist resource has increased from 87 at the end of the Review Period to 253[789] as at end-June 2011. As a result, the total resource dedicated to key prudential risk assessment is now some multiples higher than was available before the crisis. By way of illustration, a team of over 50 supervisors and specialists assessed RBS's capital, liquidity, asset quality, business model, and governance arrangements under the FSA's Core Prudential Programme, over the period July 2010 to March 2011.

777 These resourcing changes are aimed to ensure that Supervision: has a deeper understanding of the significant businesses within the largest high impact firms, such as GBM within RBS; provides more effective challenge supported by rigorous business model analysis, in particular where there are business plan risks associated with apparently very profitable and fast-growing businesses; and makes judgements on what level of risk is acceptable and implements the resulting risk mitigation actions.

Box 2.7

The Core Prudential Programme (CPP)

The FSA's Core Prudential Programme (CPP) provides intensive supervision for the largest high impact firms in the banking sector. Its objective is to identify the life-threatening issues for systemically significant deposit-takers and to intervene before these issues crystallise. This approach reflects the FSA's desire to minimise the probability of failure or near failure of a major firm.

Implementation of the CPP began in Q1 2010. Over a two-year cycle, the UK's eight largest deposit-takers – Barclays, Co-Op, HSBC, Lloyds, Nationwide, RBS, Santander UK and Standard Chartered – will be assessed against each of the CPP's five modules. These modules and their key outcomes are:

1) Business model – a sustainable business model which enables a firm to generate a return on capital within an acceptable funding and risk appetite, over a three to five year period.

2) Risk management – a risk management framework which ensures that risks are being managed within agreed appetite levels.

3) Governance – effective governance that challenges management, sets the firm's strategic plan, establishes risk appetite levels and monitors adherence to them.

4) Capital – sufficient capital of appropriate quality to absorb downside stress and remain above minimum regulatory requirements.

789 Both of these figures exclude support staff but are inclusive of life and non-life actuaries which transferred to Risk Specialists Division (previously Prudential Risk Division) from Retail Firms Division in Q2 2010.

5) Liquidity – sufficient liquidity to be able to absorb stress events, and a funding model and liquidity management that are sound.

For each module, the aim is that supervisors have an in-depth understanding of the key risks and put in place appropriate tools for their ongoing monitoring. For example, the capital module includes monitoring a firm's capital position over a time horizon of three to five years through a severe stress. On governance, supervisors use case studies, interviews and analysis of management information to assess governance in action and challenge firms on their board and management effectiveness.

One of the distinguishing features of the CPP is that it involves an 'assurance' approach in which supervisors, supported by FSA specialists, undertake a rolling programme of defined work in key areas that comprise the prudential risk profile of a firm, irrespective of its current level of risk. In this way, supervisors can gain a greater level of assurance about the current and future risk profile of a firm, providing a basis for them to intervene earlier to address key risks before they crystallise.

For firms, the CPP means more analysis and validation of the information that they provide to the FSA, more assessment against their peers and against best practice in the sector, and earlier intervention by the FSA when required, based on judgements backed by an in-depth assessment of their business.

Conclusions on the FSA's general approach to supervision

The FSA's approach to supervision

- With hindsight, the FSA's approach to the supervision of high impact firms during the Review Period, before the market crisis, was deficient. The ARROW framework led to an assessment of risks that was often too high-level to identify areas for further, more detailed work, particularly in the absence of clear indications of problems.

- A much greater focus should have been applied to understanding and assessing liquidity. With the benefit of hindsight there should also have been a greater focus on capital and asset quality (see Section 1 for the Review Team's conclusions in relation to the supervision of these areas).

- The reliance on firms' senior management and board oversight was a further reason why Supervision did not sufficiently assess and challenge key business decisions, business model risks, or prudential risks.

- The integrated approach to supervision meant that a significant amount of Supervision management time was spent on conduct issues, for example Treating Customers Fairly (TCF), at a time when the prudential risks faced by firms were increasing. This approach also failed adequately to foster the development of skills specifically focused on the prudential risks of capital, asset quality, balance sheet composition and liquidity. The centralised monitoring of periodic regulatory returns meant there was a lack of day-to-day engagement by Supervision with these prudential risks.

Major elements of the supervision of RBS

- The FSA's supervision of RBS in the pre-crisis period was flawed because the overall approach and philosophy were deficient. However, unlike in the case of Northern Rock, the Review Team found that the supervision of RBS generally met the prevailing practices and approach with one noteworthy exception relating to not confirming the capital position of the firm at end-March 2008.

- The decisions to apply a 'regulatory dividend' in both 2006 and 2007 were in line with the prevailing approach and practices, although, the FSA now believes that the regulatory dividend was a flawed concept and it is no longer part of the FSA's approach to supervision. As it turned out, while the intention was to adopt a less intensive approach following the 2007 ARROW assessment, the financial crisis worsened and the Supervision Team became increasingly involved in assessing the impact on RBS and so the engagement with the firm intensified considerably.

- The FSA's supervisory approach, when applied to RBS, one of the largest high impact firms, placed too much reliance on the firm's senior management and led to insufficient challenge of key business areas and of the progress being made on key Risk Mitigation Programme (RMP) issues.

- Although the Supervision Team generally followed the prevailing practices and approach, the Review Team's judgement is that the acquisition of ABN AMRO was of such significance to the risk profile of RBS that the FSA should have called into question, in 2007, whether the prevailing practices and approach were adequate for this acquisition or whether they should have been set aside in favour of a more intensive approach both in terms of the assessment of the bid and the 2007 ARROW assessment. Moreover, the failure of Northern Rock and the increasing liquidity pressures within the market should have caused Supervision to reconsider its intention to take a less intensive approach with RBS in 2007.

Resources applied to the supervision of RBS

- The RBS Supervision Team comprised experienced banking supervisors and was viewed by successive Supervision senior management as a strong team throughout the Review Period, despite changes of membership.

- Although it was in line with prevailing practice, the approach to supervisory resource applied to the largest banks was fundamentally flawed and, critically, the resources applied were far too low adequately to meet the challenges of supervising RBS. The Supervision Team was seriously under-resourced compared to what we now consider to be appropriate.

- The focus on FSA priorities, such as Basel II and TCF, and the amount of reactive work generated by RBS reduced the level of resource available for proactive risk assessment by the Supervision Team and resulted in considerable stretch within the Team, particularly from early 2007 to the end of the Review Period. In particular, the ABN AMRO acquisition took up a significant amount of the Supervision Team's time, but on matters that in retrospect did not address the key prudential issues. In the Review Team's opinion, additional, ideally dedicated, resource should have been made available to assess the bid in detail.

The FSA's supervision of GBM

- RBS grew rapidly during the Review Period, with the fastest growth being in GBM (see Section 1.3.1). The factors set out above and deficiencies in the regulatory regime (such as the market risk capital framework), combined with the FSA's general approach of placing reliance on senior management and the firm's own control framework, meant that there was little fundamental analysis of inventory within the trading book prior to the onset of market disruption in August 2007, or of balance sheet composition and asset quality more generally during the Review Period.

Lessons already identified where actions have been taken

- Following the *NR Report* and *The Turner Review*, the FSA has significantly enhanced its approach to the supervision of high impact firms. Considerable progress has been made following the completion of the Supervisory Enhancement Programme (SEP) and the improvements in the capital and liquidity standards both made, and in train, in preparation for Basel III. In addition, the implementation of the Core Prudential Programme (CPP) has fundamentally changed the approach to the supervision of the largest high impact firms.

- Supervisors needed a mechanism to ensure that they received adequate management information (MI) regularly from high impact firms. The SEP has introduced minimum requirements for the MI that high impact firms must provide to Supervision Teams, including board MI packs on a quarterly basis.

- Supervisors needed to undertake a detailed analysis, assessment and challenge of a firm's business strategy to confirm that all risks had been identified and adequate mitigation put in place. Supervisors are now required to do this, including by means of a formal, annual strategy meeting. It is also part of the CPP for the largest high impact firms.

- Where the boards of high impact firms could not demonstrate that they have adequately considered risks when setting their strategy, Supervisors needed to subject the firm to additional supervisory scrutiny and challenge. Supervisors are now required to do this and it is also part of the CPP for the largest high impact firms.

- More detailed supervisory scrutiny of management, governance and culture issues was required. The CPP now being implemented for the largest high impact banks includes this.

- The FSA's Remuneration Code now requires firms to ensure that their remuneration policies are consistent with sound and effective risk management, do not encourage risk-taking that exceeds the firm's level of tolerated risk, and are in line with the firm's long-term interests. The Remuneration Code includes guidance that, in designing their long-term incentive plans, firms should take account of the potential for any links to earnings per share to create an incentive to increase leverage to the detriment of the longer-term health of the firm.

- The FSA has recognised the need to assess culture at firms more effectively. The ARROW process has been updated to reflect the FSA's most recent thinking on the assessment of firm culture. The enhanced guidance produced is intended to lead to greater consistency in the FSA's identification, assessment and mitigation of culture related issues. This approach has also been incorporated into the outline supervisory approaches for both the Prudential Regulation Authority and the Financial Conduct Authority.

- A more systematic approach to assessing the quality of the FSA's relationship with firms and the risks that may flow from it was required. The FSA has introduced this approach through the SEP and it is now part of ARROW assessments and the CPP Governance module.

- Supervisors needed to take more intrusive and robust steps to assess the level and consistency of challenge provided by a board and senior management to a firm's executive directors. It is part of the CPP being implemented for the largest banks.

- It is important for good governance and effective board oversight that a firm's risk and internal audit functions can report directly to the board or its sub-committees, independently of executive management. Where this is not the case, as with RBS during the Review Period, the firm should be subject to additional FSA scrutiny and challenge. Supervisors now review and, where necessary, challenge firms on their reporting lines for Internal Audit and Risk as part of the FSA's ARROW risk assessments of high impact firms. We note that the Walker Review[790] also made a series of important recommendations concerning the governance of risk.

- Supervisors needed to have careful regard to the quality and experience of a firm's senior management. The FSA's current standard requires competence based interviews for those applying for approval as Significant Influence Function holders in high impact firms.
- The FSA needed to pay particular attention to applications for Significant Influence Function approval from weaker high impact firms, which might find it more challenging to attract the best people from the limited pool of outstanding talent to fill their front office and control functions. This additional scrutiny is now part of the new regulatory approach to the use of competence based interviews for those applying for approval as Significant Influence Function holders in high impact firms.
- Given the level of work generated by one of the UK's largest high impact firms, additional dedicated resources should have been made available, in the form of a multi-disciplinary team, in order adequately to respond to major events (including major corporate transactions), for example, the bid for ABN AMRO. It is now the practice within Supervision to set up such teams to respond to major events of this nature.
- The FSA has radically changed its resourcing model for the supervision of the largest high impact firms, greatly increasing both the numbers of supervisors directly responsible for firm supervision and the number of specialists available to support those supervisors to deliver the FSA's more intrusive and intensive approach under the CPP.

Recommendations for further change

- The CPP has been developed and is being implemented. It is important that the FSA, and subsequently the Prudential Regulation Authority and Financial Conduct Authority, ensure that all the key learnings from the CPP are used to inform their new supervisory approaches.

790 *A review of corporate governance in UK banks and other financial industry entities*, 26 November 2009

Glossary of ARROW Terms

Term	Definition
High impact firm	A category of firm where crystallised risk would have the greatest impact on the FSA's statutory objectives. The population of high impact firms was agreed by the FSA's Executive Committee (ExCo). Only high impact firms were subject to close and continuous supervision.
Regulatory period	The period of time between two consecutive ARROW risk assessments. The Regulatory Period varied in length from one to four years, although this was restricted to a maximum of two years for high impact firms.[791] The length depended on the risk profile of the firm and the time for which Supervision believed the ARROW risk assessment would remain valid. In essence, a long Regulatory Period would denote a view of a firm presenting less risk (based on an assessment of the impact and the likelihood of risks crystallising).
ARROW risk assessment	A risk assessment of the probability of the business and control risks (as defined within the ARROW risk model) crystallising within a firm. The Supervision Team had discretion to investigate any areas and issues during the assessment to the extent they saw fit, subject to challenge by those validating the risk assessment (see ARROW Panel below). ARROW II was rolled out from March 2006 and all associated changes were implemented by June 2007. The changes made from ARROW I were designed: more closely to align the firm, thematic and internal frameworks with ARROW; to implement better controls over the supervisory process; to help ensure the application of a consistent approach; and to make better use of thematic work and sector intelligence. ARROW II also aimed to improve communication to firms.
ARROW Panel	A committee of the FSA's staff convened to validate a firm's risk assessment, either at the Planning or Final Validation stage. For high impact firms, the panel would be chaired by the relevant FSA director, or a head of department and contain independent members from other supervision and specialist departments (see below for the differences between Planning and Final Validation Panels).
Planning Panel	The process by which the scope of a risk assessment and discovery plan was challenged and approved. Planning validation took place after the discovery plan was produced and before the risk assessment visit to the firm began. The aim of planning validation was to ensure that the structure of the risk assessment and the scope of the discovery plan were appropriate before starting the visit. It provided an opportunity for supervisors to receive senior and expert input to their assessment at an early stage.
Final Validation Panel	Final Validation Panels occurred after discovery (i.e. the visits to the firm) and evaluation and before sending the ARROW letter to the firm. Their aim was to ensure that the ARROW risk framework was applied consistently, to provide challenge, and to approve the conclusions of the discovery work, the ARROW letter and the appendices (including the Risk Mitigation Programme (RMP)). All high impact firm risk assessments were subject to final validation. The members of the Final Validation Panel were, as far as possible, consistent with those of the Planning Panel.

791 Following the *NR Report*, the Supervisory Enhancement Programme (SEP) set the Regulatory Period for high impact firms to a maximum of two years. See the FSA Press Release dated 26 March 2008 which set out details of the SEP, www.fsa.gov.uk/pages/Library/Communication/PR/2008/028.shtml

<table>
<tr><th>Term</th><th>Definition</th></tr>
<tr><td>ARROW letter</td><td>The FSA communicated the results of its risk assessment to the firm in an ARROW letter. This set out the FSA's view of the risks that the firm posed and was accompanied by the RMP that detailed the issues identified and the actions to be taken by the firm (and the FSA) to address those issues.</td></tr>
<tr><td>Risk Mitigation Programme</td><td>The ARROW risk assessment usually led to a programme of further actions to address specific risks during the Regulatory Period.
The RMP would set out:
• the detail of each issue;
• the intended outcome that Supervision sought for each issue;
• the action to be taken to achieve the intended outcome, specifying whether the action was to be taken by the FSA or the firm; and
• the timetable for the action.</td></tr>
<tr><td>Interim Assessment</td><td>Between full ARROW risk assessments the FSA could elect to conduct an Interim Assessment or 'stock take' to update the firm on its view of the firm's risks, as well as its progress in complying with its RMP. In practice, for a high impact firm with a 24 month Regulatory Period, this would usually take place after 12 months.</td></tr>
<tr><td>Supervision Team</td><td>The group of staff, led by a relationship manager, responsible for the direct supervision of a particular firm/group. The Supervision Team acted as the main contact point between the FSA and the firm and the focal point for coordinating the use of specialists from other areas of the FSA in order to achieve supervisory outcomes.</td></tr>
<tr><td>Supervision</td><td>The relevant supervision division responsible for the direct supervision of a particular firm/group up to and including the relevant head of department and/or the divisional Director.</td></tr>
<tr><td>Capital assessment</td><td>The framework for assessing the capital adequacy for regulated entities. For banks and investment firms, this was the supervisory review and evaluation process (SREP) under the Capital Requirements Directive (CRD). The capital assessment undertaken was part of the overall risk assessment under ARROW and conclusions and issues arising from the capital assessment were taken into consideration in the wider ARROW assessment (and vice versa). Where feasible, capital assessments were undertaken concurrently with the wider ARROW assessment.[792]</td></tr>
</table>

792 See Section 1.1, for further details on the FSA's capital assessment process.

Appendix 2A
Summary of recommendations

778 The two tables in this Appendix consolidate the lessons for the FSA's regulatory framework and supervision identified in Part 2 from the review of the regulation of RBS. Unless otherwise stated, they apply to the regulation and supervision of high impact firms.

779 Table 1 presents the lessons which, in the Review Team's judgement, have previously been identified – generally either in the *Northern Rock Report* ('*NR Report*') or *The Turner Review* – and where actions in response to the need for change are underway or have already been completed.

780 Table 2 presents the Review Team's recommendations for further change, beyond what has previously been identified. The executive management of the FSA has agreed that these further recommendations will be taken into account in the design, in collaboration with the Bank of England, of the Prudential Regulation Authority and, as appropriate, of the Financial Conduct Authority.

Table 1: Lessons which have been previously identified

	Area	Relevant section in the Report	Lesson: extract from text in relevant section	References in other sources
1	Capital	1.1	Recent reforms to the prudential framework will, once implemented, significantly increase the quality and quantity of capital that firms must hold. In the meantime the FSA has increased its focus on core capital and introduced capital benchmarks of 8% tier 1 and 4% core capital after stress.	*The Turner Review* – Recommendation on Capital Adequacy: Higher quantity and quality of capital.
2		1.1	A fundamental review of the market risk capital regime (including reliance on VaR measures) was required. This was recommended by *The Turner Review*, and is being undertaken by the Basel Committee. In the meantime, the Basel Committee has agreed a package of measures, including stressed VaR and enhancements to the capture of credit risk within the trading book, which is being implemented in the European Union. These changes have resulted in increases in capital requirements of at least three to four times for some categories of trading book assets.	*The Turner Review* – Recommendation on Capital Adequacy: Trading book capital.
3		1.1	Weaknesses in the FSA's processing and analysis of regulatory returns were previously described in the *NR Report*. Subsequently a new returns system has been introduced by the FSA.	*NR Report* – Recommendation 4 (in particular 4.3): FSA to improve its use of information and intelligence in its supervision.
4	Liquidity	1.2	The liquidity regime in place throughout the Review Period was inadequate and needed to be improved. The regime has subsequently been the subject of major policy and supervisory work domestically, for example through the introduction of the FSA's new liquidity regime, and internationally in the Basel III standards.	*NR Report* – Recommendation 3 (in particular 3.1 to 3.5): FSA to increase its focus on prudential supervision, including liquidity and stress-testing.
5	Asset quality	1.3	The FSA's supervisory approach during the Review Period did not focus sufficiently on analysis of firms' underlying assets and off balance sheet exposures. Work on asset quality now forms a key element of the FSA's supervision of the largest high impact firms.	*The Turner Review* – Recommendation on FSA supervisory approach: Further intensification of change.
6		1.3	The FSA's stress-testing regime in place throughout the Review Period was inadequate and needed to be improved. Following the crisis and the *NR Report*, significant improvements have been made to the FSA's approach to the assessment of firms' underlying asset quality, including the impact of stressed scenarios.	*NR Report* – Recommendation 3 (in particular 3.6): FSA to increase its focus on prudential supervision, including liquidity and stress-testing.

Table 1: Lessons which have been previously identified

	Area	Relevant section in the Report	Lesson: extract from text in relevant section	References in other sources
7	Losses in credit trading	1.4	*Systemic approach*: there has been a fundamental shift to greatly enhanced analysis over the last two years, now formalised in the Interim Financial Policy Committee (and, at European and global level, the European Systemic Risk Board and Financial Stability Board). There is now a continuous process of attempting to link system-wide issues to the supervisory priorities at a firm-specific level, and a determination as far as possible to avoid group think, which made the FSA (and the rest of the policy world) overly confident in financial innovation and market efficiency before the crisis. The UK regulatory reform programme should ensure that greater attention is paid to system-wide risks in future. Work is also underway in international policy fora.	*The Turner Review* – Recommendation macro-prudential analysis within UK, at European level, and globally.
8		1.4	*Regulation*: refer to lesson 2, on trading book capital.	*The Turner Review* – Recommendation for fundamental review of trading book capital regime.
9		1.4	*Supervision*: refer to lesson 5, on asset quality. In particular, the FSA now applies greater resources to investment banking, trading activities and valuation issues within major banking groups.	Internal FSA process and practice: Core Prudential Programme (CPP).
10	ABN AMRO acquisition	1.5	The implications of the ABN AMRO transaction, including the impact on the capital and liquidity position of RBS, should have been more fully tested by Supervision before a public offer was made. The FSA has since modified its approach to acquisitions to ensure that it is considerably more intrusive and challenging in its handling of major corporate takeovers.	Internal FSA process and practice.
11	Supervisory approach, priorities and resources	3	Following the *NR Report* and *The Turner Review*, the FSA has significantly enhanced its approach to the supervision of high impact firms. Considerable progress has been made with this following the completion of the Supervisory Enhancement Programme (SEP) and the improvements in the capital and liquidity standards both made, and in train, in preparation for Basel III. In addition, the implementation of the CPP has fundamentally changed the approach to supervision of the largest high impact firms.	SEP document. Internal FSA process. Basel III agreement.

Table 1: Lessons which have been previously identified

	Area	Relevant section in the Report	Lesson: extract from text in relevant section	References in other sources
12		3	Supervisors needed a mechanism to ensure that they received adequate MI regularly from high impact firms. The SEP has introduced minimum requirements for the MI that high impact firms must provide to Supervision Teams, including board MI packs on a quarterly basis.	SEP document.
13		3	Supervisors needed to undertake a detailed analysis, assessment and challenge of a firm's business strategy to confirm that all risks had been identified and adequate mitigation put in place. Supervisors are now required to do this, including by means of a formal, annual strategy meeting. It is also part of the CPP for the largest high impact firms.	Internal FSA process.
14		3	Where the boards of high impact firms could not demonstrate that they have adequately considered risks when setting their strategy, Supervisors needed to subject the firm to additional supervisory scrutiny and challenge. Supervisors are now required to do this and it is also part of the CPP for the largest high impact firms.	Internal FSA process.
15		3	More detailed supervisory scrutiny of management, governance and culture issues was required. The CPP now being implemented for the largest high impact banks includes this.	Internal FSA process.
16		3	The FSA's Remuneration Code now requires firms to ensure that their remuneration policies are consistent with sound and effective risk management, do not encourage risk-taking that exceeds the firm's level of tolerated risk, and are in line with the firm's long-term interests. The Remuneration Code includes guidance that, in designing their long-term incentive plans, firms should take account of the potential for any links to earnings per share to create an incentive to increase leverage to the detriment of the longer-term health of the firm.	
17		3	The FSA has recognised the need to assess culture at firms more effectively. The ARROW process has been updated to reflect the FSA's most recent thinking on the assessment of firm culture. The enhanced guidance produced is intended to lead to greater consistency in the FSA's identification, assessment and mitigation of culture related issues. This approach has also been incorporated into the outline supervisory approaches for both the Financial Conduct Authority and Prudential Regulation Authority.	See speech by the FSA CEO to Mansion House Conference on *Values and Trust*, 4 October 2010.

Table 1: Lessons which have been previously identified

	Area	Relevant section in the Report	Lesson: extract from text in relevant section	References in other sources
18		3	A more systematic approach to assessing the quality of the FSA's relationship with firms and the risks that may flow from it was required. The FSA has introduced this approach through the SEP and it is now part of ARROW assessments and the CPP Governance module.	Internal FSA process.
19		3	Supervisors needed to take more intrusive and robust steps to assess the level and consistency of challenge provided by a board and senior management to a firm's executive directors. The CPP now being implemented for the largest banks requires this.	Internal FSA process.
20		3	It is important for good governance and effective board oversight that a firm's risk and internal audit functions can report directly to the board or its sub-committees, independently of executive management. Where this is not the case, as with RBS during the Review Period, the firm should be subject to additional FSA scrutiny and challenge. Supervisors now review and, where necessary, challenge firms on their reporting lines for Internal Audit and Risk as part of the FSA's ARROW risk assessments of high impact firms. We note that the Walker Report also made a series of important recommendations concerning the governance of risk.	Walker Review, *A review of corporate governance in UK banks and other financial industry entities*, 26 November 2009.
21		3	Supervisors needed to have careful regard to the quality and experience of a firm's senior management. The FSA's current standard requires competence based interviews for those applying for approval as significant influence function holders in high impact firms.	FSA Policy Statement PS 10/15, *Effective corporate governance – Significant influence controlled functions and the Walker Review*, September 2010.
22		3	The FSA needed to pay particular attention to applications for significant influence function approval from weaker high impact firms, which might find it more challenging to attract the best people from the limited pool of outstanding talent to fill their front office and control functions. This additional scrutiny is now part of the new regulatory approach to the use of competence based interviews for those applying for approval as significant influence function holders in high impact firms.	FSA Policy Statement PS 10/15, *Effective corporate governance – Significant influence controlled functions and the Walker Review*, September 2010.

Table 1: Lessons which have been previously identified

	Area	Relevant section in the Report	Lesson: extract from text in relevant section	References in other sources
23		3	Given the level of work generated by one of the UK's largest high impact firms, additional dedicated resources should have been made available, in the form of a multi-disciplinary team, in order adequately to respond to major events (including major corporate transactions), for example, the bid for ABN AMRO. It is now the practice within Supervision to set up such teams to respond to major events of this nature.	Internal FSA process.
24		3	The FSA has radically changed its resourcing model for the supervision of the largest high impact firms, greatly increasing both the numbers of supervisors directly responsible for firm supervision and the number of specialists available to support those supervisors to deliver the FSA's more intrusive and intensive approach under the CPP.	SEP document.

Table 2: Additional recommendations

	Area	Relevant section in the Report	Recommendation
25	Capital	1.1	With the moves towards Basel III underway, the FSA has in train the introduction of a leverage requirement. To supplement this, it should review its current supervisory arrangements to ensure that sufficient focus is given to leverage as well as to risk-based capital ratios.
26		1.1	In order to avoid a situation in future where a firm's capital resources are over-dependent on minority interests, the FSA should consider quantitative monitoring of firms' dependence on minority interests as part of ongoing supervision.
27		1.1	The FSA should review firms' practice in calculating their regulatory capital position in order to ensure compliance with FSA rules. This will enable the FSA to form a view on the extent, if any, to which it is acceptable for firms to rely on estimates prior to the final figures becoming available, and the appropriate frequency and timeliness of the calculations.
28		1.1	Where shortcomings on the part of a firm lead to a delay in the FSA reviewing and setting capital guidance for a firm, the FSA should consider whether additional conservatism is appropriate when setting interim guidance.

Table 2: Additional recommendations

	Area	Relevant section in the Report	Recommendation
29	Reporting	1.2	When changes are proposed to quantitative, and qualitative, data reporting by firms, the Review Team recommends that, where necessary, the relevant FSA policy and risk specialists should introduce appropriate controls to ensure that there is a transitional period in which both the existing and new reporting requirements run in parallel to ensure required data continue to be collected.
30	Acquisitions	1.5	The Review Team recommends that the FSA formalise its new, more intensive approach to major corporate transactions involving high impact regulated firms, by producing internal guidelines. These might, subject to complying with the Acquisitions Directive, incorporate: • The key internal decision checkpoints during the assessment process. • Setting up a multi-disciplinary team, including internal specialists, to assess the key risks (including, in particular, capital and liquidity risks) associated with the transaction at an early stage. • Consideration of the requirements and information flows imposed by the European legislation. • Coordinated engagement with overseas regulators in cases of cross-border transactions where expectations, roles and responsibilities of each regulator are mutually agreed and understood, for example through the establishment of a Joint Liaison Committee. • The assessment of comprehensive (in particular, key prudential) information from the firm that sets out the impact of the proposed transaction; the adequacy of the combined group capital position at deal closure, taking into account financing, at forward projections, and under stressed conditions. • Meeting board members of the firm to discuss and agree FSA expectations for board oversight of the transaction. • Assessing the capability, experience and track record of the firm's management to conclude successfully the acquisition. • Early consideration, where appropriate, of the need for any collaboration between the UKLA and Supervision. • Early confirmation of the regulatory approach to be followed by the FSA (for example, a need for approval of a change in control, or a need to assess disclosures in an associated prospectus), in addition to the Threshold Conditions. • Exploring whether the firm's board had considered independent advice on the merits of the transaction. • An assessment of financial stability issues resulting from the transaction. • In the case of a contested takeover, considering setting an additional capital buffer where the bidder proceeds on limited due diligence. This would include considering the capital requirement of a UK authorised bidder where the FSA is not the decision-maker on a change in control. The capital buffer could, in certain circumstances, be set at a level which renders the deal less likely to proceed.

Table 2: Additional recommendations

	Area	Relevant section in the Report	Recommendation
31	Management, governance and culture	2.4	The Chairman or, if appropriate, the senior independent director, should discuss with their FSA supervisor the outcome of the externally facilitated effectiveness review of the board which should be undertaken at least every two to three years, and the action they propose to address any issues identified.
32		2.4	In order that boards, whether of authorised firms or of the FSA, can demonstrate that they have subjected proposals from the executive to appropriate discussion and challenge, the board secretary should ensure that minutes of board and sub-committee meetings set out the substance of the views expressed and record key elements of the debate and challenge provided, as well as the conclusions for each agenda item. This need not be a verbatim record nor, unless requested at the time by a board member, include individual comments. In the case of all authorised firms, these minutes would then be available to supervisors when assessing board effectiveness. The issue as to the appropriate standards relating to company secretaries, in order to ensure they can achieve this, should be considered in relation to the UK Corporate Governance Code.
33		2.4	Where concerns arise, the FSA should make greater use of formal significant influence function interviews to assess the competence of senior managers already in post.
34		2.4	The FSA should highlight, by means of the significant influence function process and its regular supervision, the substantive and specific responsibility of the CEO to ensure that those they appoint to senior roles or to whom significant powers are delegated, have the appropriate qualifications, skills and experience, in line with the requirements set out in APER principles 5 and 6.
35		2.4	The FSA should consider whether and how boards of regulated firms considering major acquisitions should obtain independent advice on the proposed acquisition, to assist assessment and challenge of the proposal, from an adviser whose remuneration is not linked to successful completion of the acquisition.
36	Supervisory approach, priorities and resources	3	The CPP has been developed and is being implemented. It is important that the FSA, and subsequently the Prudential Regulation Authority and Financial Conduct Authority, ensure that all the key learnings from the CPP are used to inform their new supervisory approaches.
37	Market communication	Appendix 2B	The UKLA should, as part of its planned review of the Listing Rules, consider the rationale for the '28-day circular' and the rules governing its preparation and publication.

Appendix 2B
Market communication – a review of oversight by the United Kingdom Listing Authority (UKLA)

781 The Review Team looked into two aspects of the work of the UKLA in relation to the investment circulars:

i) The Rights Issue Prospectus and Circular, dated 30 April 2008, issued by RBS to its shareholders. Among other things, this was to obtain approval for the directors to allot relevant securities as required to satisfy the rights issue.

ii) The working capital statement (the '28-day circular') that had not been included in the ABN AMRO Class 1 Circular, issued on 20 July 2007, but which was included as part of the Rights Issue Prospectus and Circular.

782 This Appendix starts by summarising the roles and responsibilities of the UKLA and the issuers and the sponsors in the capital-raising process, which have not materially changed since the Review Period. It then discusses the UKLA's handling of the two transactions and presents the Review Team's conclusions. The Appendix should be read in conjunction with Part 3, Section 3, Investment Circulars, which sets out the results of the FSA's enforcement investigation into whether there was any misconduct in relation to the disclosures that RBS made in connection with these investment circulars.

B.1 The roles of the UKLA, the issuer and the sponsor in the capital-raising process

783 The Listing and Prospectus Rules require that issuers take responsibility for the contents of prospectuses and circulars. Issuers use advisers to undertake appropriate due diligence to ensure that this responsibility is adequately discharged. On certain transactions, the Listing Rules separately require sponsors to confirm to the UKLA that due diligence in defined areas has been properly undertaken.

784 In discharging its responsibilities for reviewing prospectuses and investment circulars, the UKLA checks that they comply with the Listing and Prospectus Rules and that the required disclosures have been made. The UKLA reviews the content of such documents 'with the eye of an intelligent reader'. It does not sign off or verify the underlying due diligence, the accuracy of disclosures or compliance with rules. It is the responsibility of the issuer, together with the sponsor and advisers, to verify these matters.

785 The UKLA does not look behind or supplement this due diligence because doing so would risk blurring the important distinction between the responsibilities of

the regulator and the responsibilities of issuers, sponsors and their advisers. For example, there would be a risk that the UKLA might be seen as confirming the adequacy or suitability of the terms of a deal, the transaction benefits for shareholders or the accuracy of forecasts or projections.

786 When reviewing documents and applying the 'intelligent reader' test, the UKLA may request further information from an adviser or sponsor. It may do this, for example, where the material presented contains internal inconsistencies or where the UKLA possesses other information, whether from the market or from FSA sources, that suggests further enquiry is necessary. While such further enquiries may include questions about the due diligence that the adviser or sponsor says has been undertaken, the obligation remains on the issuer to comply with the Prospectus and Listing Rules and any relevant guidance, and to ensure that the disclosures provided are accurate and complete. In certain circumstances, the sponsor also has an obligation under the Listing Rules to confirm to the UKLA that the issuer has fully complied with the rules.

787 When reviewing documents, the UKLA also checks that any significant statements or assurances are not qualified[793] in ways that might lead to risk being inappropriately passed to investors. The UKLA aims to ensure that the wording of any such qualifications conforms as closely as possible to the wording prescribed in the relevant Directives, Listing Rules and guidance from the European Securities and Markets Authority (ESMA).[794]

788 In significant transactions involving regulated financial institutions, the UKLA also consults a firm's supervisors to ensure that it is adequately informed about any issues of potential relevance to its scrutiny of documents.

B.2 UKLA's handling of RBS's Rights Issue Prospectus and Circular

789 This section describes the steps that the UKLA took in relation to RBS's Rights Issue Prospectus and Circular and, in particular, its consideration of RBS potentially falling below its Individual Capital Guidance (ICG).

790 For the RBS rights issue in April 2008, Merrill Lynch was the sponsor that communicated with UKLA, although Goldman Sachs was jointly appointed from 9 April. The Review Team examined the FSA's internal records and correspondence with Merrill Lynch in order to assess the UKLA's engagement on the draft Rights Issue Prospectus and Circular during April 2008. The primary focus of the UKLA's work was on the level of disclosures. The evidence showed that the UKLA's dialogue with the sponsor and issuer was effective in terms of the outcomes achieved. For example, UKLA intervention resulted in improvements to the documents so that they included more extensive and innovative disclosure of RBS's credit exposures[795] and forward-looking capital ratios for the enlarged group, including ABN AMRO on a Basel II basis.[796]

793 For example by caveats, disclaimers, assumptions or sensitivities.
794 On 1 January 2011, ESMA replaced the Committee of European Securities Regulators (CESR).
795 Pages 26-27 of the Rights Issue Prospectus and Circular.
796 Page 28 of the Rights Issue Prospectus and Circular.

791 In April 2008, the UKLA was informed by the Supervision Team that RBS's capital appeared to have fallen below the level of its ICG. The circumstances of this have been described earlier in this Report.[797] While the UKLA proceeded on the basis that RBS's capital had fallen below the level of its ICG, there was some uncertainty on RBS's part about whether this was the case and, if so, the exact size of any shortfall. A subsequent RBS internal investigation in July 2008 concluded that RBS had not fallen below its ICG level in April 2008 or subsequently. While there was some doubt about RBS's capital position in relation to its ICG, it was clear to the FSA at the time that, although weak, RBS's capital remained above the formal regulatory minimum of 8%, a breach of which would have triggered action for a breach of Threshold Condition 4 (adequate resources).

792 Given this situation, the UKLA needed to assess whether, under the general Disclosure Rules that apply to all listed firms, RBS should disclose to the market that its capital might have fallen below its ICG. It also considered whether it should challenge the omission of this information about RBS's capital position from the draft Rights Issue Prospectus and Circular, against the criterion set out in Section 87A of the Financial Services and Markets Act 2000 (FSMA). This requires the disclosure of 'information necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profits and losses, and prospects of the issuer…'.

Box 1

The purpose of ICG

- Individual capital guidance (ICG) defines the amount of capital that the FSA thinks that a firm should hold, based on an evaluation of the firm's individual capital adequacy assessment process (ICAAP). ICG may be substantially greater than the firm's minimum regulatory capital requirement. The FSA expects firms to meet ICG at all times and interprets ICG as its view, at a point in time, of the adequate amount of capital that a firm must hold, based on that firm's risk profile. Should a firm's capital fall below its ICG, the FSA would take a view as to whether that constituted a breach of the threshold condition of maintaining adequate financial resources.[798]

- The FSA's current practice is to maintain the ICG it issues to a firm as confidential. There is also a strong expectation that, except in certain limited circumstances[799], a firm will not disclose its ICG to any third party. This policy is based partly on the FSA's belief that, without a good understanding of the purpose of ICG and the basis on which it was set, it would be difficult for a third party correctly to interpret or judge the significance of statements about a firm's ICG. In addition, ICGs are kept confidential in order to prevent firms from quoting their ICG levels to try to gain competitive advantage. Finally, the FSA believes that disclosure of ICG would unreasonably constrain its scope to increase ICG where necessary and to use it flexibly to help deal with crises or emergencies.

797 See Part 2, especially Section 1.1.5.
798 This is set out in the FSA's Handbook at GENPRU 1.2.26R.
799 These circumstances would include disclosure: (i) to a firm's professional advisers; (ii) to an acquirer; (iii) to an independent expert in a Part VII transfer; (iv) where, under the Disclosure Rules of the Listing Regime, a firm is obliged to disclose 'inside information' to the market and to do so as soon as possible; and (v) where, on issue of a prospectus, an issuer considers disclosure necessary to enable investors to make an informed assessment of the financial position and prospects of the issuer.

793 When it was informed that RBS had potentially fallen below its ICG level the UKLA, with appropriate legal support, considered whether it was necessary for RBS to disclose that fact immediately under the Disclosure Rules and subsequently in the Rights Issue Prospectus and Circular. Having considered all relevant factors and based on the information available to it at the time, the UKLA concluded that it would not challenge RBS's proposed non-disclosure, either as part of RBS's continuing obligations under the Disclosure Rules or in the Rights Issue Prospectus and Circular. In reaching this conclusion, the UKLA considered two factors to be particularly relevant. First, ICG is FSA guidance and has no binding legal status. It follows that there can be no formal regulatory consequences arising when a firm's capital falls below its ICG. Second, in line with the FSA's general policy that a firm's ICG should be kept confidential, ICG was not routinely disclosed to the market. As a result, it was not a key metric used by analysts or investors when assessing a bank's capital position and had not previously been considered necessary for an informed assessment of an issuer. Importantly, RBS was judged by the FSA to be continuing to meet its legal requirements in respect of the FSA's Threshold Conditions. The UKLA also took into account that the Prospectus made clear to potential investors that the purpose of the rights issue was to strengthen the group's capital position. Overall, and having regard to the disclosures provided in the Prospectus and Circular as a whole, the UKLA decided not to challenge RBS's non-disclosure that its capital might have fallen below ICG.

794 The Review Team assessed both the processes undertaken by the UKLA and the outcomes of its work, and concluded that the UKLA followed the proper processes in its review of the Rights Issue Prospectus and Circular. The Review Team saw evidence that the UKLA consulted and shared information with the RBS Supervision Team, the FSA's Prudential Policy Division and the FSA's General Counsel's Division. Where appropriate, it also escalated decisions to FSA senior management, for example on the disclosure of forward-looking capital ratios. There was good evidence to demonstrate the effectiveness of the UKLA challenge in improving the disclosures in the Rights Issue Prospectus and Circular. With the benefit of hindsight, it is apparent that the forecasts of capital in the prospectus were more favourable than turned out in practice. However, it is not reasonable to conclude that this would have been apparent to the UKLA at the time.

795 The Review Team also considered the UKLA's decision not to challenge RBS's non-disclosure in the prospectus of the fact that its capital might have fallen below its ICG level. The conclusion reached was that this decision was not unreasonable in light of all the relevant circumstances, including the FSA's policy of non-disclosure and the uncertainty at the time about the fact and extent of any fall below ICG by RBS.

B.3 UKLA's handling of the working capital statement ('28-day circular')

796 This section describes the steps that the UKLA took in relation to RBS's production of the working capital statement (or '28-day circular') and, in particular, examines the timing of that publication.

797 As explained in Part 3, Section 3, the Listing Rules require a working capital statement to be issued as so on as possible after the completion of a transaction. '*As soon as possible*' is generally taken to mean, in the absence of exceptional circumstances, within 28 days of the offer becoming or being declared wholly unconditional[800], hence the term '28-day circular'. It follows that, in the case of the acquisition of ABN AMRO and in the absence of exceptional circumstances, RBS should have produced a working capital statement within 28 days of 10 October 2007, the date on which the offer was declared wholly unconditional.

798 Well before October, RBS, through the sponsor, made clear to the UKLA that it considered the circumstances of the ABN AMRO acquisition to be '*exceptional*'. This was on the basis that it was a hostile, consortium, cross-border acquisition. RBS told the UKLA that it expected to be in a position to issue the working capital statement within three to four months of completion, that is by mid-February 2008. The UKLA accepted that the circumstances were exceptional and that it was reasonable to expect that it would not be possible to issue the working capital statement within the normal 28-day period. The UKLA did not dispute the initial estimate of three to four months, but neither did it relax the timing requirement to publish the working capital statement '*as soon as possible*'. As early as June 2007, the UKLA reminded the sponsor of the requirement to complete the work as soon as possible, in line with the disclosures in the ABN AMRO Class 1 Circular.

799 From October 2007, RBS had access to the books and records of ABN AMRO. However, even with unrestricted access, RBS encountered difficulties in accessing and processing the disaggregated information necessary for the preparation of the '28-day circular'. For example, there were particular difficulties in reconciling the RBS and ABN AMRO accounts. Another contributory factor was that RBS had limited access to information about the ABN AMRO businesses that were destined to go to Fortis and Santander.

800 From December 2007, well before the expiry of RBS's original estimate of three to four months, and then with increasing frequency during January and February 2008, the UKLA pressed the sponsor for updates on progress and sought detailed explanation of the continued delay. The UKLA was updated periodically by RBS's sponsor and challenged the reasons for the delay on a number of occasions.

801 In response, from early February 2008, RBS argued that it was necessary to prepare the 2007 year-end figures before they could finalise the '28-day circular'. This implied further delay.

800 Listing Rule 13.4.3(R)(3).

802 In February 2008, the UKLA agreed to a revised deadline of 28 May for publication. This was based on the time the sponsor and issuer estimated would be necessary to produce the consolidated accounts for RBS, including ABN AMRO. The UKLA did, however, continue to press for publication ahead of that deadline and made clear to the sponsor that further delay beyond May would be unwelcome. The UKLA continued to seek and obtain further detail from the sponsor and issuer to justify its estimate of the May timetable. In the event, this new deadline was overtaken by the April 2008 rights issue and the '28-day circular' was included in the Rights Issue Prospectus and Circular on 30 April 2008.

803 The Review Team judged that it would have been inappropriate for the UKLA to dictate, either at the outset of the process or subsequently, the level of resources that RBS should devote to the production of the '28-day circular'. It would also have been inappropriate for the UKLA to insist on publishing by a particular date, as that might have resulted in RBS publishing misleading information or undertaking less due diligence than necessary in preparing the '28-day circular'.

804 As it transpired, the amount of work involved in producing the '28-day circular' covering the ABN AMRO acquisition was such that it could never have been produced within 28 days. Although its publication was protracted, the UKLA accepted, and had limited scope to disagree with, the argument made by the sponsor that the delay was not excessive because of the complexity of the transaction, including its timing in relation to the 2007 year-end financial reporting cycle.

805 The Review Team noted that there were few comparable transactions that the UKLA might have used as precedents to inform its view. There was evidence that the UKLA consistently engaged with RBS on this issue, especially from the end of 2007 until the issue of the Rights Issue Prospectus and Circular. There was an appropriate level of interaction between the UKLA and the RBS Supervision Team, with suitable escalation to FSA senior management. On this basis, the Review Team concluded that the course of action undertaken by the UKLA was reasonable.

806 Although the evidence[801] has subsequently identified that RBS did not formulate a plan to produce the '28-day circular' as soon as reasonably practicable, this would not have been apparent to the UKLA at the time. The UKLA sought and obtained explicit assurances from the sponsor and the issuer that they were doing all they could to expedite the matter.

807 The Review Team noted that the UKLA has limited tools at its disposal to require a firm to expedite the production of a '28-day circular', especially in the case of a hostile takeover when an acquirer is not able to undertake due diligence before the acquisition is complete. Where the UKLA believes that unnecessary delays might have occurred, it can undertake an investigation after the event and this is what happened in this case. As explained in Part 3, Section 3, while the investigation identified some significant deficiencies in the processes that RBS followed, the FSA's view was that these deficiencies would not justify or be likely to lead to successful enforcement action.

801 See Part 3, Section 3: Investment circulars.

Conclusions

- The work on the Rights Issue Prospectus and Circular and the '28-day circular' appeared to have been carried out in accordance with the UKLA's established processes and approach.
- In respect of the '28-day circular', the wording of the Listing Rules may at first sight appear ambiguous. Despite the name '28-day circular', the Rules do not, in fact, specify that the working capital statement must be produced within 28 days. Instead, the Rules state that the working capital statement must be produced '*as soon as possible*'.
- The Review Team did not see any evidence that this potential ambiguity caused any confusion among issuers or sponsors. However, the work has highlighted some questions about the '28-day circular' and the value it adds to the acquisition process when shareholders have already approved the acquisition and it is unconditional. For this reason the UKLA should, as part of its planned review of the Listing Rules, consider the rationale for the '28-day circular' and the rules governing its preparation and publication.
- Since the Review period, the Listings Authority Advisory Committee (LAAC)[802] has discussed the boundary of the UKLA's work. It has looked into whether, in asking questions of issuers on the basis of information gained from the FSA's work on supervision or financial crime, the UKLA is potentially extending its role to include a more formal assessment of the due diligence undertaken. Following its review, the LAAC has confirmed its agreement to the UKLA's approach – that it is for the issuer and its sponsor to take responsibility for the accuracy and completeness of disclosures to the market. Where other parts of the FSA have relevant information, it may be shared with the UKLA and used by it to challenge issuers and sponsors on what they propose to include in prospectuses and circulars.
- The process to be followed by a competent authority when vetting a prospectus is currently being reviewed by the European Securities and Markets Authority with a view to harmonising the approach across Europe.

802 A sub-committee of the FSA Board that acts as an advisory panel for UKLA.

Appendix 2C
An outline chronology

RBS	DATE	FSA, and market events
	2005	
	1 January	**Start of Review Period.**
	28 January	2005 ARROW final validation panel meets.
	17 February	Supervision Team discusses draft ARROW letter with RBS CEO.
RBS announces £6.9bn pre-tax profit for 2004.	24 February	
	4 March	The FSA sends 2005 ARROW letter to RBS Board.
	30 March	Supervision Team presents ARROW findings to RBS Board.
	9 – 10 June	Basel II Thematic Visit.
	21 – 23 June	Traded Risk Team visits RBS Greenwich Capital in the US.
	29 June	Supervision Head of Department (HoD) and Supervision Team meet RBS Chairman to discuss strategy and governance.
	29 – 30 June	Basel II Thematic Visit.
	2 August	Supervision Team sends paper to RBS detailing expectations of the close & continuous relationship.
	15 August	Change of Supervision Team Manager.
RBS agrees to take 5% stake in Bank of China for US $1.6bn.	18 August	
	23 – 24 November	Basel II Thematic Visit.
	30 November – 1 December	Basel II Thematic Visit.
	2006	
	24 January	Supervision HoD and Supervision Team meet RBS Non-Executive Directors (NEDs) to discuss governance and strategy, and RBS CEO to discuss performance, strategy and senior management team.
Change in RBS Group Finance Director.	1 February	

RBS	DATE	FSA, and market events
	(2006 continued)	
	8 – 9 February	Basel II Models Visit.
RBS announces £1bn share buy-back. RBS announces £7.9bn pre-tax profit for 2005.	28 February	
	2 – 3 March	Basel II Thematic Visit.
Change in RBS Board Chairman.	28 April	
RBS decides to expand GBM structured credit business.	May	Change in Supervision Director.
	29 June	Supervision Director and Supervision Team meet RBS Chairman to discuss strategy and governance.
	22 September	FSA Managing Director of Retail Markets meets RBS CEO.
	5 October	The FSA sends 2006 (Interim) ARROW Letter to RBS Board.
	13 December	Supervision Team presents 2006 (Interim) ARROW findings to RBS Board.
	2007	
	1 February	RBS and Barclays Supervision Teams are merged.
	7 February	HSBC announces 20% higher debt charge than expected, due mainly to exposure to US housing market.
	27 Feb – 1 March	Supervision Team visits RBS in the US.
RBS announces £9.2bn pre-tax profit for 2006.	1 March	
	19 March	Barclays announces intention to bid for ABN AMRO. Basel II Thematic Visit.
	20 March	Barclays announces discussions have been initiated with UK, Dutch and other regulators about lead regulation of a combined Barclays/ABN AMRO group.
RBS announces new CEO of RBS America.	23 March	
RBS decides to bid for ABN AMRO.	27 March	Supervision Team meets RBS NEDs to discuss strategy and US governance.

RBS	DATE	FSA, and market events
(2007 continued)		
Consortium advises ABN AMRO of interest in making an offer for it.	12 April	
Consortium announces publicly that it is interested in making an offer for ABN AMRO.	16 April	
	17 April	The FSA's Risk Committee discusses developments in US sub-prime market.
	19 April	The FSA's Executive Committee (ExCo) considers lead regulation of a combined Barclays/ABN AMRO group.
ABN AMRO agrees to sell LaSalle to Bank of America.	23 April	Barclays and ABN AMRO announce agreement on merger terms, and that the FSA would be lead regulator for a combined group.
RBS receives due diligence information from ABN AMRO.	29 April	
	30 April	RBS CEO and Group Finance Director meet the FSA CEO, Supervision Director and HoD to outline consortium approach to an offer for ABN AMRO. 2007 ARROW Planning Panel meets.
	May	Supervision HoD responsible for RBS leaves the FSA. Replacement arrives in August (see below). In the intervening period the Supervision Team Manager reports to the Supervision Director.
A Dutch Court grants the Dutch Investors' Association a provisional injunction, preventing ABN AMRO selling LaSalle without ABN AMRO shareholder approval.	3 May	
Consortium makes offer for LaSalle.	5 May	
ABN AMRO rejects consortium's offer for LaSalle.	6 May	
	11 May	Conference call between consortium members, the FSA, DNB, Belgian CBFA and Banco de Espana to discuss the consortium's plans.
Consortium partners enter into Consortium and Shareholders' Agreement.	28 May	

RBS	DATE	FSA, and market events
	(2007 continued)	
The consortium holds press and investor conferences to announce details of its offer for ABN AMRO.	29 May	
	13 June	An FSA Decision Making Committee approves RBS's application to use an internal ratings based (IRB) approach under Basel II.
	16 June	Presentation from RBS to Supervision Team about post-acquisition capital structure of consolidated entity with and without LaSalle.
	26 June	UKLA accepts that '28-day circular' for ABN AMRO acquisition may take more than 28 days.
RBS purchases US$250m worth of hedges for super senior CDO positions held by RBS Greenwich Capital.	July	
	6 July	The FSA gives approval for RBS to become controller of ABN AMRO's UK subsidiaries.
RBS reports to the FSA that it has identified errors in the reporting of its Sterling Stock Liquidity Ratio (SLR) since 2006, which led to overstatement of RBS's SLR. RBS confirms that its overall liquidity position was not impacted by this mis-reporting. RBS announces Joint Venture Commodities business with Sempra Energy.	9 July	
	11 July	Basel II Thematic Visit.
Dutch Supreme Court rules that ABN AMRO's sale of LaSalle to Bank of America can proceed.	13 July	
RBS decides to proceed with ABN AMRO bid without LaSalle.	15 July	
Consortium announces terms of its offer for ABN AMRO.	16 July	
	17 July	The FSA's Risk Committee discusses risks in sub-prime mortgages and hedge funds.
	Mid-July	Presentation from RBS to Supervision Team about the structure of the offer for ABN AMRO.

RBS	DATE	FSA, and market events
(2007 continued)		
Consortium publishes Offer document for ABN AMRO.	20 July	Change in the FSA CEO.
RBS decides not to do a further hedge of its super senior CDO structures. RBS VaR models start showing significant back-testing exceptions.	August	New Supervision HoD takes over responsibility for RBS.
	9 August	Short-term money markets freeze; 'crisis period' begins.
RBS shareholders vote on the proposed acquisition of ABN AMRO by RBS and its consortium partners; 94.5% of the votes cast are in favour of the transaction.	10 August	
	20 August	The FSA writes to RBS about mis-reporting of sterling stock liquidity.
	September	The FSA Board discusses deteriorating liquidity conditions.
	10 September	2007 ARROW final validation panel meets, and sets interim ICG for RBS. The FSA starts collecting twice-weekly additional liquidity data via Current Status Indicator (CSI) reports.
	14 September	Northern Rock receives Bank of England liquidity support.
	17 September	DNB issues declaration of no-objection to the acquisition of ABN AMRO by the consortium.
	19 September	Assessment of impact of RBS acquiring ABN AMRO's conduit business, against the background of current difficult market conditions, provided to the FSA Chairman, CEO and Managing Director of Retail Markets.
	28 September	Further assessment of impact of RBS acquiring ABN AMRO in current market conditions (including capital and liquidity) provided to the FSA Chairman, CEO and Managing Director of Retail Markets.
	4 October	Updated assessment of impact of RBS acquiring ABN AMRO provided to FSA Managing Director of Retail Markets.

RBS	DATE	FSA, and market events
	(2007 continued)	
	5 October	Barclays withdraws offer for ABN AMRO.
ABN AMRO offer is made unconditional.	10 October	
Consortium completes the acquisition of ABN AMRO.	17 October	
	25 October	The FSA sends 2007 ARROW letter to RBS Board.
	31 October	Supervision Team and Supervision HoD present ARROW findings to RBS Board.
	November	RBS added to FSA Watchlist.
	19 & 26 November	An FSA specialist liquidity team makes thematic visits to RBS.
	5 December	The Tripartite Standing Committee on Financial Stability discusses UK banks' Basel II positions.
	Dec 2007 – Feb 2008	Several major investment banks announce significant write-downs on structured credit assets.
	31 December	Deadline for implementation of Basel II.
	2008	
RBS (and ABN AMRO) required to calculate capital position in accordance with Basel II.	1 January	
	23 January	Basel II Thematic Visit.
	29 January	The FSA 2008 Financial Risk Outlook (FRO) is published, highlighting as a priority risk the difficulties in valuing structured credit assets and the impact of those difficulties on market confidence.
	13 February	FSA Chairman and CEO meet RBS Chairman – discussion focused on RBS's capital position.
	18 February	Supervision Director meets RBS CEO: agreement that capital position is tight.
RBS Group Audit Committee considers the valuation of CDO positions.	20 February	
RBS Board considers the valuation of CDO positions.	21 February	The FSA asks RBS to rebuild its internal core tier 1 ratio to its internal target of 5.25% by end-Q1 2009.

RBS	DATE	FSA, and market events
	(2008 continued)	
RBS announces £9.9bn pre-tax profit for 2007 (including ABN AMRO).	28 February	
	16 March	JP Morgan agrees to purchase Bear Stearns.
RBS Board agrees to put a plan in place to address the FSA's request to raise its core tier 1 capital ratio.	19 March	
	31 Mar – 3 April	Supervision Team visits RBS in the US.
	April	Resource on Supervision Team falls to eight staff covering both RBS and Barclays.
RBS advises the FSA that the Group may have fallen below ICG at end-March 2008.	3 April	
	7 April	FSA Managing Director of Retail Markets leaves the FSA. Role filled in an acting capacity by FSA Chief Operating Officer. Change in Supervision Director.
	8 April	Supervision Team sends a paper on RBS's capital position to the FSA CEO and Chairman.
	9 April	FSA CEO meets RBS CEO to discuss capital position in relation to possible fall below ICG, and rights issue.
RBS confirms to the FSA that it will proceed with the rights issue.	10 April	
	15 April	ExCo agrees a core capital target of 5% for certain major banks, including RBS, using an FSA definition of core capital.
	16 April	The FSA grants RBS partial IRB model approval.
	21 April	The Bank of England launches Special Liquidity Scheme.
RBS announces capital raising of £12bn. RBS Update on Credit Market Exposures, Disposals, Capital, Trading Conditions and Outlook.	22 April	
	29 April	The FSA's paper 'Strategy for major UK Banks' (including RBS) sent to Tripartite Standing Committee.

RBS	DATE	FSA, and market events
(2008 continued)		
Rights Issue Prospectus and Circular published, which includes '28-day' working capital statement for the acquisition of ABN AMRO.	30 April	
RBS Chairman commissions Group Internal Audit report on events leading to significant credit market write-downs.	2 May	
	9 May	Supervision Team meets Head of RBS Group Internal Audit. Discussion includes scope of report on events leading to significant credit market write-downs.
RBS share price falls by 35%.	12 May – 2 June	
RBS General Meeting approves increase in authorised share capital and issue of new ordinary shares instead of interim dividend.	14 May	
	5 June	Supervision Team advises RBS of intention to perform work on its capital planning as part of SREP in second half of 2008.
RBS announces 95% acceptance of rights issue.	9 June	
RBS pre-close trading update expects performance trends to track guidance in April Interim Management Statement.	11 June	
RBS announces sale of Angel Trains.	13 June	
	19 June	Supervision HoD call to RBS Group Finance Director covers concerns about stress-testing and back-testing.
Moody's downgrades RBS's credit rating from Aa1 to Aa2.	27 June	
RBS Group Finance Director responds to the Supervision HoD's concerns about stress-testing.	30 June	
	8 July	The FSA decides not to grant RBS further IRB model approval.
	8 – 15 July	Fannie Mae and Freddie Mac share prices fall sharply.

RBS	DATE	FSA, and market events
(2008 continued)		
RBS share price reaches a low of 165 pence.	16 July	The FSA's Expected Potential Exposure (EPE) model waiver for RBS comes into effect.
	Mid-July	Evidence of deterioration in available wholesale funding maturities for major UK banks.
RBS announces half-year pre-tax loss of £691m after credit market write-downs of £5.9bn.	8 August	
	12 August	Supervision Team updates FSA CEO on RBS's capital position.
RBS announces appointment of three independent non-executive directors with effect from 1 October 2008.	27 August	
	End-August	The FSA starts collecting Liquidity Risk Profile (LRP) reports.
	7 September	Federal Housing Finance Agency (FHFA) announces Fannie Mae and Freddie Mac have been taken into conservatorship.
	8 September	New Managing Director of Retail Markets joins the FSA.
RBS share price reaches a three-month high of 249 pence.	9 September	
	11 September	FSA Chairman and CEO meet RBS Chairman and CEO – discussion includes capital plan progress, Board composition and market conditions.
	15 September	Lehman Brothers files for Chapter 11 bankruptcy protection. Bank of America announces purchase of Merrill Lynch.
	16 September	Federal Reserve announces it will lend up to US$85bn to AIG.
	18 September	Lloyds TSB and HBoS plc announce merger. The FSA announces temporary regulations prohibiting short-selling of financial shares.
	20 September	Change in FSA Chairman.
	25 September	Supervision Director updates FSA CEO on RBS's overnight wholesale funding position, and seriousness of concern about it. Collapse of Washington Mutual.

RBS	DATE	FSA, and market events
(2008 continued)		
	28 September	Belgian, Dutch and Luxembourg governments announce intention to inject €11.2bn to shore up Fortis's position, protect the interests of account-holders and help to ensure financial stability.
RBS's share price falls by 12.98%.	29 September	UK government announces guarantee arrangements for Bradford & Bingley plc. Icelandic government takes 75% stake in country's third-largest bank, Glitnir.
	30 September	Irish government announces two-year deposit guarantee for six banks, not including Ulster Bank.
	3 October	BBC News Business Editor reports that '*a big British bank was having difficulty renewing credit, which took it too close-for-comfort to the brink*'.
RBS's share price falls by 39.23%.	6 October	Standard & Poor's downgrades RBS's short-term and long-term counterparty credit ratings.
RBS fails, requiring Emergency Liquidity Assistance.	**7 October**	**End of Review Period.**

Appendix 2D
Summary of the international prudential policy framework during the Review Period and the main changes in prudential policy agreed since the financial crisis

International prudential policy framework

808 During the Review Period, the FSA's capital regime followed the internationally agreed Basel frameworks. These had been developed by the Basel Committee on Banking Supervision (Basel Committee). During the Review Period, the Basel Committee comprised representatives from 13 countries; this has since been expanded to include members from 27 states. The Bank of England and the FSA represent the UK on the Basel Committee. Therefore, through the Basel Committee, the FSA was party to the design of the two main capital frameworks applicable to RBS during the Review Period.

809 The Basel Committee's standards, guidelines and conclusions are developed in the expectation that individual authorities will take steps to implement them, but they do not, in themselves, have legal force. In the European Union (EU), the Basel capital frameworks were given legal force in European Directives. The main Directives relevant to bank capital are the Banking Consolidation Directive and the Capital Adequacy Directive, which were both recast in 2006 to implement Basel II in the EU. Together, these Directives constitute the Capital Requirements Directive (CRD).

810 EU Directives are binding on Member States, which must implement them into domestic law within a designated transposition period. The CRD was mainly implemented in the UK via the FSA Handbook. Member States have discretion to determine how to implement EU Directives and the CRD contains some options and national discretions which permit national authorities to adopt a different treatment on certain points. However, this scope for discretion is limited. It is estimated that around 70% of the FSA's policymaking effort is driven by European initiatives.

811 During the Review Period, there was no agreed quantitative liquidity risk framework, at the international or European level. The Basel Committee had developed a set of practices for managing liquidity risk in banks in 2000 and presented a review of the management of liquidity risk in financial groups in May 2006, but had not developed a set of standards on liquidity that were analogous to the detailed Basel capital frameworks.

812 During the Review Period, the FSA had, in general, committed not to go beyond minimum EU requirements and only to impose additional requirements when these were justified in their own right.[803] From late 2007, the FSA was increasingly developing a more robust supervisory approach to prudential issues. In several important respects, such as the FSA's 5% core capital target from April 2008 and its new liquidity regime set out in October 2009, this approach went beyond the prevailing international policy framework.

Prudential policy reforms since the financial crisis

813 This section concentrates on the prudential regulatory reforms developed in response to the financial crisis. It focuses on the reforms that are of greatest significance for the UK banking sector, sets out briefly the rationale for those reforms and their main elements, and provides an indication of the timing of their implementation.

814 In the aftermath of the crisis, the UK authorities and other regulators around the world began re-evaluating existing prudential regulatory standards in the banking sector.[804] While this process is not yet complete, the FSA has implemented several changes to its prudential regime and, internationally, a key milestone was reached in December 2010 with the publication by the Basel Committee of new minimum capital and liquidity requirements. These are now commonly referred to as Basel III.[805]

815 In addition to the development of new regulatory standards, since 2008 there has been significant institutional change at the international, European and national levels. The G20 has emerged as the premier forum for international economic and financial policy coordination, and the Financial Stability Board (FSB) received a new mandate to coordinate at the international level the work of national financial authorities and international standard-setting bodies for the financial sector.

816 At the European level and in the UK, institutional change has been driven by, among other factors, the need to create a clear focus on macro-prudential issues.[806] This reflects a fundamental shift in the philosophy of regulation following the financial crisis, from one in which prudential regulation was focused on individual institutions to one which explicitly seeks to address systemic factors such as credit cycles and the negative externalities that result from the failure of a systemically important institution.

803 *Better Regulation Action Plan*, FSA, December 2005.
804 This process began with a range of reviews seeking to identify the causes of the crisis and proposing institutional and regulatory changes to reduce the risk of such a crisis recurring. See, for example, the report of the High Level Group on Financial Supervision in the EU and *The Turner Review*, the report published by the Chairman of the FSA, Lord Turner, in March 2009 in response to a request by the then Chancellor of the Exchequer.
805 Bank for International Settlements' website, www.bis.org/bcbs/basel3.htm.
806 In a number of areas there are important links between these institutional changes and the regulatory reforms. For example, the countercyclical capital buffer, which has been set out as part of Basel III, will be operated in the UK by the Financial Policy Committee of the Bank of England, which will have the responsibility of identifying and taking action to remove or reduce systemic risks in order to protect the UK financial system.

817 Furthermore, although the internationally agreed capital standards set out in the Basel II framework sought to reduce the probability of bank failure to an acceptable level, they did not directly address the issue of reducing the impact of bank failure on the financial system. The issues raised in resolving a bank in an orderly fashion, especially one which is large, complex or operates internationally, have now become part of the mainstream of prudential considerations for the banking sector.

818 Basel III measures, reflecting these developments, will be phased in from 1 January 2013, with liquidity standards being introduced from 1 January 2015 and full implementation for all measures by 1 January 2019.

819 Since 2008, in addition to changes in quantitative requirements, there has also been an increase in resource and supervisory attention devoted by the FSA to assessing the quality and quantity of firms' capital, as well as firms' liquidity risk. In October 2009, the FSA set out its new liquidity regime, with qualitative requirements coming into effect on 1 December 2009 and quantitative requirements and reporting (including new liquidity returns) being introduced from June 2010 onwards.

	Standards in force during the Review Period	Changes in prudential standards since 2008
Quality and quantity of capital resources	Basel I assessed capital requirements for credit risk by weighting different categories of assets or off-balance sheet exposures according to broad categories of relative riskiness. The framework of risk weights was kept relatively simple, with only five risk weights (0%, 10%, 20%, 50% and 100%). The minimum capital requirement was 8% of risk-weighted assets (RWAs). The Basel II framework aimed to increase the risk sensitivity of capital resources requirements, particularly for credit risk, and permitted significant use of internal models requiring firms' own estimates of key credit risk parameters such as default probability. Credit risk was assessed using either a standardised approach or models within an internal ratings-based (IRB) approach, for which firms (including RBS) had to seek approval from the FSA. The overall minimum capital requirement remained unchanged at 8%. Under both Basel I and Basel II, a variety of capital instruments (including preference shares, innovative capital instruments and subordinated debt) counted towards meeting firms' capital resources requirements, alongside common equity. Capital resources were structured into tiers, with tier 1 capital instruments being higher quality than those within tier 2 or tier 3. 'Core tier 1' capital, the highest quality capital resources (mainly common equity with some adjustments), formed part of tier 1 capital resources. Non-core capital instruments were subject to certain limits. • Of tier 1, preference shares and innovative instruments could comprise 50% after deductions.	The financial crisis demonstrated the need for banks to maintain more capital which can absorb losses on a going concern basis. This supports market confidence in the bank's solvency, provides a stronger incentive for bank management to internalise the costs of risk-taking activity, and reduces the risk of a debt overhang problem.[807] Under Basel III, the overall minimum total capital ratio of 8% will remain while the required quality of capital will improve significantly, with the minimum core tier 1 (now referred to as 'common equity tier 1') ratio rising to 4.5% of RWAs and the minimum tier 1 ratio to 6% of RWAs. Banks will also be required to hold buffers above these minima, as discussed below. The revised minima for common equity tier 1 and tier 1 will be phased in between 1 January 2013 and 1 January 2015. A key focus of the regulatory reforms has been the quality of regulatory capital, especially its ability to absorb losses on a going concern basis. The crisis revealed that a range of capital instruments, notably forms of hybrid capital, did not absorb losses under stress. In addition, regulators recognised that the prevailing approach to adjusting regulatory capital for assets which could not be expected to absorb losses under stress, such as goodwill, was inadequate. These assets should be deducted from core tier 1 capital so that it provides a realistic measure of the amount of going concern loss absorbing capital. Since April 2008, the FSA has operated a 5% core capital target for certain major UK banks. During the October 2008 recapitalisation of the UK banking system, the FSA used a benchmark of 8% tier 1, and a post-stress benchmark of 4% core tier 1.[808] Further detail was provided in January 2009.[809]

807 A debt overhang problem occurs where shareholders are unwilling to provide more capital even though doing so would increase the value of the firm, because of the risk that the additional funds will ultimately serve only to reduce the losses that would otherwise have been borne not by shareholders, but by junior creditors.
808 *FSA Statement on Capital Approach Utilised in UK Bank Recapitalisation Package*, FSA, 14 November 2008.
809 *FSA Statement on regulatory approach to bank capital*, FSA, 19 January 2009.

	Standards in force during the Review Period	Changes in prudential standards since 2008
	• Admissible tier 2 capital resources could not exceed tier 1 capital resources after deductions (i.e. tier 1, net of deductions, had to be at least 50% of the total of net tier 1 and tier 2 capital resources). • This meant, in effect, that the minimum capital ratios under Basel II were low, at just 2% of RWAs for core tier 1 capital and 4% of RWAs for tier 1 capital. The crisis revealed that a range of capital instruments did not absorb losses under stress, nor whilst allowing firms to continue as a going concern. Also, the approach to adjusting regulatory capital for assets which could not be expected to absorb losses under stress was inadequate. For instance, goodwill and other intangible assets were deducted from tier 1 but not from core tier 1; hence lower quality capital could be used to meet regulatory deductions.	
Capital buffers	Neither Basel I nor Basel II established any quantitative norm for the size of capital buffer banks should hold above the regulatory minimum.	Basel III requires a capital conservation buffer of 2.5% of RWAs to be held in order to operate without additional restrictions on dividends and other distributions of capital. This buffer must be composed of common equity tier 1 capital. It will be phased in between 1 January 2016 and 1 January 2019. Furthermore, the size of this buffer can be increased through the countercyclical buffer. The size of the countercyclical buffer will be chosen by each jurisdiction's authorities and will apply to all banks with exposures to the particular jurisdiction. The capital buffers are intended to increase the resilience of the banking sector to shocks and will contribute to reducing the potential procyclicality inherent in setting risk-based capital requirements.[810] Also, these buffers will be further increased for global systemically important banks. In addition to the introduction of capital buffers, the banking regulatory community has broadly welcomed initiatives from the international accounting standard-setters to move away from an incurred loss based model of provisioning for impaired loans to a more forward-looking approach, based on expected losses.[811]

810 The countercyclical buffer is one of a number of macro-prudential tools that in future the authorities may use to address the build-up of systemic risk through the credit cycle. Further analysis of these issues is set out in the Bank of England's November 2009 Discussion Paper, *The role of macro-prudential policy*.

811 See the IASB's website, www.ifrs.org/Current+Projects/IASB+Projects/Financial+Instruments+A+Replacement+of+IAS+39+Financial+Instruments+Recognitio/Financial+Instruments+Impairment+of+Financial+Assetseplacement+of+IAS+39+Financial+Instruments+Recog/Supplementary+document/Supplementary+document.htm.

Capital regimes for market risk and counterparty credit risk	From 1996, Basel I incorporated market risk capital requirements and the concept of a regulatory trading book. From 1998, firms could apply for permission to use value-at-risk (VaR) models to calculate market risk capital requirements. Provided they met the conditions[812], firms could choose whether to hold assets in the regulatory trading book or the banking book and may transfer exposures between the books (although all trading book exposures must be fair valued). Use of VaR to calculate market risk capital requirements continued to be permitted under Basel II. However, the new framework introduced revised capital requirements for counterparty credit risk on assets in the trading book, as well as a requirement to capture default risk on traded positions. The counterparty credit risk regime is used to determine counterparty exposure figures for over-the-counter derivative and securities financing trades, which are then fed through the credit risk framework to generate a capital charge.	A weakness in regulatory capital held against trading activities was the absence of capital to absorb losses in credit risky assets which were held in the trading book but during the crisis were often found to have insufficient market liquidity such that banks were forced to retain the assets and the related credit risk. In July 2009[813], the Basel Committee announced a package of measures to address these deficiencies. These will be implemented in the EU from end-2011, and include: • improving the capture of credit risk in the trading book by introducing the Incremental Risk Charge to capture credit default and migration for firms that model traded credit; • reducing the relative cyclicality of VaR-based market risk capital charges, and improving their resilience to stressed periods through the introduction of a Stressed VaR measure; and • addressing the failings in firms' ability to model complex traded credit positions by applying standardised capital calculations for most securitisation positions in the trading book and tougher modelling standards for liquid credit index products through the introduction of the Comprehensive Risk Measure for correlation trading portfolios. In addition to these measures, the Basel Committee is currently conducting a fundamental review of the prudential regime for trading activities.[814] The existing counterparty credit risk framework only captures the jump-to-default element of counterparty risk. However, banks experienced substantial fair value losses during the crisis due to deterioration in the creditworthiness of their trading counterparties that was not captured by the current regime. As part of the Basel III amendments the Basel Committee has agreed the following changes to the counterparty credit risk framework, which will be implemented from 2013: • a new capital charge to cover the market volatility of credit valuation adjustments (CVAs), which are incurred when there are changes in counterparties' creditworthiness – this is intended as an interim measure until a more robust, longer-term solution is developed; • the removal of the zero capital charge for exposures to central counterparties, recognising that such exposures are typically low risk, but not risk-free, along with other changes to the treatment of exposures to default funds of central counterparties; and • a suite of technical measures aimed at improving the risk capture and calibration of the advanced counterparty credit risk internal model method approach.

812 The Basel Committee defined a trading book as follows: '*A trading book consists of positions in financial instruments and commodities held either with trading intent or in order to hedge other elements of the trading book. To be eligible for trading book capital treatment, financial instruments must either be free of any restrictive covenants on their tradability or be able to be hedged completely. In addition, positions should be frequently and accurately valued, and the portfolio should be actively managed*'. *International Convergence of Capital Measurement and Capital Standards: A Revised Framework, Comprehensive Version*, Basel Committee, June 2006.

813 Bank for International Settlements' website, www.bis.org/press/p090713.htm.

814 The FSA's views on the issues raised are set out in FSA Discussion Paper (DP) DP10/4, *The prudential regime for trading activities – a fundamental review*, August 2010.

	Standards in force during the Review Period	Changes in prudential standards since 2008
Capital held against securitisation positions	Under Basel I, securitisation positions typically attracted a 100% risk weight irrespective of the rating. Mortgage-backed securities which met certain conditions carried a 50% risk weight. Basel II sought greater risk sensitivity to reflect the risk within different positions and so risk weights could vary greatly depending on the rating of the asset (from 6% to 1250%). It also set out a clear framework for originators seeking capital relief in their securitisations. This promulgates three key principles that firms must meet before taking capital relief. They must: (i) have effective risk transfer; (ii) transfer significant risk; and (iii) not provide implicit support to the transaction.	At the European level, the principle that originators of securitisations should retain exposure to assets they have originated and sold on to investors has been established through a retention requirement which requires that banks may only invest in securitisation positions if the originator or sponsor retains a 5% net economic interest in the securitisation.[815] These requirements came into force on 1 January 2011. Further, the Basel Committee has introduced higher risk weights for re-securitisation positions due to their complexity and greater sensitivity to correlated losses.[816] Alongside these changes to capital requirements, investments in securitisations are subject to enhanced due diligence and disclosure requirements and strengthened underwriting standards. These changes will come into force by means of EU legislation on 31 December 2011.
Leverage ratio	Neither Basel I nor Basel II incorporated a leverage ratio as a backstop to RWA measures. During the development of Basel II, regulators had focused on increasing the risk sensitivity of capital requirements and the framework allowed very low levels of capital to be held against certain kinds of exposures, such as highly rated senior tranches of securitisations or, for those banks using the IRB approach for credit risk, prime residential mortgages. As a consequence, extremely high levels of leverage were compatible with the Basel II standards.[817]	The financial crisis was preceded by a significant increase in leverage, including among major UK banks.[818] While leverage is clearly only one factor influencing the vulnerability of a bank to unexpected shocks, a minimum leverage ratio (maximum leverage constraint) provides a simple back-stop to the risk-based capital requirements, ensuring a minimum level of bank capital safeguarding against deficiencies in model-based capital requirements. As a result, the G20[819] and the FSB[820] have endorsed the principle of incorporating a leverage ratio in the Basel III standards and the Basel Committee has agreed a minimum ratio of tier 1 capital to exposures of 3%. The measure of exposures includes traditional off balance sheet commitments, derivatives, repos and other securities financing transactions. The leverage ratio will be subject to a parallel run period from 1 January 2013 to 1 January 2017, with disclosure from 1 January 2015 and a migration to Pillar 1 from 1 January 2018.

815 Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009.
816 The Basel Committee is also currently considering the calibration of the capital requirements for securitisation positions, including reviewing the evidence on losses on these positions through the financial crisis.
817 Given a tier 1 capital requirement of 4% of RWAs and an assumed average risk weight of 50%, leverage of 50 times (a leverage ratio of 2%) is feasible.
818 See, for example, Chart 3.5 in FSA DP09/2, *A regulatory response to the global banking crisis*, March 2009.
819 *Leaders' Statement, The Pittsburgh Summit*, G20, September 2009.
820 *Financial Stability Forum Issues Recommendations and Principles to Strengthen Financial Systems*, Financial Stability Forum, 2 April 2009. The Financial Stability Forum was re-established as the FSB in April 2009.

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<tr>
<td>Liquidity</td>
<td>The prevailing FSA regulatory regime for liquidity at the time was the Sterling Stock Regime (SSR). The SSR was introduced in 1996 and applied to major UK retail banks, including RBS, on a consolidated basis. The objective of the regime was to ensure that each bank had enough highly liquid assets to meet its outflows for the first week of a liquidity crisis, without recourse to the market for renewed wholesale funding. It was considered that this would allow the authorities time to explore options for an orderly resolution.[821] The liquidity of the sterling stock banks was measured by the Sterling Stock Liquidity Ratio (SLR).</td>
<td>In October 2009, the FSA introduced a substantially new liquidity regime.[822] Its key elements are:
• over-arching principles of self-sufficiency and adequacy of liquidity resources;
• enhanced systems and controls requirements, which implement the Basel Committee's updated Principles for Sound Liquidity Risk Management and Supervision;
• updated quantitative requirements (Individual Liquidity Adequacy Standards, or ILAS), coupled with a narrow definition of liquid assets;
• a new modifications regime for branches and subsidiaries; and
• granular and frequent reporting requirements.
The ILAS framework sets out a formal process of liquidity assessment, culminating in the issuance of individual liquidity guidance (ILG), which is analogous to the established Pillar 2 process for firms' capital requirements. The introduction of this regime reflected the FSA's wish to move ahead with the development of a more comprehensive liquidity regime, rather than waiting for international developments. The qualitative requirements came into effect on 1 December 2009 and quantitative requirements and reporting (including new regulatory returns) were introduced from June 2010.
At the international level, the Basel III reforms set two new minimum standards for liquidity, intended to complement the Basel Committee's Principles for Sound Liquidity Risk Management and Supervision.[823] These aim to address both the short-term vulnerability of a bank that holds low levels of assets that will remain liquid in a stress, and the structural funding positions of banks, reducing the risk that they fund long-term assets with undue reliance on short-term unstable funding sources.
• The Liquidity Coverage Ratio (LCR) is intended to promote short-term resilience of a bank's liquidity risk profile by ensuring that a bank has an adequate level of unencumbered, high-quality liquid assets that can be converted into cash to meet its liquidity needs for a 30 calendar day time horizon under a significantly severe liquidity stress scenario. The LCR, including any revisions, will be introduced from 1 January 2015.
• The Net Stable Funding Ratio (NSFR) is intended to promote resilience over a longer time horizon by creating additional incentives for banks to fund their activities with more stable sources of funding on an ongoing basis and to limit over-reliance on short-term wholesale funding during times of buoyant market liquidity. The NSFR has a time horizon of one year – it is intended to capture structural issues to provide a sustainable maturity structure of assets and liabilities. The NSFR, including any revisions, will move to a minimum standard by 1 January 2018.</td>
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821 FSA DP07/7, *Review of the liquidity requirements for banks and building societies*, December 2007.
822 FSA Policy Statement (PS) PS09/16, *Strengthening liquidity standards*, October 2009.
823 Revised principles were published in September 2008. Bank for International Settlements' website: www.bis.org/publ/bcbs144.htm.

	Standards in force during the Review Period	Changes in prudential standards since 2008
Stress-testing	In 2005, the FSA's DP05/2 on stress-testing set out examples of good practice in this area and the FSA's *Financial Risk Outlook* highlighted the importance of stress-testing in 2006 and 2007. FSA Handbook Principles 3 (Management and Control) and 4 (Financial Prudence) applied throughout the period. SYSC 11.1.18G (which applied from end-2006) required firms to carry out appropriate stress-testing and scenario analysis, including taking reasonable steps to identify an appropriate range of realistic adverse circumstances and events in which liquidity risk might occur or crystallise. GENPRU 1.2.42R (which applied from end-2006) set out the obligation on firms to perform stress-testing; it required firms to '*take reasonable steps to identify an appropriate range of realistic adverse circumstances and events*' and to estimate the financial resources the firm would need as a consequence. Additional guidance was given in GENPRU 1.2.63G – 1.2.78G requiring deposit takers and CRD investment firms to project their capital resources over three to five years and to estimate financial resources needed to withstand the impact of a cyclical downturn. BIPRU 2.2 (applicable from 1 January 2007) required firms to project their capital through an economic recession under Pillar 2 of the Basel capital framework. BIPRU 4.3.39R (which applied from 1 January 2007) set out stress-testing requirements for those firms using the IRB approach.	In December 2009, the FSA set out its approach to stress-testing.[824] Its key elements are: • firms must develop, implement and action a robust and effective stress-testing programme which assesses their ability to meet capital and liquidity requirements in stressed conditions; • the FSA runs its own stress tests on a periodic basis for a number of firms to assess their ability to meet minimum specified capital levels throughout a stress period; and • simultaneous system-wide stress-testing undertaken by firms using a common scenario for financial stability purposes. Further, a requirement for firms to perform reverse stress-testing was introduced with effect from 14 December 2010. The FSA has subsequently articulated its appetite for stress tests for Pillar 2 and has set out '*anchor*' scenarios to serve as informative adverse scenarios to guide firms' calibrations of their own scenarios and as an indication of severity. In addition, supervisory recommended scenarios are designed to encourage engagement of firms' senior management, overcome 'disaster myopia' and enable approaches that are more easily benchmarked. Additionally, in September 2010 the FSA clarified its approach to capital planning buffers, which are set for BIPRU firms as part of Pillar 2 capital planning, so that these buffers may be drawn down during adverse external circumstances.

824 FSA PS09/20, *Stress and Scenario Testing – feedback on CP08/24 and final rules*, December 2009.

SIFIs	The Basel I and Basel II frameworks were designed for internationally active banks, but do not specifically consider systemic risk issues posed by firms deemed to be systemically important financial institutions (SIFIs).	In the context of its stated view that no firm should be too big or too complicated to fail, in November 2010 the G20 accepted the FSB's recommended approach to reducing the moral hazard posed by SIFIs.[825] The approach centres on ensuring SIFIs (and initially, in particular, global SIFIs) have higher loss absorbency capacity; can be viably resolved; and are supervised more intensively than non-SIFIs. The FSB and Basel Committee have agreed proposals for an additional loss absorbency requirement for globally systemically important banks (G-SIBs). G-SIBs will be identified using an indicator-based approach, and the level of additional capital requirement will rise with the extent to which the firm is scored as systemically important, within a range of 1%-2.5%. These reforms will be phased in from 2016 with full implementation by 1 January 2019.[826]

825 *The G20 Seoul Summit Leader's Declaration*, 11-12 November 2010.
826 *Policy Measures to Address Systemically Important Financial Institutions*, FSB, November 2011.

Appendix 2E
Estimating Basel III capital and liquidity measures for RBS

Estimating a capital Basel III proxy measure for RBS

820 To illustrate how RBS's capital position would have appeared had the Basel III regulatory reforms been in place during the Review Period, the Review Team estimated RBS's capital resources according to a proxy measure of common equity tier 1 on a Basel III basis. This proxy measure reflects significant changes to capital resources stemming from the Basel III standards published in December 2010.

821 As the Basel III regime was not part of the capital framework during the Review Period, the FSA did not collect data in a form that would now enable a calculation of Basel III capital measures. The data used to calculate the proxy measure included additional data provided by RBS on its historic capital position as part of this Review, information from published annual accounts and interim results and data collected as part of the Basel Committee on Banking Supervision's (Basel Commitee) 2010 Quantitative Impact Study (QIS) on the Basel III rules.[827] The Review Team made a number of assumptions in calculating an estimate, which are set out in this appendix.

822 The Basel III proxy measure of common equity tier 1 was calculated by taking shareholders' equity (i.e. common stock and reserves) within the regulatory consolidation group, without applying GENPRU[828] prudential filters on unrealised gains and losses (as these are removed by Basel III), and making a number of key Basel III regulatory adjustments. Interim losses, intangible assets, excess expected loss amounts, deferred tax assets (DTAs), and material holding amounts in excess of 10% of common equity tier 1 before other deductions were deducted. An adjustment was also made to take account of minority interests, which are only partially recognised within Basel III.

823 For the purposes of the partial recognition of minority interests, data up to mid-2007 were sourced from returns and data provided by RBS. The proportion recognised in those years was approximated by applying the same proportion as at end-2007. Minority interest amounts recognised in common equity tier 1 for 2007 were calculated from the bottom up, by determining eligible amounts of the ABN AMRO related minority interests stemming from RBS's consolidation of RFS Holdings.[829] The same proportion was applied to estimates for 2008.

827 Firms provided data for the QIS on a best efforts basis. This was completed in the first half of 2010, with an update in October 2010.
828 The part of the FSA Handbook that provides the basic capital adequacy requirements.
829 ABN AMRO's capital requirements were scaled up to reflect changes to market risk and counterparty credit risk rules under Basel III (as discussed in paragraph 826). This uplift was based on the increase in requirements reported by RBS in the Basel Committee's 2010 QIS (since the consolidated data provided by RBS at that time included ABN AMRO).

824 Basel III applies a number of treatments to material holdings, depending on whether they consist of significant or non-significant investments. Significant investments are treated along a '*corresponding deduction approach*'; significant investments in common stock are deducted only if they exceed a threshold of 10% of common equity tier 1 capital after other deductions and, in addition, if collectively with certain allowable DTAs and mortgage servicing rights, they exceed a threshold of 15% of common equity tier 1. The Review Team's deduction of material holdings only in excess of 10% of common equity tier 1 after other deductions assumed that all material holdings during the period were significant investments in common stock, and hence eligible for the allowance as per Basel III. This assumption is consistent with information provided by RBS as part of the Basel Committee's QIS. This showed that RBS's deductible material holdings as at end-2009 were all significant investments in common stock.

825 Basel III applies two separate treatments for DTAs where they rely on future profitability. DTAs not arising from temporary differences (e.g. net loss carry-forwards) are deducted in full from common equity tier 1. DTAs arising from temporary differences are only deducted if they exceed a threshold of 10% of RBS's common equity tier 1 capital and, in addition, if collectively with allowable significant investments in common stock and mortgage servicing rights, they exceed a threshold of 15% of RBS's common equity tier 1. Where RBS recognised net DTAs in its published accounts during the period, in the absence of a breakdown the Review Team treated them as loss carry-forwards and deducted 100% from common equity tier 1.[830] While this assumption by the Review Team is arbitrary, it is consistent with information provided by RBS as part of the Basel Committee's QIS. This reported that, of RBS's DTAs reliant on future profitability, the totality at end-2009 were net loss carry-forwards.

826 In order to provide an estimate of the capital requirements that RBS would have been subject to historically if the Basel III requirements had been in place, the Review Team used data from RBS's submission to the Basel Committee's QIS. These showed that the two significant changes in Basel III that would increase RBS's capital requirements were changes to the market risk and counterparty credit risk rules. The changes to the market risk rules were estimated to result in an increase in market risk capital requirements of 114% for RBS if they had been in place at end-2009. Changes to the counterparty credit risk rules were estimated to result in an increase of 19% in the (much larger) credit risk capital requirements. The estimated increase in the total risk-weighted assets (RWAs) of RBS from 2005 to 2008 given by adjusting RWAs by these estimates is set out in Table 1.

830 In fact, a deduction for DTAs is only taken for 2008, as RBS reported net deferred tax liabilities in its annual reports and accounts in previous years.

Table 1: Estimated increase in total RBS's total RWAs from 2005 to 2008				
Year end	2005	2006	2007	2008
Increase applied to total RWAs compared to RWAs reported at the time to estimate position had Basel III been in force	23%	24%	27%	24%

827 In addition, the Review Team took securitisation amounts previously deducted from capital on a 50/50 basis[831], and replaced this deduction with a risk-weighting of 1250% as per the Basel III rules. The resulting amounts were added to the adjusted RWAs calculated, as explained in the previous paragraph.

828 Applying the above increases, with hindsight, to the historical capital requirements of RBS does not take into account behavioural effects that the Basel III rules might have had, had these rules been in place at the time. It also does not adjust for the varying portfolio composition that RBS had at different points in time. Both of these factors mean that the calculation of Basel III equivalent capital requirements for historical periods is only an indicative estimate of the impact that the new rules might have had.

RBS's position under the Basel III proxy capital measure

829 Once it is fully in place, the Basel III regime will require a minimum common equity tier 1 ratio of 4.5%. The Review Team's estimate of 1.97% as a proxy measure for RBS's Basel III common equity tier 1 capital at end-2007 (including ABN AMRO within the consolidated position) was below the 4.5% common equity tier 1 minimum. It should be noted that this estimated ratio was heavily dependent on minority interests, which for RBS arose largely from the consortium structure behind the ABN AMRO acquisition.

830 The Review Team estimated that RBS would also have been below the 4.5% minimum at least from end-2004, based on the data that RBS submitted to the Review Team in March and September 2011.

831 The Basel III regime also introduces a capital conservation buffer (CCB) amounting to 2.5% of RWAs in common equity tier 1 above the minimum of 4.5%. This implies a total common equity tier 1 level of 7.0%. The CCB can be drawn down, but its depletion results in increasingly stringent restrictions on distributions as the level of common equity tier 1 approaches 4.5% (including dividends, share buybacks, discretionary payments on alternative tier 1 instruments, and discretionary bonus payments). Below a total common equity tier 1 level of 5.125% (i.e. a CCB of 0.625%), a firm may not make any such distributions. Based on the Review Team's estimates of a Basel III proxy measure, RBS's common equity tier 1 levels would have led to a total freeze on distributions as early as 2004 (although it should be noted that capital levels below the minimum of 4.5% would also have had further consequences).

831 Under Basel II, securitisation positions were deducted from capital resources by applying 50% of the deduction to tier 1 capital resources and the remainder to tier 2 capital resources.

832 Basel III further extends the CCB to reflect cyclical conditions. The buffer applicable to individual banks will reflect the geographic composition of their portfolio of credit exposures. Banks must apply a buffer in the range of 0%-2.5% of RWAs decided by the jurisdiction where they have the exposure. In addition, the buffer level decided by a bank's home jurisdiction may rise higher than 2.5% if the national authorities decide that this is necessary. The resulting countercyclical buffer for each bank should be held in the form of common equity tier 1, potentially taking the total common equity tier 1 level to 9.5%, or more in times of excess aggregate credit growth.

833 Given the significant build-up of excess credit growth and asset price inflation across major markets in the run-up to the crisis, by 2006 to 2007 RBS could potentially have been subject to a buffer requirement taking its total common equity tier 1 level to 9.5% or higher. From the time its common equity tier 1 ratio would have fallen below that level, RBS would potentially have faced incremental restrictions on its distributions; assuming a 9.5% common equity tier 1 level, it would potentially have been barred from making any distributions from the time its common equity tier 1 dipped below 5.75%. It was not possible to model what RBS's countercyclical buffer requirement might have been in prior years, but on the basis of these numbers it appeared likely that a total freeze of distributions would have begun before the start of the Review Period.

834 The Financial Stability Board (FSB) and the Basel Committee have agreed a framework under which the loss absorbency capacity of global systemically important banks (G-SIBs) is further extended.[832] G-SIBs will be identified using an indicator-based approach, and the level of the additional capital requirement will rise with the extent to which the banks are scored as systemically important using these indicators (within a range of 1%-2.5%). The resulting additional capital requirement will act as an extension of the CCB and is to be held in common equity tier 1.

835 Under the assumption of a countercyclical buffer component taking its common equity tier 1 buffer level to 9.5% of RWAs by 2006 to 2007, an additional G-SIB requirement could potentially have taken the level that RBS needed to hold in order to avoid restrictions on distributions to 12% of RWAs. It was not possible to model what RBS's G-SIB additional loss absorbency requirement would have been in prior years, but on the basis of these numbers it appeared all the more likely that a total freeze of distributions would have begun before the start of the Review Period.

Estimating a Basel III proxy liquidity measure for RBS

836 To illustrate how RBS's liquidity position would have appeared had the Basel III regulatory reforms been in place during the Review Period, the Review Team estimated RBS's liquidity position according to a proxy measure of the Basel III Liquidity Coverage Ratio (LCR).

832 *Policy Measures to Address Systemically Important Financial Institutions*, FSB, November 2011.

837 The Basel III LCR is a short-term metric that aims to ensure that banks hold a sufficient amount of unencumbered high-quality liquid assets, which they can convert into cash at little or no loss of value, to cover stressed net cumulative cash outflows at all times for up to 30 days.[833]

838 Using the data the FSA collected from RBS through the Liquidity Risk Profile (LRP) report at end-August 2008[834], the Review Team estimated that, had the new Basel III LCR standard been in force at the time, RBS would have had a ratio of between 18% and 32%, compared with a requirement of 100%. In order to comply with the Basel III LCR standard, RBS would have had to increase its stock of unencumbered high-quality liquid assets by between £125bn and £166bn or, alternatively, reduce its reliance on short-term wholesale funding.

839 Given that the Basel III regime was not in force during the Review Period, and that the data available to perform this estimate was not as granular as the current regulatory reporting format, the Review Team made a number of assumptions in developing a proxy Basel III LCR for RBS.[835] These are set out below.

- The LRP data were collected on a 'best efforts' basis (as not a regulatory return). Therefore, the Review Team could not assure that the data quality was in line with what is expected for a regulatory return.
- Marketable assets eligible for central bank facilities reported in line six and eight of the LRP report have been classified for the purpose of this analysis as Level 2 assets.[836] Marketable assets eligible for central bank facilities could include assets such as own-name securities, residential mortgage backed securities, and bank bonds which do not qualify as Level 2 assets. As a result the Review Team's estimate was likely to overstate the Level 2 assets.
- Operational deposits were not reported on the version of the LRP report used. The Review Team varied the proportions of operational balances (20%, 10%, 0%) in respect of wholesale deposits reported in lines 45 and 46 of the LRP report.
- The breakdown of retail and small and medium-sized enterprise (SME) deposits into the stable and non-stable categories was not available. In absence of this information, in estimating a range for the Basel III LCR the Review Team assumed a 50:50 split for stable and non-stable retail and SME deposits. It then varied the retail outflow assumptions applied to stable and non-stable deposits in four scenarios: 5% (stable) and 10% (non-stable) – the minimum required under Basel III[837]; 7.5% (stable) and 12.5% (non-stable); 12.5% (stable) and 17.5% (non-stable); and 17.5% (stable) and 22.5% (non-stable).

833 *Basel III: International framework for liquidity risk measurement, standards and monitoring*, Basel Committee, December 2010.
834 The end-August 2008 LRP data were collected via the LRP report version 1.02.
835 The Review Team acknowledged that the data it used in its estimate of RBS's liquidity position according to a proxy measure of the Basel III LCR broadens the scope for assumptions to be made and that its estimate could have been more accurate if it had RBS liquidity data at end-August 2008 in the current regulatory reporting format (which was not in place at the time). However, RBS advised the Review Team that it was not able to provide these data in that format (for the reason that this was not the regulatory reporting format at the time).
836 Level 2 assets are high quality corporate and covered bonds as well as lower quality sovereign debt (but a 15% haircut would be applied).
837 *Basel III: International framework for liquidity risk measurement, standards and monitoring*, Basel Committee, December 2010.

- The LRP applies the 40% Level 2 cap to the requirement, whereas the LCR has a dynamic limit that ‘adjusted level 2 securities’ cannot exceed two thirds of ‘adjusted level 1 securities’; only if the LCR equals 100% are the calculations identical.
- LRP uses a one-month stress horizon whereas the LCR uses a 30 calendar day horizon.
- LRP report version 1.02 reflected sponsored securitisation special purpose entities (SSPEs) by the off balance sheet commitments and these have a 100% outflow assumption under the LCR, rather than consolidating the assets and liabilities and undrawn commitments of the SSPEs themselves (as done in the new reporting forms). The impact was the same as full consolidation because the commitments to the conduits have to match the maximum potential size of the conduit.
- The calculation assumed that the data reported by RBS for end-August 2008 were correct. However, the Review Team considered that RBS was not reporting off balance sheet commitments accurately (including commitments RBS had in relation to the ABN AMRO asset-backed commercial paper conduits).

Appendix 2F
FSA policy on IRB model approvals during the Review Period

840 Decisions to grant permission for firms to use the internal ratings based (IRB) approach for credit risk under Basel II are given in the form of a waiver direction (referred to here as a waiver) under Section 148 of the Financial Services and Markets Act 2000 (FSMA). In practice, the IRB waiver modifies the main rule on capital requirements by requiring a firm to use the IRB approach for the exposures set out in the scope of the waiver according to the terms as set out. These terms include conditions, roll-out plans[838], permanent exemptions, reporting requirements and so forth.

841 FSA decisions on whether to approve firms' IRB applications were made by a Decision Making Committee (DMC). This committee, acting under delegated authority, drew its membership from Supervision divisions, the FSA's specialist Risk Review Department and the then Permissions, Decisions and Reporting division. The chair of the DMC was required to be a Head of Department or more senior person. Policy and the General Counsel's Division (the FSA's internal legal department) were obligatory attendees, in an advisory capacity.

842 Decisions by the DMC were made following a recommendation by the Supervision Team. This recommendation was made following a review of the application by supervision and risk specialists, with advice from Policy. The risk-based approach to the review of applications from major banks typically entailed in-depth review of the largest portfolios and the rating systems associated with them. Given that a major bank might operate dozens or even hundreds of rating systems, the FSA's policy was to examine a subset of the rating systems. The detailed review of a few material models was used as a window into compliance across the whole bank. On-site visits by the FSA's risk specialists and Supervision Teams looked at the quality of the models, issues that cut across individual rating systems, the institution's stress-testing, senior management understanding and corporate governance. In each case, the decision as to which rating systems to review was the subject of a DMC decision at a 'Planning DMC'.

843 The FSA's policy was that decisions made by the DMC on applications could take a number of specific forms:

- Approve: an unqualified decision to approve the application on the basis of meeting the minimum standards. In practice, all approvals of applications to move to an advanced IRB approach have been subject to conditions.
- Approve with conditions: a decision to approve, but with conditions imposed to address identified shortcomings, where overall the firm meets the minimum standards. These could be pre-implementation conditions, which the firm needed to meet before it could start to use the models for regulatory capital calculations. They could also be ongoing conditions

838 A plan for sequential implementation of the IRB approach to other portfolios within a firm.

that the firm needed to meet on an ongoing basis after an approval was given. These conditions might include specific requirements to undertake some remedial work by a set date. They were usually imposed in the FSA waiver that conferred the IRB permission and could affect the continuation of the IRB permission in cases where firms failed to satisfy a condition and where the effect of non-compliance was material and there was no appropriate remedial measure to address such failure. Firms might also be asked to satisfy supervisory conditions (for example, for further improvements or monitoring of the rating systems). Non-compliance with supervisory conditions was not expected to affect the continuation of the permission, but would be followed up as part of supervisory processes.

- Minded to grant an approval: prior to formal adoption of FSA rules relating to IRB, minded to grant decisions were made. These might be issued when a firm's models were not yet in compliance with BIPRU rules and further work was needed by the firm to achieve compliance. Such decisions might be made with pre-implementation or ongoing conditions, which might then be incorporated in the IRB waiver when issued depending on a firm's level of compliance at the time.

- Reject: a decision not to approve the application. In practice, the FSA would explain the reasons for rejection. The Review Team was not aware of any outright rejections.

844 Section 148 of FSMA requires the FSA to publish the waiver, unless it is inappropriate or unnecessary to do so. The FSA must include in its consideration whether publication would prejudice to an unreasonable degree the commercial interests of the authorised person concerned or any other member of its immediate group. In practice, IRB waivers are published, but on occasion the FSA may omit certain conditions on representation from the firm in question, if the FSA judges that their inclusion would be prejudicial to an unreasonable degree to the commercial interests of the firm.

845 A firm can apply to vary a decision. This might arise if the IRB approach is to be extended to a new business line not previously granted permission or contained within its roll-out plan. Also, a firm may significantly revise a rating system; this may not require a change to the formal direction provided the FSA continues to be satisfied that the firm's revised rating system meets the IRB requirements. During the Review Period, decisions to vary permissions were made exclusively by the DMC or a more senior FSA committee such as ExCo.

FSA policy on other model approvals during the Review Period

846 The decision-making process followed by the FSA for applications to use or vary the advanced measurement approach for operational risk and the internal models method approach for counterparty exposure (also referred to as an expected potential exposure, or EPE, model) is similar to that for IRB applications.[839]

847 The decision-making process for applications to use or vary the value-at-risk (VaR) approach for market risk is different. It involves a recommendation by a CAD Model Panel[840], chaired by FSA specialists, and subsequent final decision by supervisors. It is not further described here.

839 RBS submitted a waiver application to use its EPE model in December 2007 and the waiver was granted in July 2008. The firm did not submit an application to use the advanced measurement approach for operational risk during the Review Period.

840 The purpose of a CAD Model Panel is to make a consensus recommendation together with and to Supervision as to whether a firm should be granted model recognition and, as such, be permitted to use this model in its computation of regulatory market risk capital. 'CAD' refers to the Capital Adequacy Directive, which is the European legislation implementing the market risk capital regime.

Appendix 2G
Liquidity risk arising from RBS's exposure to ABCP conduits

848 Asset-backed commercial paper (ABCP) conduits issue short-term commercial paper (CP) backed by a pool of assets. In order to ensure it can pay the CP as it falls due, the conduit has liquidity facilities provided by a bank or banks, as well as credit enhancement. Where the bank originates the loans/assets purchased by its conduit, it is referred to as an 'own-asset' conduit; otherwise, the assets are purchased from a third party. Where the assets are purchased by the conduit from one originator, the conduit is referred to as a 'single seller' conduit; 'multi-seller' conduits have pools of assets purchased from multiple originators. A 'securities arbitrage' conduit seeks to benefit from the difference between short-term funding costs and long-term asset returns.

849 Prior to the acquisition of ABN AMRO, RBS acted in a number of capacities with respect to different ABCP conduits, including as a 'sponsor', a provider of committed liquidity facilities (both to its own, 'own-sponsored', and to third-party conduits); and in some cases also providing total rate of return swaps to third-party conduits which in effect provide capital and/or liquidity support.[841]

850 The acquisition of ABN AMRO significantly increased RBS's conduit exposure. The Review Team believes that at end-2007, RBS had provided a total of £15.2bn of liquidity facilities to own-sponsored conduits under arrangements which pre-dated the acquisition, and an additional £48.3bn[842] to ABN AMRO own-sponsored conduits arising from the ABN AMRO acquisition. That is, the acquisition quadrupled RBS's conduit exposure to own-sponsored conduits in terms of liquidity risk.

851 During the period, RBS acted as sponsor for two of its conduits, 'TAGS' and 'George Street Finance' which contained third-party assets; ABN AMRO acted as sponsor for the following of its conduits which contained third-party assets: 'Tulip', 'Orchid', 'Amsterdam', 'Windmill', 'Abel Tasman', and 'NightWatch', and its own-asset conduits: 'Grand' and 'Amstel'; and its securities arbitrage conduit, 'North Sea'.[843] In addition, the firm had exposures to a number of third-party conduits such as 'Havenrock' and 'Puma'.

852 The Review Team was not able to assemble a complete and detailed picture of the size and nature of the different conduit exposures due to limited information; however, it is clear that the variety and quantum of conduit exposures was considerable.

853 North Sea, for example, was a securities arbitrage conduit. The conduit's assets included significant exposures to collateralised debt obligations and non-conforming residential mortgage-backed securities. In the first half of 2008 the

841 Throughout Appendix 2G, information is based on the Review Team's analysis of FSA records, data provided by RBS to the Review Team and publicly available data.
842 Data provided by RBS to the Review Team in August 2011.
843 Except for Amstel and North Sea, all asset-backed commercial paper conduits listed were multi-seller.

maximum liquidity balance drawn by the conduit was £5.3bn, approximately the same as the conduit's total assets. The assets were subsequently sold to RBS in Q3 2008, at which point their fair value was determined to be approximately £4.1bn.

854 In addition to providing committed liquidity facilities to conduits, RBS was exposed to the performance of the assets held within the ABCP conduits through provision of credit enhancement (of approximately £2.4bn)[844] and holding ABCP conduit CP (the latter was also a way to provide liquidity to those conduits other than through a drawdown against committed liquidity facilities). It would also be exposed in the event that it brought assets back on to the balance sheet.

855 The Review Team saw evidence of FSA analysis, after the start of the crisis period, of the ABCP market and the exposure to ABCP conduits of major UK banks, including RBS.[845] There was also an increasing awareness by the market of the risks posed by conduits. In Q4 2007, the markets appeared to be aware of the potential liquidity risk run by RBS and ABN AMRO with regard to the liquidity facilities provided to their combined ABCP conduit business. In September 2007, Fitch and JP Morgan commented on RBS and ABN AMRO respectively in terms of their liquidity exposure to ABCP conduits.[846] In October, Moody's Global Banking provided further analysis of RBS's conduit exposure as it understood it.[847] While none of these commentaries was particularly negative, they did highlight the size of RBS's ABCP conduit exposure including the impact of the acquisition of ABN AMRO.

856 As described in Section 1.2, the Review Team concluded that the acquisition of ABN AMRO very significantly increased RBS's exposure to ABCP conduits. At end-June 2008, the liquidity drawn by own-sponsored conduits under the committed liquidity facilities and still outstanding (i.e. had been drawn but not yet repaid) was £8.6bn. The highest drawn balance for each of RBS's and ABN AMRO's own-sponsored conduits peaked at different points during the six months between January and June 2008. In total, the maximum drawn balances reached by these conduits was £10.2bn (of which £8.5bn related to ABN AMRO own-sponsored conduits).[848] These data demonstrate that RBS's and ABN AMRO's own-sponsored ABCP conduits suffered significant liquidity problems during 2008. The Review Team noted that these data did not include instances where RBS bought CP as a means to provide funding to these conduits. Therefore, the liquidity provided may have been greater than indicated here. The Review Team considered that the liquidity provided to RBS's and ABN AMRO's own-sponsored conduits represented a significant liquidity drain on RBS. The Review Team was not able to estimate a comparable figure for third-party ABCP conduits as RBS could not provide the required information.

844 2008 RBS annual report and accounts.
845 FSA records, August 2007.
846 Fitch Report, *Bank Exposure to ABCP is manageable for majority of banks*, 7 September 2007; JP Morgan Equity Research Report, 27 September 2007.
847 Moody's Global Banking, Bank Credit Analysis RBS, October 2007.
848 Data provided by RBS to the Review Team in August 2011.

Appendix 2H
RBS Board membership during the Review Period
(1 January 2005 to 7 October 2008)

Executive directors

Sir Fred Goodwin (CEO)

Gordon Pell

Fred Watt (to January 2006)

Lawrence Fish (to April 2008)

Guy Whittaker (from February 2006)

Johnny Cameron (from March 2006)

Mark Fisher (from March 2006)

Non-executive directors

Sir George Mathewson (Chairman to April 2006)

Sir Tom McKillop (joined Board in September 2005, Chairman from April 2006)

Bob Scott (Senior Independent Director)

Colin Buchan

Jim Currie

Archie Hunter

Charles 'Bud' Koch

Joe MacHale

Sir Steve Robson

Peter Sutherland

Sir Angus Grossart (to April 2005)

Iain Robertson (to April 2005)

Lord Vallance (to April 2005)

Eileen Mackay (to December 2005)

Janis Kong (from January 2006)

Bill Friedrich (from March 2006)

Lawrence Fish (from May 2008)

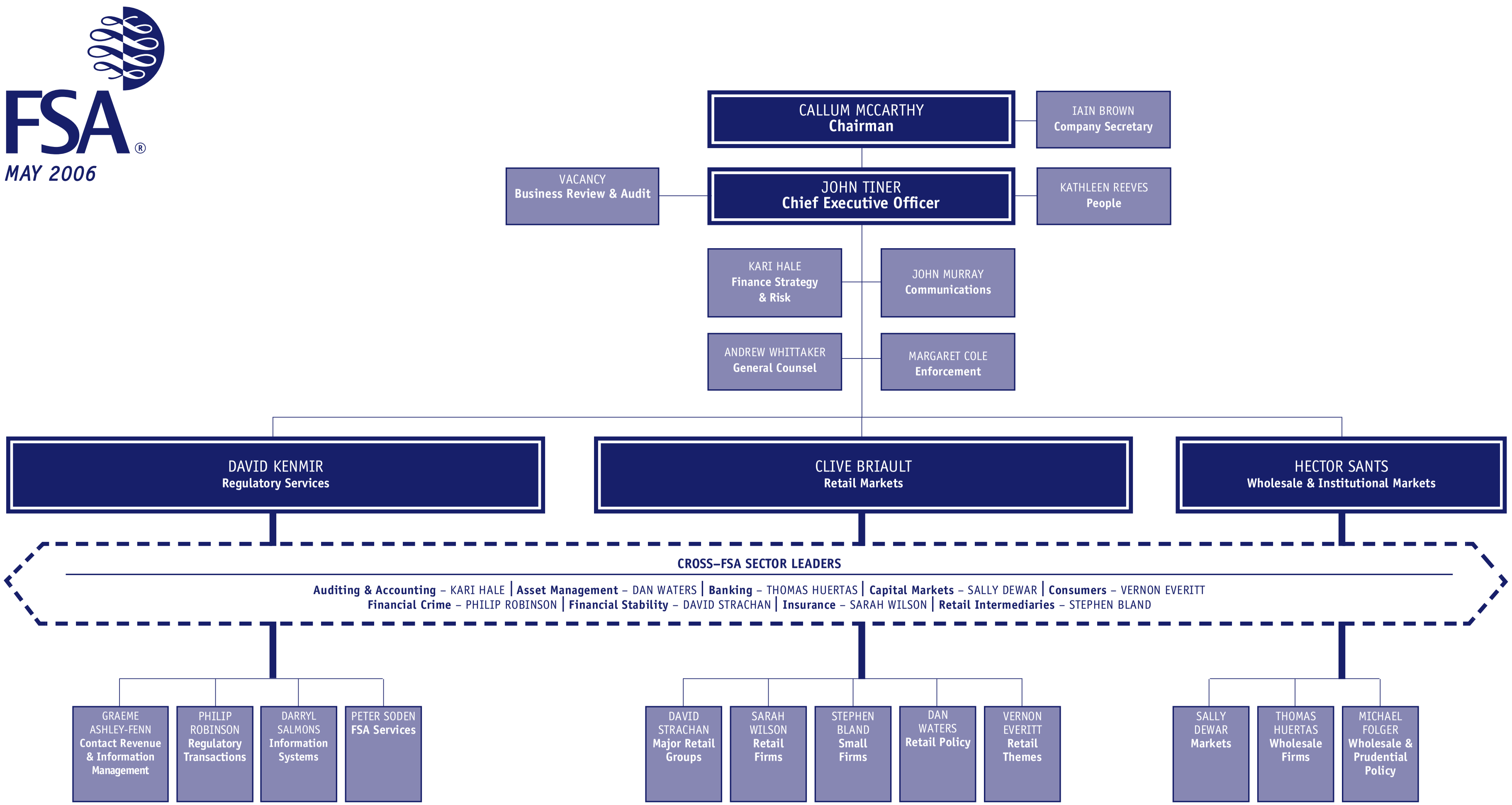
Stephen Hester (from October 2008)

John McFarlane (from October 2008)

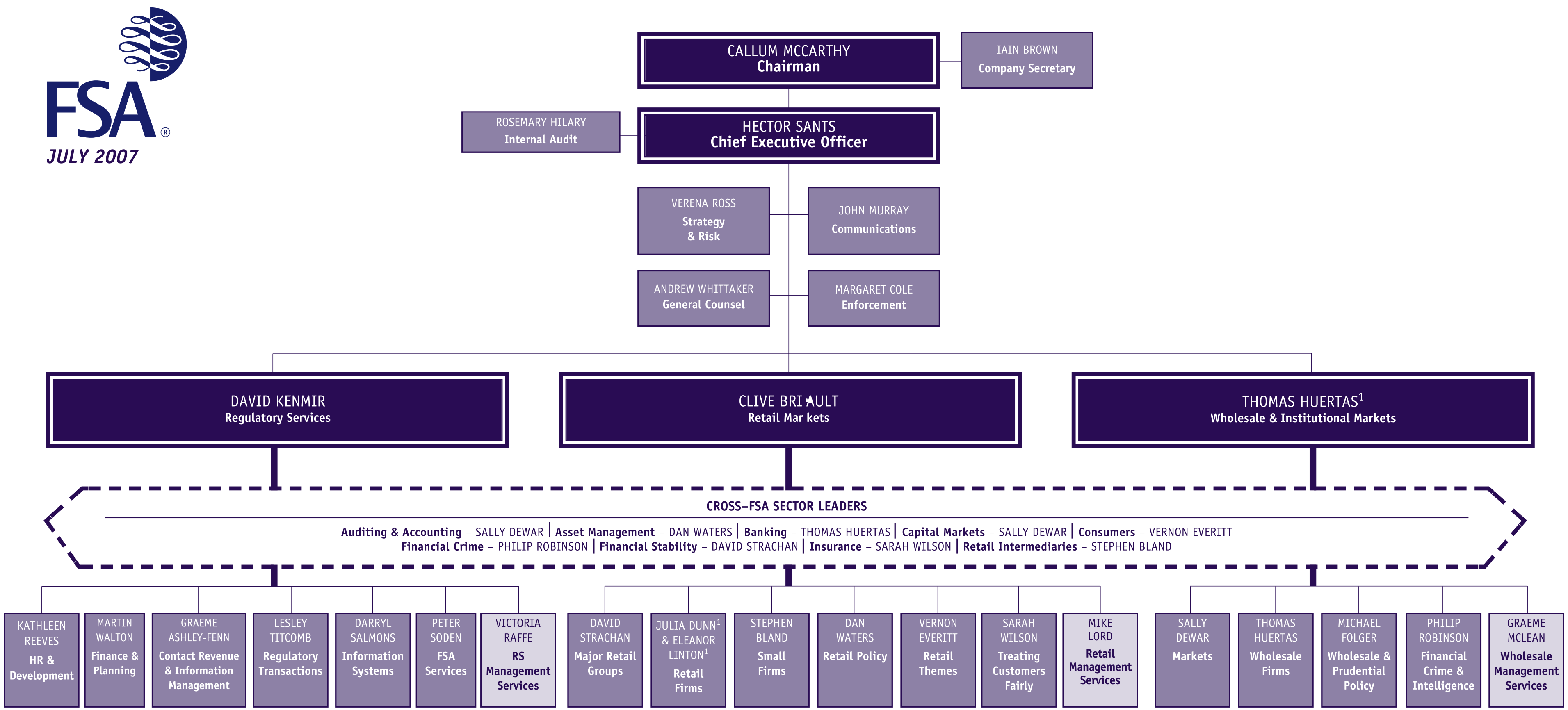
Arthur Ryan (from October 2008)

Appendix 2I
The FSA's management and Board during the Review Period

1. FSA organogram as at May 2006



2. FSA organogram as at July 2007



[1] Acting

3. Table of FSA Board members during the Review Period of 1 January 2005 – 7 October 2008

FSA Board members	Title	Period on FSA Board
Sir Callum McCarthy	Chairman	Start of Review Period – 19 September 2008
Lord Turner	Chairman	20 September 2008 – End of Review Period
Non-executive directors		
Dame Deirdre Hutton CBE	Deputy Chairman	Start of Review Period – 10 December 2007
Kyra Hazou		Start of Review Period – 18 January 2007
Tom de Swaan		Start of Review Period – 18 January 2007
Clive Wilkinson		Start of Review Period – 18 January 2007
Sir Andrew Large		Start of Review Period – 15 January 2006
Steve Thieke		Start of Review Period – 30 June 2005
Sir James Crosby		Throughout Review Period
	Deputy Chairman from	11 December 2007 – End of Review Period
Karin Forseke		Throughout Review Period
Prof David Miles		Throughout Review Period
Michael Slack		Throughout Review Period
Hugh Stevenson		Throughout Review Period
Sir John Gieve		16 January 2006 – End of Review Period
Peter Fisher		19 January 2007 – End of Review Period
Brian Flanagan		19 January 2007 – End of Review Period
Carolyn Fairbairn		11 December 2007 – End of Review Period
Executive directors		
John Tiner	CEO	Start of Review Period – 19 July 2007
Hector Sants	CEO	20 July 2007 – End of Review Period
	Managing Director of Wholesale and Institutional Markets	Start of Review Period until becoming CEO
Sally Dewar	Managing Director of Wholesale and Institutional Markets	9 January 2008 – End of Review Period
Clive Briault	Managing Director of Retail Markets	Start of Review Period – 30 April 2008
Jon Pain	Managing Director of Retail Markets	8 September 2008 – End of Review Period
David Kenmir*	Managing Director of Regulatory Services	Throughout Review Period

* David Kenmir acted as Managing Director of Retail Markets from 7 April 2008 – 7 September 2008.

4. Table of FSA ExCo members during the Review Period of 1 January 2005 – 7 October 2008

ExCo members	Title	Period on ExCo
John Tiner	CEO	Start of Review Period – 19 July 2007
Hector Sants	Managing Director of Wholesale and Institutional Markets	Start of Review Period until becoming CEO
	CEO	20 July 2007 – End of Review Period
Thomas Huertas*	Managing Director of Wholesale and Institutional Markets	20 July 2007 – 7 January 2008
Sally Dewar	Managing Director of Wholesale and Institutional Markets	9 January 2008 – End of Review Period
Clive Briault	Managing Director of Retail Markets	Start of Review Period – 30 April 2008
Jon Pain	Managing Director of Retail Markets	8 September 2008 – End of Review Period
David Kenmir**	Managing Director of Regulatory Services	Throughout Review Period
Andrew Whittaker	General Counsel	Throughout Review Period
Andrew Procter	Director of Enforcement	Start of Review Period – 7 January 2005
Margaret Cole	Director of Enforcement	18 July 2005 – End of Review Period
Vernon Everitt	Director of Human Resources	Start of Review Period – 23 September 2005
Kathleen Reeves***	Director of Human Resources	18 October 2005 – End of Review Period
Kari Hale	Director of Finance Strategy & Risk Division	Start of Review Period – 12 October 2006
Verena Ross	Director of Finance Strategy & Risk Division	29 November 2006 – End of Review Period

* Thomas Huertas was acting Managing Director of Wholesale and Institutional Markets from 20 July 2007 – 7 January 2008.
** David Kenmir was acting Managing Director of Retail Markets from 7 April 2008 – 7 September 2008.
*** Kathleen Reeves was acting Chief Operating Officer from 16 April 2008 – 7 September 2008.

Appendix 2J
Approach and processes followed by the Review Team

857 The coverage of Part 2 of the Report is explained in both the main Introduction and the Introduction to Part 2. This Appendix provides some supplementary detail on the approach and processes followed by the Review Team.

858 As outlined in the introductory material, Part 2 identifies the key lessons from RBS's failure rather than seeking to give a complete chronological account of events in RBS or of the FSA's supervision of RBS. It does not, for example, reflect or provide a comprehensive assessment of the firm's compliance with all parts of the FSA's prevailing Handbook; instead it reflects judgements by the Review Team about the areas on which to focus its work. There are, as a result, a number of significant areas of supervisory focus at the time, such as RBS's insurance businesses and the Treating Customers Fairly agenda, about which the Report says little or nothing.

859 Nor does the Report give specific focus to the question of the relationship between the firm's auditors and Supervision. It does, however, look at the auditors' role in relation to the end-2007 accounts in particular[849] and the fact that the Supervision Team was in contact with RBS's auditors at least annually.[850]

860 Part 2 of the Report was not produced as an internal audit report, but the main work conducted by the Review Team was carried out following the approach used by the FSA for its internal audit work, including for the Northern Rock Report. In line with that methodology, the information initially drawn on, apart from publicly available material, was largely internally sourced: material gathered from the FSA's supervisory relationship with RBS, together with that available from the enforcement work summarised in Part 3. That information was usually from sources protected under section 348 of the Financial Services and Markets Act. Document and information availability was, as a result, limited to what was available to the FSA through these means. Partly in response to this, at a second stage, interviews were held with a number of those who were part of RBS's executive management and Board members (both executive and non-executive members) at the relevant time.

849 See Part 2, Section 1.4.2.
850 See Part 2, Section 3.4.1.

Part 3

FSA Enforcement

Introduction

1 Parts 1 and 2 of this Report explain that RBS's failure in October 2008 stemmed from a complex combination of factors, some resulting from poor management decisions within RBS and others from inadequate regulatory approaches. Among those key factors, Parts 1 and 2 explain that:

- The losses incurred by RBS on credit trading – which amounted to £1.4bn in 2007 and £12.2bn in 2008 – played a significant role in eroding inadequate capital and in precipitating the collapse of confidence.
- The ABN AMRO acquisition was another key contributor to RBS's failure for a number of reasons:
  - it greatly increased RBS's exposure to risky trading assets;
  - the decision to fund the acquisition principally with debt rather than equity reduced its already low capital ratio and increased potential funding strains; and
  - the consolidation of the whole of ABN AMRO on to RBS's balance sheet initially introduced uncertainties which impacted on market confidence.

2 As explained in the Introduction to this Report, the growth of Global Banking and Markets (GBM)'s credit markets activity and the acquisition of ABN AMRO were the subjects of two of the three investigations initiated by the FSA's Enforcement and Financial Crime Division (Enforcement Division) in March 2009 in which they were assisted by PricewaterhouseCoopers (PwC). The third aspect of Enforcement Division's investigation work related to certain investment circulars issued by RBS. This work was undertaken because of concerns that investors had been asked to agree to a takeover which ultimately resulted in large losses and to provide new capital shortly before RBS failed. Enforcement Division was therefore keen to ensure that the investment circulars contained accurate information about the implications of the takeover and the firm's financial position and outlook.

3 As also explained in the Introduction, while it is clear from the account of RBS's failure in Part 1 of this Report that there is an overlap between some of the underlying reasons for the failure of the bank and the matters covered in its investigations, Enforcement Division did not carry out this investigation work for the purpose of publishing an account of why RBS failed. The purpose of Enforcement Division's investigation work was exclusively to establish whether any misconduct had taken place in relation to the three specific matters that it examined and to determine whether there was a basis for bringing successful disciplinary action. PwC's work was scoped to achieve these objectives and the direction of their work was guided by this. The work involved over 50 interviews with RBS executives, non-executives and other staff, and a review of over 20,000 documents.

4 Unlike the material set out in Parts 1 and 2 of this Report, the information and documents gathered in Enforcement Division's investigation and review were assessed to a forensic standard (i.e. to a standard appropriate for a contentious

regulatory process in which every allegation made must be capable of being convincingly evidenced before a tribunal) for the purposes of determining in each case whether there was a basis for bringing disciplinary action. Enforcement Division also, however, considered whether various other issues set out in Parts 1 and 2 of the Report warrant enforcement action. It concluded this was not appropriate and the reasoning behind this conclusion is set out in the final section of this Introduction. The fact that Enforcement Division decided not to proceed with enforcement action did not imply, and should not be taken to imply, that its investigation led to any view about the quality of processes in place or the correctness of judgements made by RBS other than in the context of possible enforcement action.

5 This Part of the Report aims to cover all of the most important points raised in the investigation reports prepared by PwC but does not reproduce those reports in full. The FSA is prevented from publishing PwC's reports in full because of its confidentiality obligations under the Financial Services and Markets Act 2000 (FSMA), which impose legal restrictions on its ability to disclose information belonging to or provided by firms or individuals without their consent. However, the FSA recognised that the particularly strong and legitimate public interest in the RBS case made it desirable to provide further detail if at all possible. Enforcement Division has therefore reviewed the information gathered by PwC and drawn upon it to give an account of the key decisions made by the RBS Board and executives in relation to the growth of GBM, the acquisition of ABN AMRO and the investment circulars issued by RBS. In addition to providing this account, this Part of the Report also sets out the findings of Enforcement Division's investigation, including its consideration of whether the PwC reports provided a basis for potential enforcement action.

6 The purpose of this Part of the Report is therefore two-fold:

- It provides a fair and balanced summary of the evidence gathered by PwC and Enforcement Division's findings on the key decisions made by the RBS Board and executives which were relevant to the growth of GBM's credit markets activity, the acquisition of ABN AMRO and the investment circulars issued by RBS.
- It explains the reasons why in each case Enforcement Division decided not to proceed with enforcement action.

7 This Part of the Report deals with the following matters:

- The rest of this Introduction explains why Enforcement Division chose to focus its resources on GBM, the ABN AMRO takeover and investment circulars, and what it needs to establish in order to take enforcement action. It then summarises the outcomes of Enforcement Division's investigation. The Introduction also sets out Enforcement Division's assessment of the appropriateness of now commencing further enforcement investigations in relation to the various failings at RBS identified earlier in this Report.
- Section 1 summarises the growth of those GBM businesses which contributed to the majority of credit market losses, namely structured credit (focusing in

particular on the losses relating to collateralised debt obligations (CDOs)) and leveraged finance. The key decisions focused on are: those to expand the US structured credit and leveraged finance businesses; the decision to continue to issue CDOs in early 2007 when initial signs of a deterioration in the US housing market had begun to emerge; and the decisions around hedging of retained CDOs positions throughout 2007.

- Section 2 sets out an account of the process followed by RBS in considering the takeover of ABN AMRO. This focuses on the due diligence undertaken, the involvement of the Board and the processes used in RBS's decision-making. The key decisions focused on are the decision to enter into the acquisition; the decision to proceed with the bid following very limited due diligence; the decision to proceed with the bid after LaSalle bank was sold to Bank of America; and the decision to continue with the bid in the face of deteriorating market conditions.
- Section 3 summarises Enforcement Division's findings in relation to the investment circulars. The key decisions focused on are the decisions made by RBS about the working capital statements included in the investment circulars.

Scope of Enforcement Division's investigations

8 This section explains why the FSA chose to focus resources on GBM, the ABN AMRO takeover and investment circulars.

9 Enforcement Division's objective was to identify whether individuals had acted in a way which could lead to formal disciplinary action, i.e. whether they had acted in a dishonest, reckless or incompetent way. A starting-point for Enforcement Division on all three topics was investigating those areas where it was most likely FSA requirements had been breached and the impact, or potential impact, of any breach was significant. It therefore chose: GBM, which had recorded significant losses in 2007 and 2008; the ABN AMRO takeover, which had a major impact on the financial position of the RBS in 2008; and the investment circulars associated with key investor decisions, which resulted in large shareholder losses.

10 Before Enforcement Division began its investigation work in March 2009, it held extensive discussions with the FSA's Supervision team and other specialists within the FSA, during which it sought to identify, on the basis of the information it had at the time, examples of potential wrong-doing which had had a material impact on RBS's financial position or on its investors. In scoping its investigations, Enforcement Division was looking primarily for examples of actionable misconduct by individuals, rather than by RBS as a firm. This is because it considered that, in the circumstances, disciplinary action against the individuals responsible for any misconduct would serve as a much greater deterrent than action against the firm.

11 The legal framework for taking action against individuals required Enforcement Division, at the time, to take disciplinary action within two years from the date on which the FSA knew of the misconduct or had information from which the

misconduct could reasonably be inferred.[1] This two-year time limit meant it was important to focus the investigations on the areas where Enforcement Division judged the potential of evidencing serious wrongdoing was greatest.

12 Moreover, the legislation requires that, when discharging its functions, the FSA must have regard (among other factors) to the need to use its resources in the most efficient and economic way. This impacts directly on what Enforcement Division chooses to investigate (although it was not a reason behind the decision not to proceed with enforcement action). The legislative requirements include assessing the likelihood of Enforcement Division being able to establish conclusive evidence to prove any case. This is particularly relevant in cases against individuals, which require a high standard of evidence and very strong evidence of an individual's personal culpability. The FSA's obligations are therefore different from those of a private party to litigation. This is important because when assessing the activities of any individual over a period of time, it is inevitable that there will be decisions made or processes adopted by him or her that could have been carried out differently or better. However, it would not be possible or appropriate for Enforcement Division to investigate all such matters, and it is neither acceptable nor desirable for it to make wide-ranging requests that seek all information on a matter without reason to believe these will progress investigations. Enforcement Division therefore often has to make careful judgements when choosing which areas it investigates.

13 Before Enforcement Division started its work, it sought and obtained support from the FSA Board for the scope of the investigations and the related budget. This Introduction explains in more detail why it decided to focus on each of the three areas.

GBM

14 Enforcement Division chose GBM because there were significant losses on structured credit assets which gave rise to concerns over the controls in place at GBM. Enforcement Division's approach was to place Mr Johnny Cameron under investigation because he was the senior manager responsible for the business. It therefore started an investigation focusing on Mr Cameron's potential personal culpability for any control failures within GBM.

15 As previously explained, in scoping such an investigation, Enforcement Division has to follow the policy and legal framework, which means it can only investigate those areas where it has concerns that its requirements have been breached. This meant it could not look at every area of GBM or the wider group. Instead, it focused on structured credit and leveraged finance where there were large losses and where an RBS Group Internal Audit report produced in July 2008 suggested problems with controls. When looking at these areas, Enforcement Division kept alert to whether there were related matters which might provide a basis for bringing enforcement action. Examples of such matters included the valuation of GBM's credit market positions towards the end of 2007 and in the first part of 2008, as well as whether it should take action against RBS Group

1 This limit was increased to three years by the Financial Services Act 2010.

CEO Sir Fred Goodwin for failing to delegate senior management roles in GBM to appropriately qualified staff. Enforcement Division's conclusions on these issues are discussed in paragraphs 184 to 189 of this Part of the Report.

ABN AMRO

16 Enforcement Division decided to investigate the acquisition of ABN AMRO because losses arising from the takeover were significant and because of allegations from various sources, many of which were the subject of media reporting, of governance failures in relation to the takeover. Enforcement Division was particularly interested in whether the RBS Board had been properly involved in the decision-making process and whether it had been provided with adequate information on which to make its decisions.

Investment circulars

17 Enforcement Division decided to investigate the investment circulars because it was concerned that investors had been asked to agree to a takeover which ultimately resulted in large losses and to provide new capital shortly before RBS failed. Given this background, it decided it was important to establish if RBS had taken the proper steps to ensure that the investment circulars set out the impact of the takeover and contained accurate information about the financial position and outlook for the firm.

Taking action against senior managers

18 Primary responsibility for ensuring compliance with a firm's regulatory obligations rests with the firm itself rather than the firm's individual employees. As previously set out the FSA will, however, where appropriate, bring cases against individual senior managers at a firm. The FSA believes that deterrence will most effectively be achieved by bringing home to such individuals the consequences of their actions. Accordingly, Enforcement Division's work focused on the responsibility of senior managers rather than seeking to sanction a bank that had already failed.

19 In order to take disciplinary action against an individual who has been approved by the FSA to perform a certain role at a firm (e.g. an executive or non-executive director), the legislation requires Enforcement Division to prove either that the individual has failed to comply with the FSA's Statements of Principle for Approved Persons or that he or she was otherwise knowingly concerned in a breach by the firm. If it can demonstrate either of these matters, it can impose a financial penalty on and/or publicly censure that approved person. In more serious matters, if it appears that the individual is not a fit and proper person, Enforcement Division can also seek a prohibition order preventing the individual from holding either any roles or specific roles within the financial services industry.

20 In bringing enforcement action against either a firm or an individual, the burden of proof is on the FSA and the standard of proof required is the civil standard (i.e. the balance of probabilities). However, the FSA can take disciplinary action against an approved person only where there is evidence of personal culpability on his or her

part. Personal culpability arises either where the behaviour was deliberate or where the approved person's standard of behaviour was below that which would be reasonable in all the circumstances at the time of the conduct concerned.[2]

21 For example, in cases where there is no indication of a lack of integrity on the part of a senior manager under investigation, the issue may be whether he or she has acted without due skill, care and diligence in carrying out the approved role, or whether he or she is competent to carry out the role. In such a case Enforcement Division would have to show that the actions or decisions of that senior manager fell below those which could be considered reasonable taking into account all the relevant circumstances at the time.

22 Enforcement Division does not have the power to take action simply because a failure occurs in an area for which an individual is responsible (i.e. there is no requirement of strict liability). It cannot, therefore, take action against the CEO of a firm simply on the grounds that there were a number of failures at the firm, even though the CEO is ultimately responsible for the actions of the firm. As explained above, to take enforcement action Enforcement Division needs to have clear evidence of personal culpability. Nor can it take action just because a decision is made which subsequently proves to be a wrong decision. In order to succeed in enforcement action, it needs to prove that the individual's action or decision, when viewed without the benefit of hindsight, was below reasonable standards at the time it was taken.

Taking action against the firm

23 In addition to taking enforcement action for matters individually, Enforcement Division can take action where there are a number of failings which while themselves not sufficiently serious, together warrant enforcement action. In the case of RBS, Enforcement Division identified a number of areas where it appeared there were systems and controls failures, some of which were not central to the business of the bank. These failures were not all attributable to a single individual but were the responsibility of the firm. It was therefore a matter of qualitative judgement whether Enforcement Division started action against the firm. Enforcement Division did not, however, think this was appropriate in this case. This was primarily because of its view that taking action against an individual was preferable to seeking to sanction a bank that had already failed. In addition, the matters causing it concern, which might under some circumstances lead to action against a firm, were in this case not central to the decisions that led to RBS taking on significant risks, a number of which crystallised into large losses.

24 In relation to a case against an individual or a firm, a decision on whether to proceed with enforcement action also requires consideration of a number of factors. These include the strength of the evidence gathered in the investigation and whether Enforcement Division is likely to be successful in persuading relevant decision-makers, including a tribunal which is independent of the FSA, that the matters justify enforcement sanction.

2 The FSA's policy on disciplinary action against senior management and other approved persons is set out in DEPP 6.2.4 G to DEPP 6.2.9 G.

Outcomes of Enforcement Division's investigation work

25 The outcomes of Enforcement Division's investigation work were as follows:

- In May 2010 the FSA agreed a settlement with Mr Cameron that he would not perform any significant influence function in relation to any regulated activity carried on by any authorised person, exempt person or exempt professional firm; or undertake any further full-time employment in the financial services industry. In return for this undertaking, the FSA agreed that it would not take any disciplinary action against Mr Cameron. The FSA did not make any findings of regulatory breach against Mr Cameron and he did not make any admissions.[3]
- On 2 December 2010 the FSA announced the outcome of the remainder of Enforcement Division's work, which stated:

  'The Review confirmed that RBS made a series of bad decisions in the years immediately before the financial crisis, most significantly the acquisition of ABN AMRO and the decision to aggressively expand its investment banking business. However, the Review concluded that these bad decisions were not the result of a lack of integrity by any individual and we did not identify any instances of fraud or dishonest activity by RBS senior individuals or a failure of governance on the part of the Board.[4]

  The issues we investigated did not warrant us taking any enforcement action, either against the firm or against individuals. However, the competence of RBS individuals can, and will, be taken into account in any future applications made by them to work at FSA regulated firms.'[5]

26 On the basis of the information gathered during the investigation, aside from the settlement it entered into with Mr Cameron, Enforcement Division decided not to pursue any further enforcement action. The decisions on whether to pursue enforcement action were discussed at the time at Head of Department and Director level in the Enforcement Division and at the FSA Executive Committee, and were reported to the FSA Board. The following sections explain for each of the matters investigated why Enforcement Division made these decisions.

27 In general, Enforcement Division identified that a number of decisions, which ultimately resulted in significant losses, were taken in 2006 and 2007 before the full extent of the financial crisis became apparent. Further, Enforcement Division identified that several of these decisions were based on assumptions and views that were shared by a significant number of other firms and market commentators. While Enforcement Division's work identified that there were deficiencies, some of which were significant, in the individual actions taken by RBS (in terms of the processes that RBS followed and the information it

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3 The FSA's full statement on this matter which includes the terms of Mr Cameron's undertaking can be found at www.fsa.gov.uk/pages/Library/Communication/PR/2010/081.shtml.

4 As described in Part 2, Section 2.2, while there were not failures of formal governance processes which could be subject to enforcement action, there were clearly deficiencies in the assessments made by the RBS Board.

5 The FSA's full statement on this matter can be found at www.fsa.gov.uk/pages/Library/Communication/Statements/2010/investigation_rbs.shtml.

gathered as the basis on which the decisions were made), it did not consider that these deficiencies provided a basis for successful enforcement action.

28 If additional matters come to light in the future, Enforcement Division will consider whether further action is appropriate. An example of an additional matter that has come to light since it closed its original enforcement investigations in December 2010 is an enquiry into valuations of various ABN AMRO structured credit products in the period after ABN AMRO was acquired by RBS. The enquiry is currently being run by the Securities and Exchange Commission in the US with the assistance of the FSA. A further example is the investigation being conducted in both the US and the UK into allegations that various banks, including RBS, failed to conduct proper due diligence in the sale of mortgage securities to US mortgage lenders Fannie Mae and Freddie Mac. Again, a major factor in any decision regarding these matters will be the strength of the evidence that Enforcement Division has.

Enforcement Division's approach to further failings identified in this Report

29 The scope of this Report is much wider-ranging than the enforcement investigations begun in March 2009 and, as previously explained in this Introduction, has had a very different objective, i.e. to identify the reasons why RBS failed. Parts 1 and 2 of the Report identify and analyse seven main factors contributing to the failure:

- Significant weaknesses in capital resulting from and permitted by inadequate regulation and management decisions.
- Over-reliance on risky wholesale short-term funding.
- Concerns and uncertainties about asset quality.
- Substantial losses in credit trading, which eroded market confidence.
- The ABN AMRO acquisition on which RBS proceeded without appropriate heed to the risks involved and with inadequate due diligence.
- An overall systemic crisis in which the banks in worse relative positions were extremely vulnerable to failure.
- Underlying deficiencies in RBS management style, governance and culture which made it prone to making poor decisions.

30 Of the seven, Enforcement Division's investigations focused on two of the factors: losses in credit trading (the investigation into Mr Cameron and GBM) and the ABN AMRO acquisition. While the conclusions about weaknesses in RBS made in Parts 1 and 2 of the Report should not be taken to imply a regulatory breach, in light of the Report's findings, Enforcement Division has considered if it should undertake further enforcement investigations or other action in relation to the remaining five issues. It concluded, ultimately, that further enforcement investigations or action are not appropriate. This was based on an assessment of a number of relevant factors including, in particular, the extent to which the failings,

viewed without the benefit of hindsight, reflected breaches of standards accepted at the time. In particular Enforcement Division took account of the following:

- While governance, systems and controls and decision-making may have fallen well short of best practice, and below the practices of a number of peer firms, the decisions taken and systems in place were not outside the bounds of reasonableness given all the circumstances at the time, including the approach of the FSA to various matters. Notably, although in key respects RBS's capital adequacy and liquidity positions may have been at the low end of what was permitted, the firm was still within the relevant legal minimum requirements. The FSA may not seek to apply standards of conduct retrospectively against the firms and individuals it regulates, on the basis that to do so would raise serious issues of unfairness.

- Within overarching topics such as capital adequacy and liquidity, specific individual failings have been identified. Some of these might give rise to an enforceable regulatory breach. However, they were small parts of the overall picture and were not of themselves significant contributors to the failure of RBS.

- In many cases the weaknesses were identified a number of years ago and RBS's systems and staff have since changed, which has a significant impact on Enforcement Division's ability to gather further robust evidence.

- Some of the opinions and questions raised in Parts 1 and 2 of the Report are with the benefit of hindsight and, as such, could not be used as evidence to prove a regulatory breach. The Report's conclusions regarding the overall systemic crisis in which banks in worse relative positions were extremely vulnerable to failure provides one such example. This highlights RBS's particular vulnerability to the various events that transpired (which resulted from its overall strategy). However, on the information available at the time (and noting again that RBS was not outside minimum legal requirements for capital, liquidity and asset quality), it was not *unreasonable* for RBS (and many other banks) to fail to anticipate the severity of the external market conditions that contributed to the firm's failure.

- As described in paragraph 4 above, the questions raised and conclusions reached in a number of areas, notably some of those in relation to the overall effectiveness of RBS management style, governance and culture, while an important part of the overall story of RBS's failure, would not, given the evidence of those involved, support enforcement action.

31 To give an example of its approach to specific weaknesses identified in the Report, Enforcement Division considered whether it should take action in relation to RBS's systems and controls for the calculation and management of its capital position. In particular, it looked at the circumstances surrounding the firm's apparent fall below its Individual Capital Guidance (ICG) at end-March 2008, following which it appeared unsure of its position in early April and possibly longer (as discussed in Part 2, Section 1.1.5). Although falling below ICG is not of itself a breach of FSA requirements, Enforcement Division looked

at whether the circumstances of RBS falling below its ICG, its lack of certainty over its capital position and its own subsequent analysis which showed it had not actually fallen below its ICG suggested RBS lacked adequate controls to monitor its position in relation to its capital requirements. While this may have been a sustainable case, RBS did not breach the Pillar 1 rules and there was only one occasion on which these weaknesses led to potential confusion about the position relative to the ICG. Enforcement Division therefore concluded that it would not be appropriate to take enforcement action against what was ultimately a process breach rather than a substantive breach of capital requirements. It also took into account that this was consistent with the approach that the FSA took at the time – i.e. it was aware of the matter and chose to address it by means other than enforcement.

32 Similarly, Enforcement Division considered whether it should take further enforcement action against RBS in respect of liquidity issues. In particular, it looked at the fact that, as set out in Part 2, Section 1.2.4, over a 16-month period from March 2006 to July 2007, RBS overstated its group Sterling Stock Liquidity Ratio (SLR) as a result of internal error. The impact of this mis-reporting was that RBS did not meet the minimum SLR during the period from 21 April 2006 to 5 July 2007. Again, however, Enforcement Division took into account that RBS's overall liquidity position was not affected and that RBS identified and informed both the FSA and the Bank of England of the error in July 2007. The FSA then entered into communications with RBS and a decision was therefore taken at the time to address the breach by methods other than enforcement.

33 As the two examples illustrate, any potential enforcement action in respect of the individual failings arising out of the five further factors contributing to RBS's failure identified by this Report would face serious obstacles and might raise issues of unfairness because it would involve a retrospective application of the FSA's standards of conduct. On balance, Enforcement Division was not persuaded that it was appropriate for the failings, whether considered individually or collectively, to form the basis of an enforcement action. However, as indicated in the Introduction to this Part, the fact that that Enforcement Division decided not to proceed with enforcement action did not imply, and should not be taken to imply, that its investigation led to any view about the quality of processes in place or the correctness of judgements made by RBS other than in the context of possible enforcement action.

1 Global Banking and Markets

1.1 Summary of Enforcement Division's investigation and conclusions

34 This section sets out the factual background to the growth of the Global Banking and Markets (GBM) division of RBS and the losses sustained by various of its businesses in 2007 and 2008. In particular, it explains how:

- In mid 2006, GBM committed itself to a strategy of growth, including growth in structured credit and leveraged finance in what seemed at the time a logical extension of these existing businesses. This reflected its desire to become more aggressive and ambitious. In 2007, this was expressed as an objective for GBM to become the leading player by profits by 2010.
- In early 2007 the market turned, leaving GBM holding large super senior CDO positions. These positions were rated as 'better than AAA' and, like many in the industry at the time, GBM believed that they carried very little risk.
- From Q2 2007 onwards, the mark-to-market prices of the super senior positions gradually deteriorated, and the likelihood of default by the monoline insurers with whom GBM had insured some of those positions increased, leading GBM eventually to incur major losses. Given that GBM had from late 2006 stopped taking on new positions, the issue from Q2 2007 became the management of those positions and the decisions GBM made regarding whether to hedge them and how to value them for external market disclosure.

35 In light of the above, the key issues which Enforcement Division investigated were:

- Whether the expansion of GBM in late 2006 was characterised a by a lack of controls which was sanctionable.
- Whether the decision to retain the super seniors in early 2007 was characterised by decision-making or lack of controls which were sanctionable.
- Whether, once GBM had retained the super senior positions, its decisions on the hedging and management of the positions were characterised by lack of controls which were sanctionable.
- Whether GBM's decisions on valuation and reporting to the market were sanctionable.

36 Enforcement Division reached the conclusion that, while there were many instances of imperfect decision-making:

- the decisions made by GBM in 2006 and early 2007 were in line with the dominant market assumptions; and
- the decisions on the hedging and management of its positions, while in retrospect poor, were not outside the bounds of reasonableness at the time.

37 Enforcement Division also concluded that while there was a bias towards optimism in GBM's valuation of its CDO positions, which gave it concern and might not reflect well on the judgements of various individuals within senior management, RBS's auditors and its Group Audit Committee, it did not identify clear evidence that these decisions were outside the bounds of plausible judgement at the time.[6] There was therefore no reasonable basis for enforcement action.

38 These factual findings and Enforcement Division's conclusions in relation to enforcement action are set out in further detail below.

1.2 Background

39 The rest of this section explains the strategic decisions and other matters considered by senior management and the RBS Board in respect of the growth of the structured credit and leveraged finance businesses during 2006 to 2008. These are:

- The background to the structured credit market, GBM's participation in it, and GBM's governance controls, roles and responsibilities.
- The decision in June 2006 to expand the structured credit business, in particular the focus on CDOs.
- The adequacy of risk control systems in respect of the growth of the structured credit business.
- The decision in January 2007 to continue to issue CDOs as conditions in the US housing market deteriorated.
- The decisions in mid 2007 not to hedge its CDO exposures to any significant extent.
- How GBM's exposures to monoline insurers grew during the course of 2007, and how the increasing risk of failure of monoline insurers to meet claims arising from losses on the retained super senior positions caused RBS to make write-downs in the insured super senior positions.
- How the structured credit exposures were monitored and reported internally.
- How these structured credit exposures were valued and reported externally.
- In relation to leveraged finance, the key decision in June 2006 to expand the business, with the main period of growth experienced during the first half of 2007.

40 The section then explains why Enforcement Division decided not to proceed with enforcement action in respect of these matters.

41 The material under the sub-headings that follow summarises the key issues covered in the underlying report prepared by PwC. A list of the chapter headings to that report is set out at Appendix 3A.

6 The valuation of the CDO positions for the 2007 Annual Report and Accounts is covered in Section 1.9.2.

1.2.1 Background to the structured credit market, GBM's participation in it and GBM governance controls and roles and responsibilities

42 GBM is the investment banking division of RBS. In 2005 it already had a significant credit markets business in structured credit and leveraged finance (see Box 3.1 below). In 2006, GBM committed itself to a strategy of 25% compound annual growth, including an increase of CDOs issuance, in order to become a market leader by profits by 2010.

43 The CDOs issued by GBM in 2006 and 2007 were based mainly on US sub-prime asset-backed securities (ABSs) collateral. Developments in the CDO market in 2007 resulted in RBS retaining the super senior tranches of a number of the CDOs that it completed. Like many other financial institutions, RBS had given limited consideration in 2006 to the market risks arising from a failure to distribute the super senior tranches, because of the perception at the time that the risk of these exposures suffering any loss was low.

44 During 2007 and 2008 in particular, financial institutions with high exposure to US housing market debt experienced significant losses and, in some cases, bankruptcy.

45 RBS's exposures to super senior CDOs and associated exposures, including to monoline insurers (see Section 1.7), caused it to suffer major losses.

Box 3.1

Structured credit and leveraged finance

Structured credit is a broad term used to describe a technique that was developed by financial institutions to help transfer credit risk between market participants. An integral part of structuring credit is the process of securitisation. This involves the parcelling of various assets, such as mortgages and credit card receivables, into investment classes of varying quality. This securitisation creates securities that represent an interest in the underlying pool of assets and which provide a stream of income to the investors. These are known as asset-backed securities (ABSs). Collateralised debt obligations (CDOs) are a type of ABS based on pools of underlying ABS assets from which tranches of notes are issued to investors. The notes are backed by the cash flows of the underlying ABS assets. The creation of a CDO typically requires the accumulation in a *'warehouse'* of the underlying ABSs.

The tranching process in the creation of CDOs produces at least one class of securities whose credit rating is higher than the average rating of the underlying collateral pool. This credit enhancement is achieved by prioritising any losses arising from the underlying ABSs to more junior tranches before losses are allocated to the more senior tranches, thus giving the senior tranches a better credit rating. In CDOs, the tranche which receives payments in preference to all other tranches (including the AAA-rated tranches) is known as the 'super senior' tranche. The super senior tranches were therefore a lower-risk, low-yield by-product of the creation of the higher-yielding, riskier junior tranches sought by investors prior to the financial crisis.

Leveraged finance is a type of lending in which a lender funds a business with more debt than would be considered normal for that company or industry, implying that the funding is riskier, and therefore yields a higher return for the lender than normal borrowing. As such, the finance is commonly used to achieve a specific, often temporary, transaction (for example, to make an acquisition, to effect a buy-out, to repurchase shares or to fund a one-time dividend).

46 The principal credit market losses incurred by the GBM business unit during 2007 and 2008 are summarised by product in Table 3.1.

Table 3.1: GBM credit market losses in 2007 and 2008[7]

Credit market losses (£m)			31 December 2007			31 December 2008
	RBS	ABN AMRO	Group	RBS	ABN AMRO	Group
Super senior CDOs	659	345	1,004	1,863	1,113	2,976
Monolines	456	406	862	1,821	1,736	3,557
US residential mortgages	627	304	931	n/a[8]	n/a	1,467
US commercial mortgages	108	-	108	n/a	n/a	95
Leveraged finance	285	2	287	907	181	1,088
Collaterised loan obligations (CLOs)	107	-	107	n/a	n/a	240
	2,242	**1,057**	**3,299**	**n/a**	**n/a**	**9,423**
CDS hedging (not specific to the above products)			(118)	n/a	n/a	(1,642)
Total losses			**3,181**	**5,511**	**2,270**	**7,781**

47 RBS's credit market losses for the years ended 31 December 2007 and 2008 related to assets with a balance sheet exposure (net of hedging and mark-to-market losses) of £28.4bn and £13.2bn, respectively. The majority of the credit market exposure and losses resulted from super senior CDOs, monolines, US residential mortgage-backed securities (RMBSs) and leveraged finance. Despite these losses, other areas of GBM achieved a strong performance in 2008, for example, portfolio and asset management, rates and currencies and commodities businesses.

48 Enforcement Division focused its investigation on those areas of GBM's business which it decided to expand in 2006 and which made significant contributions to RBS's losses[9] in 2008. These losses were on assets it owned before it acquired ABN AMRO, i.e.:

- super senior CDOs which had been retained uninsured on RBS's balance sheet, which caused a loss of £1.86bn;
- monolines, which caused a loss of £1.82bn; and
- leveraged finance, which caused a loss of £907m.

49 In its investigation work, Enforcement Division found that the losses incurred by RBS in 2007 and 2008 in relation to structured credit and leveraged finance

7 RBS Group plc Annual Report and Accounts 2008, Global Markets 2008 'Exposures & Write-downs DRAFT', pages 3-5.
8 Where 'n/a' is indicated in this table, the figures were not available to the investigators.
9 Under mark-to-market accounting, mark-to-market gains and losses are recognised when they occur rather than when an instrument is sold. As a result, where appropriate, super senior CDO write-downs and monoline CVA adjustments should be considered as recognised but not necessarily realised losses.

flowed in large part from a number of key strategic decisions made by RBS regarding the businesses in 2006 and 2007. These decisions were taken before the full extent of the financial crisis became apparent and were based on assumptions and views that were shared by a significant number of other firms and commentators. Further, as explained in Part 2, these losses were compounded by additional losses on similar assets acquired by RBS as part of its acquisition of the wholesale business of ABN AMRO (see Part 2, Section 1.4).

1.2.2 The GBM business

50 GBM provides a range of debt financing, risk management and investment services to medium and large international corporate clients and institutions. In addition, GBM takes on proprietary risk positions in financial instruments such as debt securities, loans, deposits, equities, sale and repurchase agreements and derivative financial instruments such as futures, forwards, swaps and options.

51 Table 3.2 summarises the results of the GBM business unit for 2006 to 2008 in the context of the RBS group as a whole. It also provides context as to the size of the credit markets business relative to the size of the overall GBM business and the consolidated RBS group. It shows that in 2006, 2007 and 2008, GBM represented approximately 57%, 62% and 70% respectively of the total assets of the RBS group. These figures included derivative assets, which were concentrated in GBM and which grew particularly rapidly.[10] In 2006 and 2007, GBM represented 41% and 37% of RBS's contribution (i.e. total profit before tax and centrally allocated overheads) and 24% and 22% of RBS's revenue respectively. In 2008, the RBS group was loss-making and GBM had negative income that year. The negative contribution of £40.7bn in 2008 involved a goodwill write-down. While credit markets' negative contribution of £4.2bn was only 10% of this total, it was a considerably higher percentage of the losses which actually reduced tangible equity. The information provided for 2007 and 2008 includes the ABN AMRO business.

52 Table 3.3 summarises the group's credit market exposures and losses by product at 6 December 2007 (the date RBS issued a trading statement), 31 December 2007 and 31 December 2008. These amounts include both GBM and ABN AMRO credit exposures and losses. The table also includes figures in respect of projected credit market losses which were included in the April 2008 Rights Issue prospectus (i.e. these were not year to date mark-to-market losses but expected future losses). The exposures over these time periods demonstrate the growth in the credit market losses in 2007 and 2008.

10 The value of derivatives changes in response to a change in an underlying variable (such as an interest rate, security price or index), and therefore changes in the value of derivative contracts do not necessarily reflect underlying activity and trading volumes.

Table 3.2: GBM results for 2006 to 2008 in the context of the RBS group[11]

Year ended 31 December (£m) (% total RBS)	**2006**		**2007[12]**		**2008**	
Credit Markets						
Revenue	-[13]		2,827	9%	(2,192)	n/a
Contribution	-		2,300	23%	(4,246)	10%
GBM						
Revenue[14]	6,704	24%	6,819	22%	(2,520)	n/a
Contribution[15]	3,811	41%	3,653	37%	(10,515)[16]	26%
Total assets – GBM	498,495[17]	57%	1,147,384[18]	62%	1,672,158[19]	70%
RBS Group						
Revenue[20]	28,002		30,366		25,868	
Contribution[21]	9,186		9,832		(40,667)	
Profit/(Loss) after tax[22]	6,202		7,303		(24,137)	
Total assets – RBS	871,432[23]		1,840,829[24]		2,401,652[25]	

53 In 2006, approximately a quarter of GBM's revenues were derived from its North American operations, of which US investment bank/broker-dealer RBS Greenwich Capital (now known as RBS Securities Inc) provided the majority. RBS Greenwich Capital was founded in 1981 and was acquired by RBS when it took over National Westminster Bank Plc (NatWest) in 2000. RBS Greenwich Capital's exposure to the US housing market was the focus of Enforcement Division's investigation work: the growth of RBS Greenwich Capital was a key factor in GBM's growth strategy for 2007 onwards, and a significant proportion of the losses made by GBM were incurred by the businesses which were exposed to the US housing market.

11 Detailed Business Commentary, page 8; RBS Group plc Annual Report and Accounts 2007; RBS Group plc Annual Report and Accounts 2008.
12 Including ABN AMRO from the date of acquisition.
13 Not publicly available.
14 RBS Group plc Annual Report and Accounts 2008, page 260.
15 RBS Group plc Annual Report and Accounts 2008, page 260.
16 Of which £4.5bn (2007 £3.6bn) is attributable to RBS and £6bn (2007 £15m) is attributable to ABN AMRO.
17 RBS Group plc Annual Report and Accounts 2007, page 209 (comparative data used due to different divisional presentation used in the 2007 annual accounts).
18 RBS Group plc Annual Report and Accounts 2008, page 261.
19 RBS Group plc Annual Report and Accounts 2008, page 261.
20 RBS Group plc Annual Report and Accounts 2008, page 174.
21 RBS Group plc Annual Report and Accounts 2008, page 174.
22 Attributable to ordinary shareholders. RBS Annual Report and Accounts 2008, page 14.
23 RBS Group plc Annual Report and Accounts 2007, page 121.
24 RBS Group plc Annual Report and Accounts 2008, page 175.
25 RBS Group plc Annual Report and Accounts 2008, page 175.

Table 3.3: RBS group's credit market exposures and losses by product[26]

(£m)	6 December 2007 (Trading Statement)		31 December 2007		22 April 2008 (estimated 2008 writedowns)		31 December 2008	
	Net exposure*	YTD mark-to-market loss	Net exposure*	YTD mark-to-market loss	Net exposure*	YTD mark-to-market loss	Net exposure*	YTD mark-to-market loss
Super senior CDO								
High grade	2,767	307**	2,581	467	1,608	990	1,231	1,836
Mezzanine	1,256	538**	1,253	537	361	902	144	1,140
Total super senior CDO	4,023	*845***	3,834	1,004	1,969	1,892	1,375	2,976
Monoline exposure	[n]	[n]	2,547	862	3,174	1,752	4,804	3,557
US residential mortgages	[n]	[n]	4,319	931	2,267	1,171	-	1,467
US commercial mortgages	[n]	[n]	1,809	108	1,397	201	437	95
Leveraged finance	[n]	[n]	14,506	287	12,354	1,250	6,023	1,088
CLO	[n]	[n]	1,386	107	1,214	106	520	240
Subtotal			*28,401***	3,299	*22,375***	6,372	13,159	9,423
CDS hedging	[n]	[n]		(118)		(470)		(1,642)
Total			**28,401** **	**3,181**	**22,375** **	**5,902**	**13,159**	**7,781**

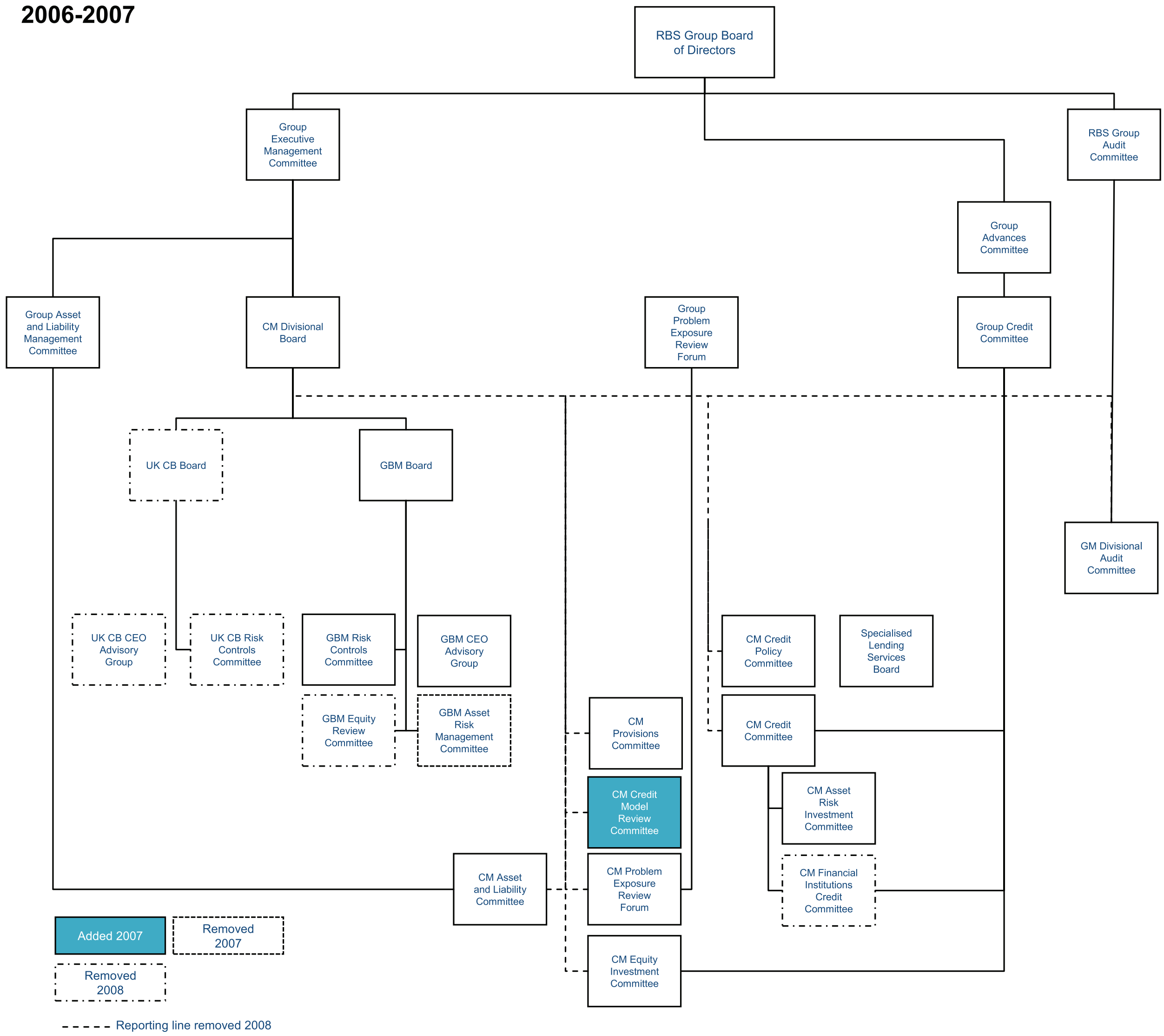
* Net of hedging and mark-to-market losses.
** Calculated by the investigators.
[n] Number not publicly available.

1.2.3 GBM's place in the RBS group governance structure

54 The running of GBM's businesses was overseen by a number of management boards and governance committees. At group level these included the RBS Group Board of Directors, the Group Executive Management Committee (GEMC), the RBS Group Audit Committee, the Group Asset and Liability Management Committee and the Group Risk Committee. At divisional level (i.e. the Corporate Markets/Global Markets division, within which sat GBM), these included the Divisional Board and the Divisional Audit Committee. At GBM level, the principal committees were the GBM Board and the quarterly GBM Risk Controls Committee. Figure 3.1 and Figure 3.2 illustrate how GBM reported into the divisional and Group Boards and Committees:

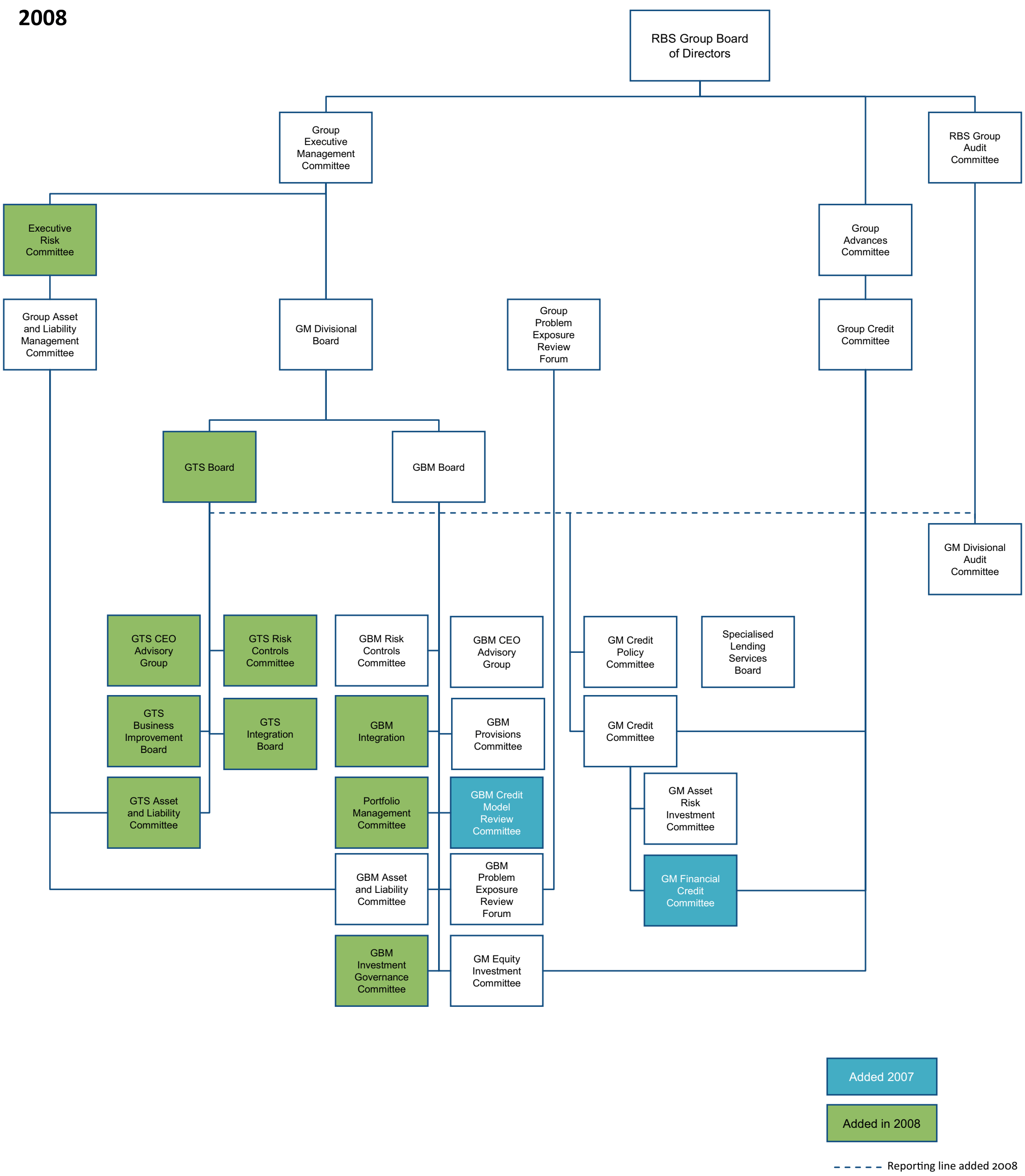
26 Group Chief Accountants Credit market exposures, issued to members of the group Board 5 August 2008; RBS Annual Report and Accounts 2008; RBS Pre-close Trading Update, 6 December 2007; investigator calculation.

Figure 3.1: GBM high-level management board and governance committee structure 2006 to 2007[27]



27 RBS High Level Controls Report, June 2006; RBS High Level Controls Report, May 2007; RBS High Level Controls Report, October 2008; Corporate Markets High Level Controls Report, June 2006; Corporate Markets High Level Controls Report, May 2007; Global Markets High Level Controls Report, October 2008, pages 1 to 13; Global Markets High Level Controls Report, October 2008, pages 14 to 91.

Figure 3.2: GBM high-level management board and governance committee structure 2008 (post the acquisition of ABN AMRO, the transfer of UK Corporate Banking out of Corporate Markets and the name change from Corporate Markets to Global Markets)[28]



28 RBS High Level Controls Report, June 2006; RBS High Level Controls Report, May 2007; RBS High Level Controls Report, October 2008; Corporate Markets High Level Controls Report, June 2006; Corporate Markets High Level Controls Report, May 2007; Global Markets High Level Controls Report, October 2008, pages 1 to 13; Global Markets High Level Controls Report, October 2008, pages 14 to 91.

55 The RBS Board was ultimately responsible for the internal controls in place throughout the group. It sought assurance from management and Internal Audit that the system was functioning effectively. In particular, the RBS Board received the Risk Management Monthly Report setting out what were considered to be the most significant risks across the group and the controls in place to mitigate these risks. The GEMC also received the Risk Management Monthly Report and reviewed an annual risk and control report prior to its submission to the Group Audit Committee and the Group Board. From early 2008, the Group Chief Risk Officer became a full voting member of the GEMC and had regular direct reporting access to the Group Board as well as the Group Audit Committee.

56 The role of Group Internal Audit was to:

- assess how key business risks were managed and controlled throughout the group and report the results to the Group Executive and Group Audit Committee; and
- influence the continuous development of the risk management and control process by sharing best practices across the group.

57 The primary objectives of the Group Risk function included advising the RBS Board and GEMC on risk matters (including credit and market risk) and enforcing group risk management policy so that risk taken was in line with the desired risk appetite for the group. Group Risk was also required to review divisional management information produced for the Divisional Risk Committee and RBS Board to ensure that all material issues identified were appropriately incorporated into group level management information and escalated appropriately.

58 At the divisional level, the Corporate Markets/Global Markets Divisional Audit Committee was responsible for reviewing the arrangements of systems of internal controls in relation to risk, financial management, compliance with laws and regulations and safeguarding of assets, and the procedures for monitoring the effectiveness of such controls, as well as concluding on the status of the control environment and confirming that all control standards remained robust and appropriate. The Chairman and some members of the Divisional Audit Committee were independent of GBM.

59 At GBM level, the main responsibility of the GBM Board was to review strategic matters, budgets and performance and to establish and monitor the implementation of policy in relation to risk. The primary fora for considering risk at the GBM and divisional levels were the GBM Risk Controls Committee (RCC) and the Chief Risk Officer (CRO)'s Monthly Risk Meeting. The main function of the GBM RCC was to carry out the responsibilities delegated to it by the GBM Board in respect of internal controls, financial reporting controls and risk assessment.

60 A key role in the control environment was also played by the GBM Finance function, which reported to both GBM senior management and the RBS Group Chief Financial Officer. The responsibilities of GBM Finance included the GBM strategy and budgeting process, the reporting of financial management information and the Independent Price Verification process. GBM Finance produced the

following three regular results reports for GBM senior management: (i) a daily profit and loss report; (ii) monthly Flash results for GBM, comprising a profit and loss account for the entire GBM business together with supporting analyses; and (iii) the GBM Performance Highlights report produced following the finalisation of the monthly results, which was the main report for communicating the GBM financial performance and was sent to the GBM Board and the RBS Board. The primary focus of the Performance Highlights report was profit and loss performance, but it also included two balance sheets accompanied by key observations explaining variances to budget.

1.2.4 Apportionment of roles and responsibilities

61 For much of the relevant period, GBM was run by Johnny Cameron and Brian Crowe. On paper both had similar responsibilities: much of the formal role profile documentation for the two men was identical. However, whereas Mr Cameron was Chairman of GBM and responsible for managing Corporate Markets (later renamed Global Markets after the takeover of ABN AMRO) which included oversight of GBM, Mr Crowe, who reported to Mr Cameron, was CEO of GBM. In practice, therefore, Mr Crowe's role was more day-to-day management of the GBM business while Mr Cameron focused more on GBM's strategic client relationships, RBS Board matters and credit committees.

62 Mr Cameron's role and responsibilities remained broadly the same during the period investigated by Enforcement Division. He was the CEO of the Corporate Markets Division that comprised the two separate divisions of GBM and UK Corporate Banking. After October 2007 Mr Cameron also had responsibility for the business division of Global Transaction Services. The role of CEO of GBM was held by Mr Crowe until he transferred to ABN AMRO in October 2007, returning to RBS in late March 2008 to work on preparation for the rights issue and taking up the GBM CEO role again in May 2008. The secondment of Mr Crowe to ABN AMRO created a gap in traded markets experience in GBM, although Mr Cameron told Enforcement Division that Mr Drake-Brockman and Mr Nielsen (who both had traded markets backgrounds) stepped up to fill the gap.

63 The difference in roles and responsibilities of Mr Crowe and Mr Cameron reflected their differing backgrounds and skills. Mr Crowe was from a markets background whereas Mr Cameron had more of a corporate banking background. In interview Mr Levine (Head of North America to November 2007 and joint Head of North America November 2007 to March 2008) said *'Johnny was the bigger thinker, more customer involvement. Brian was more focused on the markets and market risks'*.[29]

64 Mr Cameron's role, however, was not that of a non-executive. He was closely involved in some aspects of the business and when he identified possible issues he became engaged in them; for example, when the sub-prime crisis emerged he was active in requesting information and furthering his understanding of the risks and products.

29 Compelled interview with Mr Levine, 9 October 2009, part 1 of 4, lines 389-390.

65 Mr Crowe and Mr Cameron were responsible for submitting reports to the RBS Board and both were members of the GEMC. Mr Cameron was also a member of the RBS Board. Previous positions held by some of the Board suggest that they would have had relevant knowledge and experience in the traded markets. These included Colin Buchan, a NED who was formerly a member of the group management board of UBS AG, formerly head of Equities at UBS Warburg and at the time chairman of UBS securities Canada; and Guy Whittaker, RBS Group Finance Director, who was formerly group treasurer at Citibank. However, as the only representative of GBM on the Board, Mr Cameron was in a unique position to provide input to the Board as to how markets issues were affecting the GBM business. Mr Cameron's absence of in depth traded markets experience resulted in the potential for ineffective reporting of those matters to the Board. Mr Cameron, however, was able to rely on the input of Mr Crowe and others with the relevant expertise in both his day-to-day management of traded markets issues and his preparation for RBS Board meetings.

1.3 RBS's decision in June 2006 to expand structured credit

66 Enforcement considered that the first key strategic decision which led to the credit market losses incurred by GBM was RBS's decision in June 2006 to expand its structured credit business, in particular to issue more CDOs.

67 By 2006, RBS Greenwich Capital had already established a significant business in the origination, sales and trading of ABSs and specialised in securitisation of US residential mortgage-backed securities and commercial mortgage-backed securities. However, the Board considered that RBS lagged behind its rivals in the credit markets. According to GBM senior managers, in 2006 there was a clear impetus from the Board to focus on organic growth, which involved expanding significantly in those areas where RBS considered itself to be behind its peers and to be more aggressive and ambitious in its outlook. The desire for a more ambitious approach is demonstrated in an email from Mr Crowe (GBM CEO) in June 2006 which stated:

'the Board has been very bullish over the last 24 hours across all the GBM business in wanting to avoid the defensiveness in approach that we tend to adopt, and to be more aggressive and ambitious'.[30]

68 In order to achieve higher rates of organic growth, in February 2006 GBM identified a number of key strategic initiatives for 2007 onwards, which were presented to the Group Board in June 2006. The overall strategy endorsed by the RBS Board was one of consistent growth in GBM's existing business lines such as structured credit and leveraged finance to bring GBM in line with its competitors. This reflected the desire to become more aggressive and ambitious. GBM's 2007 strategy required its revenue to grow at a compound annual rate of 25%. Income for GBM was forecast to grow by 18% in 2007. This built on increases in GBM's income of 30% in 2005 and 24% in 2006.

30 Email from Mr Crowe to Mr Robertson, Mr Coleman, Mr Cameron, 21 June 2006, page 1 and 2.

69 The structured credit strategy – in particular the increased issuance of CDOs by RBS Greenwich Capital – was seen as a key driver of revenue growth. RBS's target was to achieve a top five position in market share terms for structured credit by 2010 (as opposed to just for ABSs, in which it already held a top three position). This required GBM to increase its level of CDOs activity by at least 50%. The revenue and profit targets for structured credit assumed ambitious and sustained growth. GBM revenues from structured credit were projected to grow from £51m in 2005 to £128m in 2006, £200m in 2007 and £300m in 2008. In 2006, GBM made £63m profit in this area, while the profit target for 2010 was £200m (an increase of 217% on 2006).

70 As previously mentioned, GBM had already established itself as a market leader and active arranger of third-party securitisations and a secondary dealer in ABSs.

71 During 2007, GBM was named Sterling Bond House of the Year and European and North American Securitisation House of the Year.[31] During 2005 and 2006, RBS Greenwich Capital was the second and third largest issuer of RMBSs and commercial mortgage-backed securities (CMBSs) in the market, behind Bear Stearns in 2005, and Lehman Brothers and Bear Stearns in 2006. Table 3.4 presents GBM's position in the ABSs market. It shows issuance amounts, the number of deals completed and the market share (all of which fell in 2007 as RBS scaled back this business as the market deteriorated).

Table 3.4: GBM's market position in the ABSs market, 2005 to 2007[32]

Year	Market position	Issuance ($m)	No. of deals	Market Share (%)	Total size of market ($m)
2005	2	60,713	78	11.8%	514,240
2006	3	52,670	67	9.3%	566,252
2007	9	25,844	40	5.9%	435,816

72 RBS Greenwich Capital structured, distributed and traded various types of ABSs. The ABSs business consisted of the following main activities:

- trading and sales of Agency Sponsored securities (Fannie Mae, Freddie Mac and Ginnie Mae);
- origination, sales and trading of RMBSs and CMBSs; and
- origination, sales and trading of other ABSs, for example, credit card loans.

73 GBM's senior management believed that CDOs were a natural expansion of business for GBM because structured credit, and in particular ABSs (in effect the raw material for CDOs), had already been one of RBS Greenwich Capital's core businesses for a number of years.

74 In relation to CDOs, GBM had been acting as lead manager for clients issuing CDOs prior to 2006. Table 3.5 below shows the issuance and number of CDOs

31 2007 RBS Annual Report and Accounts, page 13.
32 Asset-Backed Alert (ABAlert.com) – Bookrunners of US MBS – 2005; Asset Backed Alert (ABAlert.com) – Bookrunners of US MBS – 2006; Asset Backed Alert (ABAlert.com) – Bookrunners of US MBS – 2007.

transactions completed by year from 2002 to 2008 for RBS and the CDOs market as a whole. The table also shows RBS's market share and ranking by total issuance.

Table 3.5: RBS's share of CDOs market and ranking by total issuance[33]

Year ($m)	CDOs Market		RBS			
	Issuance	Number of deals	Issuance	Number of deals	Market share	Ranking
2002	86,373	288	400	2	0.46%	24
2003	79,474	298	826	4	1.04%	19
2004	96,964	302	2,493	10	2.57%	14
2005	217,171	496	3,342	11	1.54%	17
2006	445,279	965	16,349	26	3.69%	15
2007	410,117	701	11,354	28	2.77%	15
2008	156,336	182	1,901	2	1.22%	14

75 The data in Table 3.5 shows that the size of the CDOs market more than doubled in 2005 and again in 2006. Between 2005 and 2006, RBS's share of the market also more than doubled in accordance with its strategy to increase its structured credit business. Both the market and RBS's market share peaked in 2006, while RBS's ranking was relatively stable through the period 2004 to 2008. The fall in both the size of the market and RBS's share of it in 2007 and 2008 are indications of the market's and RBS's reactions to worsening market conditions.

76 The structured credit strategy formulated in 2006 focused on the issue of CDOs by RBS Greenwich Capital rather than GBM London. Whereas in 2005 GBM (London and RBS Greenwich Capital together) completed 11 CDO deals totalling $3.3bn, between July 2006 and May 2007 RBS Greenwich Capital alone completed 15 CDO deals totalling $11.7bn. RBS Greenwich Capital approved these 15 CDO deals between April and October 2006 (a CDO transaction can take a number of months to complete while the underlying ABSs are accumulated in the warehouse). Although GBM's issuance of CDOs increased almost five times from 2005 to 2006, the CDOs business still made up only 9% of GBM's total structured credit issuance of $188.5bn in 2006 (the other structured credit activities included RMBSs and CMBSs). GBM's CDOs average deal size was below the market average apart from in 2006 and 2008.

77 As this was an extension of what RBS considered to be a core GBM business (i.e. its ABSs business), the growth objective was considered by RBS to be realistic and achievable. These increases were to be achieved by a growth in the balance sheet commitment from $2.75bn in 2006 to $33.5bn over the course of 2007. Although the projected profits from structured credit were a relatively small proportion of the total profits made by the RBS Group (roughly 1% in

33 Bookrunners of Worldwide Collateralized Debt Obligations.

2006), this increase in the balance sheet commitment greatly increased the potential for losses should the market deteriorate, as ultimately occurred.

78 The strategic initiatives for 2007 were established in 2006 during what were perceived by many market commentators at the time to be stable and liquid market conditions. This pursuit of growth and demanding revenue and profit targets coincided with the US housing market reaching its peak in 2006. While in the first three quarters of 2006 a number of commentators detected signs of a cooling-off in the US housing market, there was not a widely held view during this period that there would be a sharp and prolonged slowdown.

79 The strategy documentation provided to the RBS Board in June 2006 was not detailed. Beyond high-level slides setting out the strategic objectives and growth targets, it does not appear that the RBS Board was provided with any detailed analysis of the relevant markets to support the aspirations for growth or of the key risks involved. There were limited references in the documentation regarding the balance sheet impact of structured credit growth. It was noted that the strategy to expand the CDOs business would require additional balance sheet capacity (in order to accumulate assets in the warehouse) of some £15bn to increase revenues to £200m by 2007. However, due to benign market conditions at the time, when assessing the appropriateness of the structured credit business for growth, the consequences of building up the balance sheet received very little attention when compared with the planned revenue and profit increments.

80 From the documentation provided by RBS, there was no evidence of any significant challenge by the Risk function to the strategic initiatives proposed during the relevant periods. The documentation did not contain separate risk assessments for the various initiatives. The risk impact was typically summarised in a bullet point for each initiative, with no information as to how the various risks identified were to be addressed or mitigated. As a result, no documents were received by Enforcement Division to suggest that the GBM or Group Boards were provided with any comprehensive risk analysis at the strategy setting offsites. While the Risk function was involved later during the year in the strategy-setting process, the documentation received and produced by Risk was limited and did not cover the entirety of the strategies being proposed. There was therefore no consistent and comprehensive review of the following year's strategy in respect of risk. Documentation concerning structured credit was particularly light.

81 In particular, there was little consideration by the RBS Board at this time of the risk that GBM would not be able to sell the super senior CDOs tranches and so would subsequently be exposed to the value of the retained tranches fluctuating. During interviews of former senior managers, Enforcement Division found differing views as to whether it was envisaged that the super senior CDOs would be retained by RBS. One did not recall management having had any intention to retain the super senior tranches. Another recollected that there had always been a sense that there would be some element of super seniors on RBS's balance sheet (but could not recollect any specific decision to retain any one tranche) and that the overall strategy had been to insure or hedge any retained tranches. The risks associated with retaining super senior CDOs were identified

by the relevant RBS Greenwich Capital credit & commitments committees at the point of approval of individual transactions. However, they were considered in a cursory manner because at that time the risk of super senior CDOs being impaired was assessed as having a very low probability. In particular, RBS took comfort from the fact that the super senior tranches were rated as better than AAA by rating agencies. This was in line with assumptions and views that were shared by a significant number of other firms and commentators at the time. Enforcement Division did not see evidence of an increase in RBS Group control and oversight of RBS Greenwich Capital following the formulation of the 2007 structured credit strategy.

82 RBS Greenwich Capital also considered the risk of monoline insurers defaulting to be very low because they were also rated highly by the rating agencies. Neither did it appreciate at the time it took out the monoline insurance (i.e. prior to April 2007) that the counterparty credit exposure created by transferring retained risk to monoline bond insurers would grow under stressed market conditions. Again, this was in line with assumptions and views that were shared by a significant number of other firms and commentators at the time. GBM's use of monolines to insure retained super senior CDOs is explained further in Section 1.7.

83 The relevant risk functions within RBS were not heavily involved in the process of strategy formulation and they did not carry out a risk assessment until after the strategy had been presented to the RBS Board (see paragraph 80). When the strategy was presented to the RBS Board in June 2006, the key risks were identified as *'Market risk from newly evolved products and model complexity'*.[34] Enforcement Division found no evidence to suggest that this brief description was expanded on to provide more detail as to the nature of the risk, how and when it would crystallise, and what steps GBM or Group Risk would take to minimise it. The RBS Board in approving the strategy was aware that it involved the growth of existing business lines which were already subject to existing risk controls monitored by Group Risk and GBM Risk rather than new areas (see Section 1.4). Senior management did not consider any individual strategy to be material to GBM and did not consider the strategy to expand the GBM business to alter the risk appetite or risk profile of RBS as a whole.

84 Overall the GBM structured credit growth strategy and the processes surrounding its approval were underpinned by a number of assumptions, many of which were common within the industry at the time, but which were ultimately shown to be incorrect. These included the continuation of favourable market conditions at a point when it is now apparent the markets had peaked.

34 Compelled interview with Mr Cameron, 19 November 2009, part 3 of 3, lines 75-771.

1.4 The adequacy of risk control systems in the structured credit business

85 The market risk of the structured credit business was monitored and limited principally through the implementation of Value-at-risk (VaR) limits and a ten-day historical stress-test limit both of which were set by Group Risk. The VaR and stress-test limits were used at both group and GBM level to set risk appetite, and were intended to contain the potential losses the GBM business might incur in order to achieve its revenue and profit targets. The various business areas within GBM were also subject to individual business limits. The main involvement of the Risk function in the formulation of the strategy was to assess the impact of the required budget on this existing limit framework.

86 VaR was a widely used measure of risk in the industry and, like many other financial institutions at the time, RBS used it as the primary measure of market risk associated with its business activities. It provided an estimate of the losses that might occur as a result of adverse market movements, by using a historical data-set. The estimate of potential losses implicitly assumed that the portfolio remained broadly the same over the course of a defined time period and that markets were sufficiently liquid to allow traders to close out their positions within this time period.

87 Before 2008, RBS considered that its limits, particularly VaR, were low in comparison to its peers. Having remained at £30m from 2005 to early 2008, the group VaR limit was increased substantially during 2008 so that it stood at £50m in April 2008 and at £55m by September 2008. It is evident that limits were regularly considered and were not ignored by GBM. However, GBM's use of its VaR limits also increased over 2007 and into 2008. At the outset of 2007, GBM had sufficient headroom within the VaR limit to grow. GBM's utilisation of the limit then rose particularly sharply from Q3 2007 when deteriorating market conditions began to affect the VaR. Towards the end of 2007 and the start of 2008, GBM breached the £30m VaR limit on several occasions, partly as a result of the sensitivity of CDOs to the unstable market conditions. GBM's super senior CDO exposures were all within the VaR limits at the time they were taken on.

88 Although VaR is a useful risk measurement tool, there are limitations to its use, in particular that it produces an assessment based on historical data which is not necessarily indicative of what may happen in the future. These limitations become more acute in times of market turbulence when markets become illiquid. Following the financial crisis, it is now clear that the assumption that the historic volatility of prices – particularly when measured over relatively short time periods but also in general – gives a strong indicator of future volatility, is fundamentally and dangerously flawed.

89 Even at the time, it was important to supplement the use of VaR with other methods of evaluating risk. Accordingly, RBS also used a number of hypothetical and historical scenarios for stress testing. Stress-testing is used to establish an acceptable stress loss limit, which is the loss that a bank or financial institution is prepared to accept as a result of adverse market conditions for a given level of

risk appetite. One of the primary stress tests used by RBS was the ten-day historical stress test, which examined the ten worst days of market movements experienced by the group to see what the possible losses would be to its portfolio should a similar event occur in the near future. Again, as it relied on the use of historical data-sets, the usefulness of the ten-day historical stress test diminished when the severity of the market conditions exceeded those in the models. RBS, along with many other financial institutions, did not predict the market events that unfolded in 2007 and 2008 thus could not have anticipated the impact of those events on its stress testing.

90 The stress test was monitored on a daily basis. The ten-day historical stress-test limit was increased in August 2006 from £200m to £250m (a permanent increase); in January 2007 from £250m to £275m (a temporary increase); and in May 2007 from £250m to £375m (a permanent increase). RBS had breached the limit in December 2006 primarily due to an increased exposure from a widening in credit spreads arising from purchases of assets held for future securitisations by RBS Greenwich Capital. The rationale for the significant permanent increase in May 2007 was presented to the GEMC as: organic growth (predominantly in credit-related business such as loan trading and the London CDOs warehouse); new business initiatives; and the inclusion of new asset classes in the limit (for example loans). The most significant contribution to the stress-test utilisation remained the group's exposure to a widening in credit spreads. The increase in the limits was viewed by RBS as necessary to accommodate the growth in its business and as a reflection of its success. Following the May 2007 increase, GBM stayed within the ten-day historical stress-test limit for the remainder of 2007. The limit was breached in February 2008 when the stress test indicated that, should the circumstances anticipated in the stress test materialise, potential losses could reach £413m against the £375m limit. This limit breach occurred due to downgrades in RBS Greenwich's super senior exposures.

91 In addition to the ten-day historical stress test, a macroeconomic stress test was performed to assess the potential impact of a range of recessionary scenarios on the RBS group portfolio and the group's capital base. The three scenarios used in the 2006 macroeconomic stress test were:

- **Scenario 1:** *Mild recession* – two quarters of negative GDP growth, followed by a rapid recovery. This was assumed to occur once in 15 years.
- **Scenario 2:** *1990s style recession* – continued rise in oil prices led to devaluation in the US dollar, and increased interest rates in the UK, US and Europe. This was assumed to occur once in 20 years.
- **Scenario 3:** *Severe recession* – this arose for similar reasons to scenario 2, but included a more severe impact on household debt, particularly in the UK and the US. A slowdown in housing markets led to significant levels of negative equity thereby exacerbating the downturn in consumer spending. This was assumed to occur less than once in 50 years.

92 Enforcement Division did not seek to establish, for example, the maximum fall in house prices assumed by these tests, but clearly the severity of events that subsequently unfolded during the financial crisis, particularly within the US mortgage market and the subsequent severity of market volatility, were not covered in the range of the stress tests. Again, it is unlikely that many other financial institutions' stress tests adopted a scenario as severe as the financial crisis that subsequently occurred.

93 Following their preliminary development by management, the strategic objectives were assessed by the Risk function in light of the group's expressed risk appetite as part of the Annual Divisional Budget Risk Assessment Process. The Risk function also assessed the appropriateness of the budgets' impact on existing limits. Group Risk's assessment of the strategies formed part of its commentary on the Annual Budget in December. In November 2006, following the approval of the strategy by the RBS Board in June 2006 and as part of this process, Group Risk concluded that the budgeted growth for the structured credit and leveraged finance initiatives would fit within RBS's existing limit framework, although the pressure on the ten-day historical stress test limit would increase as the size of the deals undertaken by RBS Greenwich Capital grew. This budget was approved by the RBS Board on 13 December 2006.

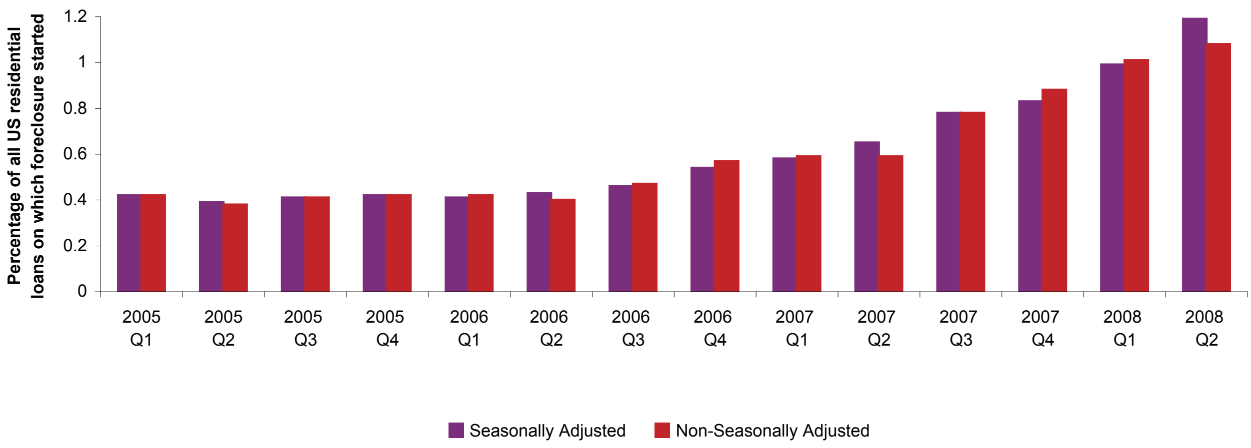
94 Overall it is apparent that RBS relied on methods of monitoring and limiting risk in its structured credit and leveraged finance businesses that, with hindsight, did not enable it to anticipate the severity of the market volatility that subsequently occurred. The extent to which RBS's risk control systems can be considered reasonably adequate at the time in question is discussed in Section 1.11, which also explains why Enforcement Division did not proceed to take enforcement action.

1.5 RBS's decision to continue to issue CDOs when market conditions deteriorated

95 The second key decision Enforcement Division reviewed in relation to RBS's structured credit initiative was its decision in Q1 2007 to continue to issue CDOs in the face of deteriorating market conditions.

96 Conditions in the US housing market gradually deteriorated in 2006 and early 2007. In March 2007 US national home sales and prices both fell sharply and it became apparent that a more serious correction in the housing market was occurring. The fall in the housing market continued across most of the US throughout 2007 and into 2008. As prices declined, borrowers with adjustable-rate mortgages could not re-finance to avoid the higher payments associated with rising interest rates and began to default. During 2007, lenders began foreclosure proceedings on nearly 1.3m US properties, a 79% increase over 2006. This increased to 2.3m properties in 2008, an 81% increase over 2007. This deterioration in the US housing market was particularly severe in the sub-prime market, which had a significant impact on CDOs.

Graph 3.1: Rates of foreclosures on US residential mortgage loans in 2005 to 2008[35]



97 Graph 3.1 shows the rise in the rates of foreclosures among all US residential mortgage loans started from around Q3 of 2006 onwards, with a more marked increase in Q4 of 2006.

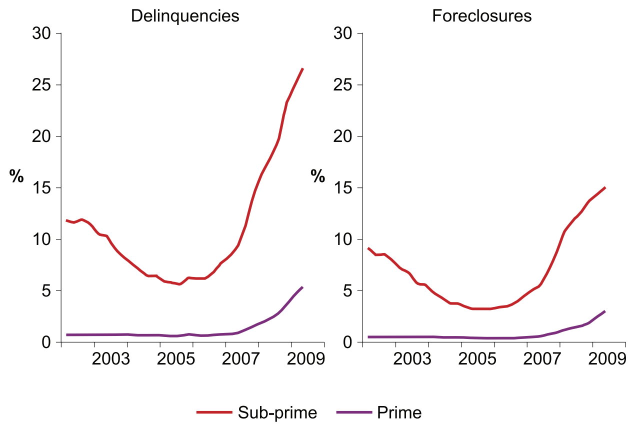
98 Graph 3.2 illustrates how the percentage of delinquencies (defined as loans in arrears for more than 90 days) and foreclosures in the sub-prime mortgage market in particular began to increase from the second half of 2006 onwards, increasing rapidly during 2007.

99 Concerns over the US sub-prime mortgage market were noted by GBM in the fourth quarter of 2006 when spreads were widening in mortgage-based securities. Also, super senior CDOs tranches were less attractive to investors because of their comparatively low yield compared with the riskier junior tranches. In addition, the growing market for CDOs meant that there was a greater demand for the underlying ABSs and so the cost of purchasing the ABSs to build CDOs rose. Around the same time, low interest rates led to reduced interest cash flows from mortgages. This meant that the returns on CDOs fell. By end 2006, RBS Greenwich Capital had five uncompleted CDOs deals where an open super senior exposure was retained, with a combined value of $3.35bn.

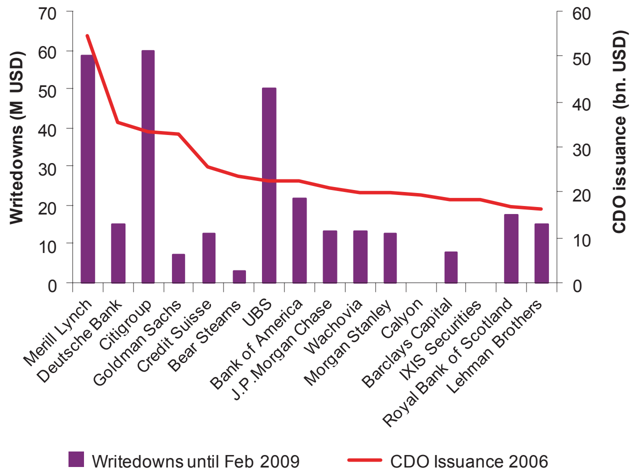
100 At the 23 January 2007 Group Risk Committee it was noted that *'a number of sub-prime mortgage lenders had withdrawn from the market, and that there had been a slight increase in foreclosure activity centring (sic) around Michigan.'*[36] Faced with a deteriorating market in January 2007 and a lack of investor demand for the super senior tranches, GBM believed it had two options. The first was that it could cancel the uncompleted CDO deals and sell the ABSs in the warehouse, potentially incurring major losses on those assets. The second was that it could complete the CDOs, sell the riskier, lower-rated junior tranches and seek to sell the lower-risk, highly rated super senior tranches later when, as it believed at the time, the market would improve. GBM considered that RBS would suffer greater damage if it tried to sell out the warehouses at that time.

35 Graph based on data from The Mortgage Bankers Association National Delinquency Survey – Rates of foreclosures started – all loans.
36 Minutes of GRC 23 January 2007, page 10.

Graph 3.2: US Mortgage Delinquencies & Foreclosures[37]



Graph 3.3: Top CDOs issuers and their writedowns as of February 2009 (in USD billions)[38]



It believed that completing the CDO deals and focusing on selling off the riskier assets was a sensible way to mitigate the risk of loss to RBS. RBS did not foresee at this point that the US housing market was entering into a period of sustained decline. It therefore did not anticipate that it would be unable to distribute, or that it would take significant losses on, the super senior CDOs. A number of other firms appeared to have shared this view, as is illustrated in Graph 3.3 which sets out the writedowns on CDOs as at February 2009 taken by the top CDOs issuers.

101 By way of further example, Morgan Stanley is widely reported to have increased its highly rated CDO positions late in 2006 and in early 2007 while at the same time shorting, to a lesser extent, higher-risk CDO tranches. This appears to have reflected a view that while the decline in the US housing market might impact to some extent on higher-risk CDO tranches it would not result in losses on AAA and better rated tranches. This trading position contributed to Morgan Stanley disclosing sub-prime losses of $7.8bn for the last three months of 2007.

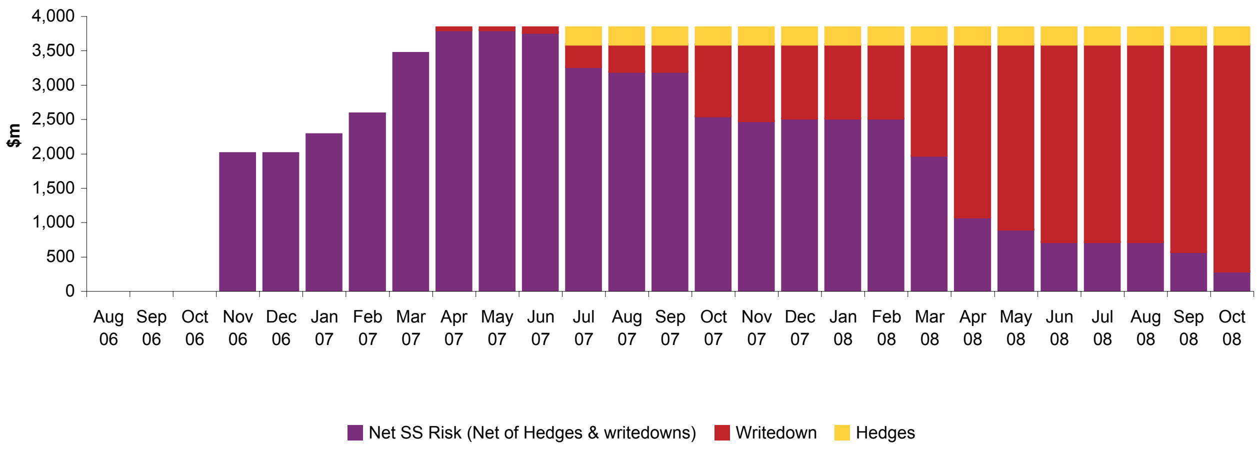
102 In view of the changing market, GBM decided that it was important to continue with the transactions and that it should concentrate first on completing the CDOs and selling the junior tranches in order to reduce RBS's overall risk, with the intention of selling the super senior tranches later. As a result, RBS Greenwich Capital retained the super senior tranches on its balance sheet for the majority of the CDOs it issued between the second half of 2006 and April 2007. In some cases, RBS obtained monoline insurance in respect of the retained risk.

103 Of the 15 CDO deals that RBS Greenwich Capital completed between July 2006 and April 2007:

- RBS fully sold four CDOs;
- RBS retained the super senior tranches in three deals (totalling approximately $2.3bn) and fully insured them with monolines; and

37 Bloomberg Finance LP. 'Delinquencies' is used to mean loans in arrears for more than 90 days.
38 Benesova Report – page 65 – The Dark Side of Collateralized Debt Obligation's Valuation During the 2008/2009 Financial Crisis.

Graph 3.4: GBM super senior CDO exposure – RBS Greenwich Capital[39]



- RBS retained the super senior tranches in eight deals uninsured (totalling approximately $3.6bn, net of hedges, as at April 2007).

104 Graph 3.4 illustrates the build-up of RBS Greenwich Capital's uninsured super senior CDOs exposures from 2006 to 2008 as the CDO deals were completed (i.e. the retained super senior tranches which had not been insured with monolines).

105 At end-2006, out of a balance sheet of £500bn, GBM's super senior exposures (held by GBM London and RBS Greenwich Capital) totalled £1.8bn or 0.4% (0.2% of the RBS group balance sheet of £871bn). RBS Greenwich Capital's exposure to uninsured super senior CDO positions increased by £0.8bn in the first half of 2007. At the end of 2007, GBM's uninsured super senior exposures made up 0.3% of its balance sheet (0.1% of the RBS group balance sheet).

106 Overall, GBM's decision in early 2007 to continue to issue the pipeline RBS Greenwich Capital CDOs reflected a view within RBS that the uncertain market conditions were a short-term issue that would not affect long-term growth. At the time the decision was made, GBM management like many others in the credit market did not anticipate the extreme market volatility that developed later in 2007 and during 2008, and the implications that would have for its super senior exposures. The decision to continue to issue CDOs is considered in Section 1.11, which also explains why Enforcement Division did not proceed to take enforcement action.

1.6 RBS's decision in mid-2007 not to hedge its super senior exposures

107 The third key decision Enforcement Division reviewed in relation to RBS's structured credit initiative was its decision in Q2 and Q3 2007 not to hedge its CDOs exposures to any significant extent.

39 Investigator analysis of credit market exposure details provided by RBS.

108 From February 2007, GBM senior management considered hedging super senior CDOs positions using the ABX. The ABX is a series of indices for the price of sub-prime mortgage-backed securities of various vintages and credit ratings. GBM decided not to hedge because it considered that the ABX was imperfectly correlated with the market price of the underlying securities. GBM was therefore concerned the index might move in an unrelated manner to the price of the underlying securities, which would render any hedge ineffective.

109 From around July 2007, GBM became more concerned about the risks of the retained super senior tranches, and again considered hedging some of the exposures. In that month, it purchased hedges worth $250m for three of the eight uninsured super senior positions retained by RBS Greenwich Capital.

110 During August 2007, GBM contemplated a further hedge, which would have involved locking in mark-to-market losses of about $460m. Discussions took place within GBM and at a senior level within the Group and it was considered at the time that for losses of that magnitude to occur, there would have to be a decline in house prices across the US on a scale not seen since the 1930s. RBS thought that this was unlikely to occur and was optimistic that the market would recover.

111 In addition, effective hedging options were limited and increasingly expensive after the second quarter of 2007. Consequently, RBS decided not to hedge. However, Mr Cameron, when assessing the falling market, summed up the difficulty faced by RBS when he stated in interview:

'…the trouble was the ABX index was always viewed as oversold, for technical reasons, and therefore to hedge, you were effectively locking in a loss that might never occur… I can't really answer for you when I became aware of that sort of general feeling that, we always seemed to be thinking, "Oh... It's too late now – if only we'd hedged last week"'.[40]

112 Overall the efforts made by GBM in mid 2007 to monitor and mitigate the risks associated with the super senior CDOs were made against the backdrop of an uncertain and illiquid market, in which hedging options were complex and increasingly expensive to achieve as 2007 progressed. RBS's reluctance to hedge its super senior exposures in July and August 2007, because it thought the housing market would recover and it did not want to lock in losses, illustrates the optimism with which it viewed the prevailing circumstances. This reflected an optimistic approach throughout RBS, which was consistent with the approach of the Group CEO. Mr Cameron in interview described the RBS Group CEO as follows:

'He is and was an optimist and he tended to take an optimistic view of what was likely to happen and had often in his life been proved right... He genuinely did not believe that house prices could possibly decline as much as other people thought and held that view strongly.'[41]

40 Compelled interview with Mr Cameron, 19 November 2009, part 7 of 8, lines 676-683.
41 Compelled interview with Mr Cameron, 19 November 2009, part 3 of 8, lines 164-182.

113 These issues are considered in Section 1.11, which also explains why Enforcement Division did not proceed to take enforcement action.

1.7 Increase in RBS's exposure to monoline insurers

114 In addition to the strategic decisions peviously outlined, RBS's losses were increased by the risk of monoline insurers failing to meet claims arising from losses on the retained super senior positions.

Box 3.2

Monoline insurers

Monoline insurers are regulated insurance companies that guarantee the timely repayment of principal and interest cash flows on debt instruments (e.g. bonds), in effect transferring the risk of default from the bond-holder to the insurance company. Credit protection is taken out on the nominal value of the position, for example, the face value of a bond. The credit protection is in the form of a separate credit default swap (CDS) derivative contract with a monoline. A mark-to-market exposure to the monoline emerges when the market value of the bond falls below the face value of the bond. This shortfall between the face value of the bond and its market value is referred to as the 'Gross Monoline Exposure'.

While purchasing the monoline insurance provides protection against the risk of default of the underlying asset, it creates a new credit risk exposure to the monoline. In fact, there is an inverse relationship between the value of the insured instrument and the exposure to the insurer. As the value of the insured instruments declines, the exposure to the insurer increases. As that happens, the risk that the insurer will default also increases. This is known as 'wrong-way risk'.

Counterparty credit risk on derivatives or 'wrong-way risk' is calculated using a Credit Valuation Adjustment (CVA). The CVA is the market value of counterparty credit risk and in this situation represents the estimated adjustment a market participant would have to make to the price of an asset to compensate for the credit risk of the counterparty of the credit default swaps. In other words, the CVA is an adjustment to fair value to incorporate the risk of the monoline insurers' inability to pay upon default of the underlying ABSs, CDOs or collateralised loan obligations (CLOs).

115 RBS's exposure to monolines during 2007 and 2008 and the associated CVAs are presented in Table 3.6.

Table 3.6: RBS's exposure to monolines during 2007 and 2008[42]

	RBS monoline exposures							
	31 December 2007				31 December 2008			
(£m)	Notional amount protected assets	Fair value protected assets	Gross exposure	Cumulative Credit valuation adjustment	Notional amount protected assets	Fair value protected assets	Gross exposure	Cumulative Credit valuation adjustment
CDOs	5,894	3,459	2,435	615	5,779	1,395	4,384	2,201
RMBSs	73	73	-	-	93	65	28	10
CMBSs	3,731	3,421	310	34	4,849	2,388	2,461	1,429
CLOs	9,941	9,702	239	44	12,865	9,673	3,192	1,556
Other ABSs	4,553	4,388	165	14	3,666	2,460	1,206	617
Other	776	516	260	155	769	458	311	175
	24,968	**21,559**	**3,409**	**862**	**28,021**	**16,439**	**11,582**	**5,988**
Hedges with bank counterparties				-				(790)
Net monoline exposure*				**2,547**				**4,804**

* The total net monoline exposure (£2,547m) is calculated as the total gross exposure (£3,409m) less the total Cumulative CVA (£862m) less hedges with bank counterparties (nil).[43]

42 RBS Annual Report and Accounts 2008.
43 The Cumulative Credit Valuation Adjustment reduces the total Gross Exposure because it has already been taken as a deduction to the Profit & Loss account.

Table 3.7: Credit valuation adjustment for RBS's monoline exposure during 2007 and 2008[44]

The cumulative credit valuation adjustment comprises:			
Change in monoline CVA	**RBS plc**	**ABN AMRO[45]**	**(£m)**
Balance as at 31 December 2007	452	410	862
Effect of movements in 2008			
CVA realised in 2008	**(662)**	**(1,075)**	**(1,737)**
Net benefit on counterparty hedges	189	115	304
Foreign currency movements	748	338	1,086
Net benefit on reclassified debt securities	741	1,175	1,916
Net income statement effect (31 December 2008 mark-to-market loss)	1,821	1,736	3,557
Balance as at 31 December 2008	**3,289**	**2,699**	**5,988**

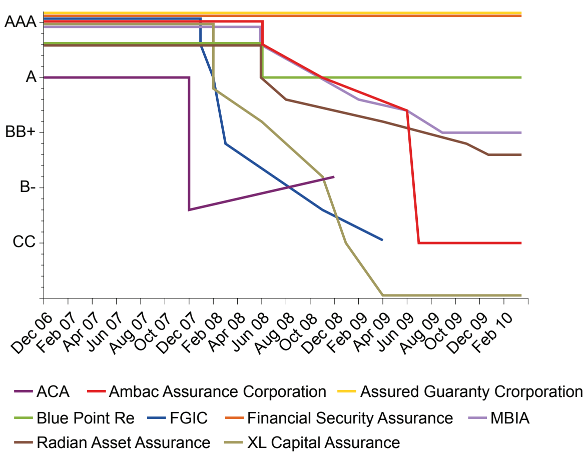
116 Table 3.7 shows that monolines were used by RBS to insure a number of other structured credit positions in addition to CDOs (e.g. RMBSs, CMBSs, CLOs and other ABSs). The figures aggregate RBS's monoline exposures for both its legacy structured credit positions and the structured credit positions it acquired from ABN AMRO. RBS's monoline exposure almost doubled on the acquisition of ABN AMRO (see Table 3.6). The significant increase in the gross exposure to monolines from 2007 to 2008 is primarily the result of the decline in the fair value of the protected assets. The fourth quarter of 2007 was the first quarter when a significant CVA was recognised.

117 Of the 15 CDOs deals that RBS Greenwich Capital completed in the period, it retained the super senior tranches in three deals (totalling approximately $2.3bn) and fully insured them with monolines. GBM's decisions to take up insurance were made on the completion of each transaction (i.e. before April 2007). Its exposures were concentrated on two of the largest monoline insurers, which remained AAA-rated in early 2008. As a result of the reduction in value of the super senior CDOs, the gross mark-to-market exposure to insurers increased from $200m at the end of June 2007 to $2bn by the end of September 2007.

118 RBS reviewed its exposure to monolines in October 2007 after it began to rise significantly as a result of the fall in the value of protected assets. By the time that concerns about the increase in monoline exposure were raised with RBS senior management in October, little could be done to limit the potential for loss. In any event, RBS continued to take comfort from the view of some rating agencies, which did not expect the negative third quarter 2007 results for monolines to affect their very high credit ratings. The ratings given by Standard & Poor's to the monolines with which RBS insured its positions are set out in

44 RBS Group plc Annual Report and Accounts 2008, page 136.
45 Source: RBS Group 2008 Annual Report and Accounts, RBS plc 2008 Annual Report and Accounts. ABN AMRO amounts calculated as difference between RBS Group and RBS plc totals.

Graph 3.5: Standard & Poor's ratings of monoline insurers used by RBS[46]



Graph 3.5. It shows that it was not until end 2007 and first half of 2008 that the ratings began to decline.

119 GBM's exposure to monolines as against its risk limits was presented to the FSA on 29 February 2008. The details of the RBS exposures at that time are set out in Table 3.8.

Table 3.8: RBS's monoline exposures against counterparty limits as at February 2008[47]

($m) Insurer	S&P credit rating	Limit	Mark-to-market exposure	CDS hedges	Total mark-to-market*	Limit excess
as at 29 February 2008						
ACA	CCC	110	831	-	831	(721)
Ambac Credit Products[48]	AAA	954	2,534	(480)	2,054	(1,100)
Assured Guaranty Corp	AAA	258	146	-	146	112
BluePoint Re	AA	35	227	-	227	(192)
FGIC	A	348	180	-	180	168
Financial Security Assurance	AAA	796	106	-	106	690
MBIA	AAA	793	895	(65)	830	(37)
Radian Asset Assurance	AA	147	70	-	70	77
XL Capital Assurance	A	299	13	-	13	286
Total RBS		**3,740**	**5,002**	**(545)**	**4,457**	**(717)**

120 RBS's write-downs in relation to monolines totalled £862m in 2007 and £3.56bn in 2008. These related to both the legacy RBS business and the acquired ABN AMRO business: £1.82bn can be attributed to RBS legacy

46 Graph prepared by investigators using data provided by Standard & Poor's.
47 RBS Global Exposure to US Monoline Insurance Companies; investigator calculation.
48 Ambac Credit Products is a subsidiary of Ambac Assurance Corp.

business in 2008. RBS was not alone in recording write-downs in relation to insurance on CDOs. For example UBS, in its 2007 accounts, recorded credit valuation adjustments on protection bought from monoline insurers of US$800m, reflecting the degree to which it considered its claims against these counterparties to be impaired. Citigroup recorded CVAs on its exposure to monoline insurers of US$967m in 2007 and $5.7bn in 2008.

121 Table 3.9 compares the exposure to monoline insurers of RBS and a number of its peer banks in the period March to May 2008. For Bank 3 and Bank 7 exposures are as at end-March 2008 (although CVA data is as at end May 2008 for Bank 3); for Bank 1, Bank 2 and Bank 6, as at end April 2008; and for RBS, Bank 4 and Bank 5, as at end May 2008.

Table 3.9: RBS's exposure to monoline insurers compared to peer banks, March to May 2008[49]

US $ billions	Bank 1	Bank 2	Bank 3	RBS	Bank 4	Bank 5	Bank 6	Bank 7
Direct exposure[50]								
- notional	83.5	31.0	32.0[51]	53.7	42.8	14.8	1.4	5.6
- MTM	12.8	9.1	8.0	11.7	5.1	2.6	0.7	2.0[52]
Wrapped[53]								
- notional	N/A	N/A	N/A	11.5	4.1	10.8	7.5	4.6
- MTM	1.4	12.7	N/A	0	0.1	1.7	0.8	N/A
CVAs	6.5	3.0	5.4	5.9	0.3	1.2	0.1	N/A

122 Overall RBS's exposure to monoline insurers grew during the course of 2007 and 2008, both as a result of the acquisition of ABN AMRO and as the value of the underlying insured assets declined. Like many others in the industry, RBS relied on the high ratings given to the monolines, and failed to anticipate the 'wrong way risk' associated with exposure to them. These issues are discussed in Section 1.11, which also explains why Enforcement Division did not proceed to take enforcement action.

1.8 RBS's monitoring and internal reporting of structured credit exposures

123 The initial internal monitoring of and reporting on the structured credit strategy in 2007 focused on revenue and profit. Along with many other financial institutions in the market, RBS relied on the credit rating agencies' high rating of super senior CDOs and assumed that what was at risk was the forecast profit and loss, not the balance sheet exposure. As the year went on and credit market conditions worsened, the reporting focused more on the super senior CDOs accumulating on RBS's balance sheet.

49 Tripartite Committee on Financial Stability – June 2008.
50 Direct exposure to monolines, through credit default protection purchased from the insurers, largely via credit default swaps.
51 These include wrapped exposures as well as direct.
52 MTM includes wrapped exposures.
53 'Wrapped' indicates where the firm owned trading book assets, particularly ABSs, that were wrapped (i.e. guaranteed) by monolines.

124 The key management information reported in respect of the structured credit business can be summarised as follows:

- The progress and performance of GBM's 2007 structured credit strategy was monitored in a *'Strategic Action Plan'* which was reported monthly to the GEMC. The information focused on a comparison of actual profit and loss results compared with budget and not on any accumulating balance-sheet exposures. This was in line with GBM reporting as specified by Group Finance which, while it contained some balance-sheet information, generally focused on revenue and profit rather than balance-sheet positions. While the underlying data were held on RBS's systems, there was no regular reporting which would have highlighted major exposures including super senior CDOs positions. The US CDO business was behind budget from the start of 2007, but RBS's senior management initially considered this to be a revenue, rather than a risk, problem due to challenging US credit market conditions. This analysis appears to have stemmed in large part from the longer-than-anticipated time it took to complete the structured credit deals and the rising costs of doing so.

- On 22 February 2007, the RBS Board was briefed on the US sub-prime mortgage market and its implications for GBM. The minutes recorded RBS Board comment that the briefing was *'positive and should be seen in the light of HSBC's recent difficulties in the sector'*.[54] The briefing did not refer to the super senior exposures, which at that time amounted to approximately $2.6bn. Enforcement Division was informed in interview that this was because super senior CDOs were not at that point viewed within GBM as sub-prime exposures as they were rated as better than AAA.

- Similarly in March 2007, the RBS Board was informed that *'a full review of the RBS Greenwich sub-prime lending book had been carried out and no material concerns had been identified'*.[55]

- The first reference to the size of the super senior exposure in a divisional finance or risk report was in the April 2007 Risk Report for the Divisional Audit Committee, in which the CDOs exposure was reported in the context of wider sub-prime exposures:

  'Greenwich has indirect exposure to sub-prime mortgages through the retained CDO bond inventory. These are bonds not yet sold from having securitized mostly sub-prime mortgage collateral into CDSs. The desk is currently long $4.2b of CDO bonds created from ABS Mezzanine deals of which $3.8b[56] are Super Senior AAA's.'[57]

- In response to more uncertain trading conditions, increasingly detailed management information was provided by GBM to GEMC and the RBS Board in its monthly Performance Highlights report beginning in May 2007. This information identified the split of revenue by component and therefore separated out the retained super senior CDOs. The report did not at that

54 RBS Group Board Meeting Minutes 22 February 2007, pages 11 to 12.
55 Minutes of the RBS Group Board 28 March 2007, page 3.
56 This figure does not include retained super senior CDOs which were insured with monolines.
57 GBM Risk Report to the Divisional Audit Committee, April 2007, page 9.

point show the build-up on balance sheet of the retained super senior CDOs exposures. The focus within RBS management was still on the fall in revenues from the super senior CDOs, rather than on the risk posed by the exposures. At that point, the US CDO business continued to be behind budget but significant adverse budget variances did not begin to appear until June 2007. At that stage GBM management was still unclear about the extent to which CDOs were impacted by difficulties in the sub-prime market and was paying increasing attention to the subject. For example, on 14 May 2007, Mr Cameron asked Mr Crowe for an explanation of why the daily profit and loss summary for debt capital markets was worse than asset-backed securities and in particular *'how much leakage of sub-prime into CDO business? … I'd like to be clear in the truth circle before thinking what to say to others who currently think our issue is all abs'*.[58] Mr Crowe responded stating *'CDO is all sub prime related'*. In interview, while Mr Cameron could not recollect when he became aware that the value of super senior CDOs was threatened by developments in the sub-prime market, he explained that:

'I don't think, even at that point, I fully, I had enough information. Brian may have thought I understood more than I did… And it's around this time that I became clearer on what CDOs were, but it's probably later.'[59]

- RBS's focus on the retained super seniors became more acute in July 2007. A draft memorandum dated 20 July was prepared for RBS senior management which included full details of GBM's exposure to CDOs and showed the retained super senior holdings separately. As at that month, the super senior exposures held by GBM were approximately £3.5bn, of which £1.87bn were held by RBS Greenwich Capital. However, RBS considered the risk of loss to be small because the super senior CDOs were considered better than AAA-rated.

- During July, August and September 2007, there was significant analysis of market developments and their impact on the RBS Group. The RBS Board was informed on 26 July 2007 that mark-downs of US$240m had been taken in respect of RBS Greenwich Capital's super senior CDOs on 30 June 2007 and in September that further mark-downs of US$185m had been taken in July 2007. Risk reports and Performance Packs commented on the losses sustained and the potential stress loss scenarios. From August 2007 the RBS Board received reports of the super senior positions retained on the balance sheet. It discussed market turmoil on 24 August 2007 and again on 16 September 2007. However, although detailed analysis of market developments and their impact on the RBS group was carried out by senior management, Enforcement Division saw no evidence of any of the papers on this matter being presented to the RBS Board.

- The August 2007 Group Risk Management Report presented to GEMC on 28 August, as well as to the RBS Board, observed that the fall-out from the US sub-prime mortgage market meant that the portfolio of

58 Email from Mr Crowe to Mr Cameron 14 May 2007, Re GBM daily P&L consolidated report.
59 Compelled interview with Mr Cameron,19 November 2009, part 7 of 8, lines 403 to 409.

super seniors held by RBS Greenwich Capital had suffered from reduced liquidity and limited price observability. It also stated that adverse stress tests on these securities indicated a potential further \$220m to \$290m loss. It appears that management's reaction to the forecast was that, although they would rather avoid such a loss, it was bearable given the financial standing of RBS as a whole.

- A review of the build-up of the super senior positions by RBS senior management in October 2007 confirmed that, at the time the positions were taken on, they were all within VaR and stress limits and that, as they were rated highly by the external rating agencies, they were deemed to have extremely low volatility. However, management raised queries as to why some repeat CDOs transactions with issuers, as well as some increases in the size of CDOs transactions, had been put through without formal approval from the relevant credit committees. The explanation given was that because the super senior CDOs that RBS retained were not funded (i.e. GBM did not need to pay cash up front for them) those transactions were not viewed by the credit committees which would otherwise have reviewed them as a credit risk. In response, Mr Cameron correctly questioned this logic, asking: *'Since when did funded/unfunded decide whether something was an extension of credit?'*.[60]

125 By end 2007, revenue from the structured credit business, excluding ABN AMRO, was £1.2bn behind budget as the business had been scaled back due to market conditions. Of this shortfall, revenue from the US CDOs business run by RBS Greenwich Capital was £1bn behind budget. Mark-to-market losses on super senior CDOs were just over £1bn at year end.

126 Overall, as the year progressed and RBS's structured credit write-downs grew, senior management scrutiny of the exposures increased significantly. However, by the time the severity of the potential losses began to become apparent, there was little RBS could do to minimise those losses. These issues are considered in Section 1.11, which also explains why Enforcement Division did not proceed to take enforcement action.

1.9 External reporting and valuation of structured credit exposures

127 Lastly, in relation to structured credit, Enforcement Division considered how RBS reported and valued its retained super senior CDOs positions in 2007 and 2008. Major valuation and accounting decisions in respect of the positions were made at group level. Overall, RBS's approach to valuation, while at the time being within the range of its peers and externally audited, meant that its marks (i.e. the values attributed by RBS to its positions) were some of the highest amongst its peer banks.

60 Email from Mr Cameron entitled 'Fw: Accumulation of positions, 30 October 2007'.

1.9.1 2007 Trading Update

128 The level of retained super seniors was neither separately identified nor referred to in RBS's 2007 Interim Report.

129 By June 2007, liquidity in the CDOs market had largely disappeared. From July 2007, faced with a lack of observable market reference points, RBS began to develop and calibrate a model for the valuation of the super senior CDOs known as the Loss Severity of Default (LSD) model.

130 By late August 2007, RBS's super senior CDOs were marked down to close to 90 cents in the dollar. Around that time RBS began to consider, for the purpose of hedging, whether it would be appropriate to mark them down further to either 85 cents or 80 cents, which would have required taking a further write-down of \$190m or \$380m. The source of these potential marks is uncertain and it is therefore unclear whether they could have been used for valuation purposes. In the event, no further hedges were put in place (for the reasons explained in Section 1.6) and no further mark-downs were made at the time.

131 During the period in which the LSD model was being developed, RBS, along with its peers, found it increasingly difficult to identify readily available prices by reference to market transactions. This lack of transparency contributed to a lack of clarity within RBS as to the correct valuation of super senior CDOs. On 8 November 2007 the Managing Director for Risk Management at RBS Greenwich Capital, Victor Hong resigned. His resignation letter states *'my expected oversight and sign off responsibilities for monthly price verification would be intolerable, based upon persistent discrepancies between trader marks and analytical fair market values'*.[61]

132 As at 31 October 2007, four months after a lack of observable prices was first identified in July, RBS valued its super senior CDOs positions using the valuation provided by the LSD model with an additional buffer to reflect model uncertainty. As the LSD model was not developed independently of the front office, and had not been reviewed and approved independently of the front office, it would not have complied with the FSA's requirements. An independent review of the model did not take place until after the 2007 annual results had been announced.

133 The valuations produced using the model were consistent with a Net Asset Value (NAV) methodology based on observable market trading (or suitable proxies). In November 2007, RBS moved some of the super senior CDOs from the regulatory trading book to the regulatory banking book on the grounds that the positions had changed their fundamental characteristics and could no longer meet the requirements set out in the RBS Trading Book policy statement or the FSA rules. They were not re-classified for accounting purposes and therefore RBS continued to value them at fair value. The re-classification was not therefore designed to reduce, nor did it have the effect of reducing, the extent to which fair value losses were reflected in RBS's P&L. However, the

61 Attachment to email from Mr Kyle to Mr Cameron, 12 November 2007, Re: Resignation, page 3.

regulatory re-classification did mean that, from then on, RBS no longer had a regulatory requirement to independently verify the values of those positions on at least a monthly basis, but could instead do so just with 'reasonable' frequency.

134 RBS's valuations of its super senior CDOs positions as at end-October 2007 were included in its Trading Update on 6 December 2007. As illustrated by Table 3.10, at that point RBS's average marks were at the upper end of, but still within, the range of seven of its peers' marks. Of those seven firms, three published information on implied marks for high grade super senior exposures which ranged from 81 to 91 cents and four published information on implied marks for mezzanine super seniors which ranged from 53 to 75 cents. By comparison, RBS adopted an implied price of 90 cents for high grade and 70 cents for mezzanine super seniors.

Table 3.10: Comparison of GBM's average super senior CDOs marks and those of peer banks in October 2007[62]

	(£bn)	Implied peer maximum	Implied peer minimum	Implied peer average	*Difference between GBM and peer average
High grade	90	91	81	85.6	4.4
Mezzanine	70	75	53	62.8	7.2

*Investigator analysis.

135 Five of the seven comparative peer announcements were as at the end of September 2007, and by the time RBS released its Trading Update on 6 December, these peer data were two months old and the ABX index had fallen from around 39 to below 21. However, accurate comparison of the marks taken by different firms is difficult without knowing the age of the mortgages underlying the CDOs they were holding. Older CDOs were generally recognised as retaining their value better than newer ones because over the years there was a decline in mortgage underwriting standards in the US.

136 The retention of the super seniors was described in RBS's 2007 Trading Update issued on 6 December 2007, as follows:

'The Royal Bank of Scotland Group's Global Banking & Markets business ('GBM') has a leading position in structuring, distributing and trading asset-backed securities ('ABS'). These activities include buying mortgage-backed securities, including securities backed by US sub-prime mortgages, and repackaging them into collateralised debt obligations (CDOs) for subsequent sale to investors. It retains exposure to some of the super senior tranches of these CDOs…'.

'At 30 November, GBM's exposure to these super senior tranches, net of hedges and write-downs, totalled £1.1 billion to high grade CDOs which include

62 RBS document entitled 'Trading Statement 201107v22_presented to Fred.xls', Sheet: 'Peer Comparison'; investigator analysis.

commercial loan collateral as well as prime and sub-prime mortgage collateral, and £1.3 billion to mezzanine CDOs based predominantly on residential mortgage collateral. The CDOs are largely based on ABS issued between 2004 and the first half of 2006. GBM also had under £1 billion of exposure to sub-prime mortgages through a trading inventory of mortgage-backed securities and CDOs, and £0.1 billion through securitisation residuals. GBM has no exposure to Structured Investment Vehicles ('SIVs') or to SIV-Lites.'[63]

137 The figure given for exposure to super senior CDOs in the Trading Update of £2.4bn (£1.1bn high grade plus £1.3bn mezzanine) was consistent with the management information from around the time of the Trading Update.

1.9.2 2007 Annual Report and Accounts

138 The 2007 RBS Annual Report and Accounts disclosed the net exposure (after write-downs and hedging) to super senior CDOs, and explained that write-downs had occurred in the second half of the year. The amount of the losses incurred in respect of the super senior positions (including in ABN AMRO) was not quantified. The amount of losses was subsequently disclosed in the June 2008 Interim Results and the December 2008 Annual Report and Accounts.

139 Compared with the values applied at the time of the 6 December 2007 Trading Update, the value of the ABN AMRO's super senior CDOs was reduced by £188m as at 31 December 2007. No adjustment was made in respect of RBS's super senior CDOs exposures at year end.

140 RBS's Group Audit Committee and the RBS Board were involved in extensive consideration of the valuation of RBS's super senior CDOs for the purposes of the 2007 accounts, by which time some of RBS's peers had significantly reduced their marks. The Group Audit Committee was presented with a number of alternative approaches to valuation including index based pricing, a NAV methodology and peer comparison. The range of valuations and effect of applying those valuations at 31 December 2007 is summarised in Table 3.11.

141 As illustrated in Table 3.12, as at 31 December 2007 the marks taken by RBS's peers for high grade super seniors ranged from 32 to 80 cents, with a European peer average of 72 cents and a US peer average of 53 cents. By comparison, RBS adopted a price of 90 cents based on the LSD model output and the additional buffer applied by management. The marks taken by RBS's peers for mezzanine super seniors ranged from 27 to 80 cents, with a European peer average of 66 cents and a US peer average of 38 cents. By comparison, RBS adopted a price of 70 cents based on the LSD model output and the additional buffer.

63 RBS Group Pre-Close Trading Update, 6 December 2007, page 5.

Table 3.11: Range of super senior CDOs valuations and effect of applying those valuations at 31 December 2007[64]

(£m)		Applied as at 31 Dec 07[b]	Adjusted ABX[a]	Adjusted peer range[b]	ABX[b]	NAV[b]	US peer[c] average
Source:			**Deloitte**	**Deloitte**	**RBS**	**RBS**	**RBS**
RBS	High grade	90%	93%	85%	87%	81%	53%
	Mezzanine	70%	56%	60%	50%	53%	38%
ABN AMRO	High grade	90%	79%	63%	67%	58%	53%
Effect of moving to mark: Increase/(decrease)							
RBS	High grade		N/R	(61)	(37)	(110)	N/R
	Mezzanine		N/R	(175)	(350)	(298)	N/R
Subtotal			**(200)**	**(236)**	**(387)**	**(408)**	**N/R**
ABN AMRO	High grade		N/R	(450)	(383)	(533)	N/R
Total			**(200)**	**(686)**	**(770)**	**(941)**	**(1,760)**
Effect of adjustment in ABN AMRO mark to 80%			-	188	188	188	188
Remaining effect after ABN AMRO adjustment			**(200)**	**(498)**	**(582)**	**(753)**	**(1,572)**

a – Supplement to Audit Summary Report Year ended 31 December 2007, 25 February 08, page 3.
b – Hardcopy document production by RBS produced pursuant to two US subpoenas, page 76 to 77. Deloitte Audit Summary Report, 15 February 2008, pages 9 to 10.
c – Peer Group Sub Prime Disclosures 20 February 2008, page 7.

Table 3.12: RBS's average super senior CDOs marks compared to those of peer banks as at 31 December 2007[65]

Super Senior CDOs Valuations (£m)	High grade	Mezzanine
RBS	**90**	**70**
Merrill Lynch	32	27
Citigroup	47	36
Morgan Stanley	n/a	30
Bank of America	78	55
Wachovia	n/a	44
US peer average	**53**	**38**
UBS	72	53
Barclays*	80	66
Societe Generale	64	80
European peer average**	**72**	**66**

* Average total of 77 included in presentation. Investigators calculated high grade and mezzanine marks from figures included in Barclays 2008 Results Announcement and Barclays 2007 Annual Report and Accounts.
** Investigator analysis.

64 Supplement to Audit Summary Report Year ended 31 December 2007, 25 February 08, page 3; Hardcopy document production by RBS produced pursuant to two US subpoenas, page 76-77. Deloitte Audit Summary Report, 15 February 2008, pages 9-10; Peer Group Sub Prime Disclosures 20 February 2008, page 7.
65 Peer Group Sub Prime Disclosures; investigator analysis.

142 RBS's auditor, Deloitte, reported on 15 February 2008 that a range of some £686m to £941m of additional mark-to-market losses could be required on the CDOs positions, depending on the valuation approach adopted (this included £450m to £533m relating to the ABN AMRO acquired portfolio). Based on the LSD model output with the applied buffer, an adjustment of £188m was made on ABN AMRO's high grade CDOs output (a mark down to 80%). This was treated as a pre-acquisition adjustment and had no impact on RBS Group profit. Deloitte concluded on 25 February 2008 that the minimum downward adjustment required to bring the valuation of the legacy GBM CDOs positions to within an acceptable range for accounting purposes was between £200m and £350m (based on valuations implied by relevant indices). An amount of £200m was ultimately identified by Deloitte as a minimum reduction to bring the valuations within what Deloitte believed to be an appropriate range.

143 Both the Group Audit Committee and Deloitte considered the unadjusted difference of £200m to be immaterial in the context of RBS's overall results. Deloitte concluded that: *'Based on our discussion of each of the known unadjusted items with management, and taking into account quantitative and qualitative factors, we concur with management's view that these items, individually and collectively, are not material to the results and financial position of the Group'*.[66] The decision as to whether there should be any further write-down was therefore left to the RBS Board who decided that no adjustment was necessary. RBS's total operating profit for the year ending 2007 was £10.3bn and its profit after tax was £7.7bn.

144 RBS continued to consider valuations and the outlook for CDOs and other credit market exposures during Q1 2008. As a result of an absence of observable market reference points in January or February 2008, RBS continued to run the LSD model and gave further consideration to the size of the additional buffer that should be applied to the model output and the impact this would have on credit losses. Shortly before the results announcement, senior management was also alerted to the consideration being given to further write-downs in areas such as leveraged finance and the Alt-A book (i.e. the portfolio of securities based on mortgages that were of a higher credit quality than sub-prime mortgages but lower than prime borrowers). GBM's exposure to Alt-A had increased when it purchased a $1bn portfolio of Alt-A whole loans (assets purchased by RBS for subsequent securitisation) in August 2007. These loans were originally held as collateral for an advance to a firm that subsequently experienced liquidity issues. However, the information provided to senior management in late February 2008 in relation to potential write-downs on Alt-A, leveraged finance and other areas was non-specific, and it underwent further discussion and review throughout March.

145 On 17 March 2008, GBM produced a schedule of potential write-downs across all credit market products, including super senior CDOs, Alt-A and leveraged finance. This showed a potential loss across all products of £3.3bn to £3.6bn, of which £1.4bn was super senior CDOs, £400m to £700m was Alt-A and £500m was leveraged finance. Further review of the Alt-A marks, in particular during March and April, indicated that traders might not have been marking their

66 Supplement to Audit Summary Report Year ended 31 December 2007, 25 February 2008, page 5.

illiquid positions to market on a daily basis, with the result that a large IPV variance had arisen between the marks applied by front office and the results of the review. This prompted a sale on 18 April 2008 of $1.2 bn (face value) of the Alt-A portfolio, which provided actual transaction prices which could then be used to value the remainder of the Alt-A book. Together, the internal review and 'test' sale processes culminated in further write-downs being made on credit market exposures in April 2008, including mark-to-market and trading losses on Alt-A of $614m. These losses were then reflected in the Rights Issue Prospectus and Circular.

146 The LSD model was not independently reviewed within RBS until March 2008, when significant limitations were found. The changes to the LSD model in April 2008 together with continuing deterioration in market conditions resulted in the average implied mark for RBS Greenwich Capital's mezzanine super senior CDOs falling from about 75 cents to 44 cents (the changes in the LSD model had very little impact on the valuation to the high grade super senior CDOs). These write-downs were reflected in the Rights Issue Prospectus and Circular.

147 Table 3.13 illustrates GBM's monthly gross risk position (gross exposure less hedged risk and monoline coverage) in connection with the CDOs retained and the related mark-to-market losses between April 2007 and June 2008.

148 RBS made write-downs in respect of uninsured super senior CDOs of just over £1bn in 2007 (of which £659m related to RBS legacy super senior CDOs). A further £2.9bn was written down in 2008 (which included super senior CDOs retained by ABN AMRO).

149 Overall it is now apparent that RBS's valuations of its structured credit exposures towards the end of 2007 and at the start of 2008 were at the optimistic end of the valuation range. Nevertheless, it is also clear that valuation at that time was a highly complex and subjective exercise and that it is difficult to make accurate comparisons between RBS's marks and those of its peers because of variations between the underlying assets. These issues are considered further in Section 1.11, which also explains why Enforcement Division did not proceed to take enforcement action.

1.10 Leveraged finance

150 A further area in which GBM suffered major losses was its leveraged finance business. Leveraged finance had been offered by RBS since 1993, so it was not a new product. RBS had completed 190 leveraged finance transactions in 2001, underwriting more than €6.2bn and was one of the largest arrangers and providers of leveraged finance in Europe. Having been initially based largely in centres around the UK and Europe, by early 2002 RBS had expanded its leveraged finance business to New York, although RBS's market share in the US remained considerably lower than its share of the European market.

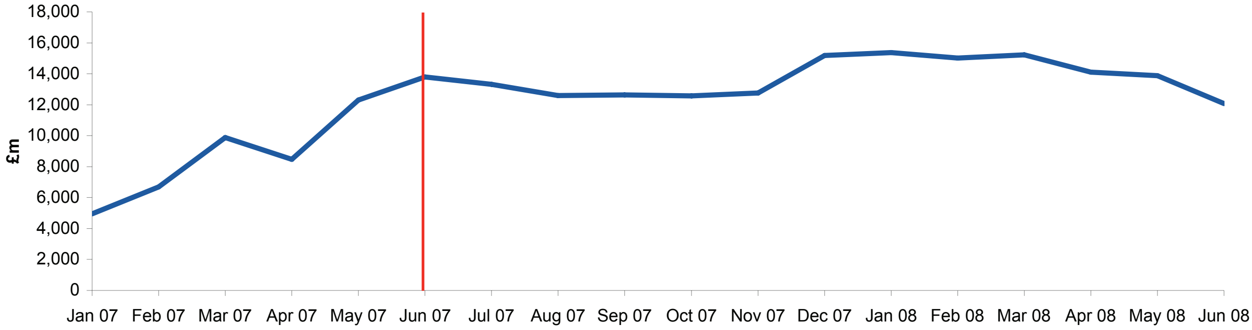
Table 3.13: GBM's monthly gross risk position of retained CDOs and related mark-to-market losses during 2007 and 2008[67]

	London high grade			ABN AMRO high grade			Greenwich mezzanine			Group total		
(£m)	Gross risk position[a] (£m)	Mark[b] (%)	Month write-down[e] (£m)	Gross risk position[a] ($m)	Mark[b] (%)	Month write-down[e]	Gross risk position[a]	Mark[b] (%)	Month write-down[e] (£m)	Gross risk position[a]	Month write-down[e]	YTD write-down[e]
2007												
April 2007	1,223	100%	-				1,919	99%	19	3,142	19	19
May 2007	1,237	100%	-				1,940	99%	-	3,177	-	19
June 2007	1,220	100%	-				1,913	98%	19	3,133	19	38
July 2007	1,204	100%	-				1,765	91%	121	2,969	121	159
August 2007	1,213	100%	-				1,778	89%	37	2,991	37	196
September 2007	1,201	97%	36				1,761	89%	(2)	2,962	34	230
October 2007	1,178	90%	82	1,173	90%	117	1,727	71%	307	4,078	506	736
November 2007	1,190	90%	1	1,805	90%	64	1,745	69%	40	4,740	105	841
December 2007	1,221[f]	90%	3	1,852	80%	189	1,790[d]	70%	(4)	4,863[d]	188	**1,029[d]**
2008												
January 2008	1,232	90%	1	1,860	80%	2	1,801	70%	3	4,893	6	6
February 2008	1,231	90%	-	1,859	80%	-	1,800	70%	-	4,890	-	6
March 2008	1,232	85%	62	1,861	70%	186	1,802	55%	271	4,895	519	525
April 2008	1,237	85%	1	1,867	70%	2	1,808	30%	455	4,912	458	983
May 2008	1,239	85%	-	1,871	65%	95	1,812	25%	93	4,922	188	1,171
June 2008	1,231[f]	70%	181	1,859	40%	460	1,800[d]	20%	80	4,890[d]	721	**1,892**
Total		**367**			**1,115**			**1,439[d]**				**2,921[d]**

Note: ABN AMRO exposure included from date of acquisition (17 October 2007) only.[67]
a Represents gross exposure less hedged amount.
b Data provided by RBS - October 09, 'Sheet 1 Super Senior CDO's', Mezzanine marks for June 2007 to December 2007 sourced from additional data provided by RBS.
c Data provided by RBS – October 2009, 'Appendix 4 Reconciliation 2 RBS Group - Comparison of Movements in Exposures between Year End and April 2008.'
d RBS Group plc Interim Results 2008, 'Credit market and related exposures - additional information.'
e Derived number based on information provided.
f RBS plc Interim Results 2008.

67 RBS Group plc Annual Report and Accounts 2007; RBS Group plc Interim Results 2008; information provided by RBS in October 2009; and super senior Mezzanine position marks as recorded in the RBS Greenwich management accounts. Monthly gross exposures calculated by investigators using: deal information provided by RBS; exposure information from RBS Group plc Interim Results 2008, Appendix 2, page 3; and exposure information from RBS Group plc Interim Results 2008, page 8, adjusted for exchange rate movements (exchange rates sourced from Datastream).

Graph 3.6: RBS Group leveraged finance exposure (excluding ABN AMRO) (£m)[68]



151 Like structured credit, leveraged finance was a growth area identified by GBM in May 2006 which it sought to expand from 2007 with a significant focus in growth in the US market. There were clear limits on underwriting leveraged finance risk, but limited consideration was given by RBS senior management or the RBS Board, in deciding to grow the business in June 2006, to the risks of taking on additional exposures which RBS might then be unable to distribute and have to carry on its balance sheet. This was because they viewed the likelihood of a failure to distribute as extremely small. In July 2007 when the leveraged finance market froze, RBS like many other market participants had already built up a pipeline of deals and was unable to take evasive action. For RBS this resulted in credit write-downs of approximately £1.4bn in 2007 and 2008.

152 GBM did not set any specific revenue or profit targets for the business when it was first identified as a growth area in May 2006. Growth for leveraged finance assets between 2005 and 2008 was forecast to be 289%, with an associated increase in headcount within the department from 41 to 110 people. In mid-2006 RBS was ranked 11th in the US for leveraged loans that year, and 18th for leveraged finance revenues. RBS's aim was to enter the top ten in the US for lead arranged leveraged loans and US high yield sales, trading and underwriting.

153 There was no significant assessment of the risks involved in the strategic initiative for leveraged finance. GBM in May 2006 considered that the main challenge to the business was the competitive markets for both talent and customers. No documentation was provided to the RBS Board during the strategy-setting process outlining the leveraged finance initiative, or the associated risks, including underwriting/distribution risk (i.e. the risk of a failure to distribute a portion of the transaction requiring RBS to hold that portion on its own balance sheet or sell at a discounted level where that was possible). Again, in much the same way that the structured credit initiative was the expansion of an existing business lines, the leveraged finance strategy involved the growth of an existing business line which was already subject to existing credit and risk controls (such as the loan underwriting limits and stress-testing set by Group Risk) rather than new areas.

154 The principal method of monitoring loan underwriting was the monthly Loan Markets Underwriting Report, provided to GBM and Group senior

68 Information provided by RBS, October 2009, 'Sheet 3 Leveraged Loans'.

management, which set out the size of the underwriting book, newly approved deals, and detail of overdue positions.

155 RBS's exposure to leveraged finance deals grew from £4.9bn in January 2007 to a peak of £15.4bn in January 2008 before reducing again to £12.1bn in June 2008. As illustrated by Graph 3.6, the main period of growth in this exposure was during the first half of 2007, where RBS's exposure increased by 180% from £4.9bn.

156 From March 2007, competition in the leveraged finance market for lenders such as RBS began to increase, as evidenced by the increase in 'covenant-lite' deals (i.e. deals with diluted lender protections). During May and June 2007, leveraged finance spreads began to widen as a result of concerns about the high volume of deals in the market. Nevertheless, on 20 June 2007, GBM senior management observed that the four syndicated deals they had in the market were going well and that GBM had just been successful in another recent deal.

157 In May 2007, the loan underwriting limit, which was RBS's main control of its underwriting/distribution risk, was temporarily increased from £50bn to £60bn to accommodate a larger pipeline of leveraged finance deals. RBS did not anticipate a problem with distributing leveraged finance deals at this time. RBS senior management was active in highlighting risks and areas of concern, and acknowledged that it was desirable to operate the business within the agreed limits in place at the time. However, there was also a prevailing view that, as the business grew, it could reasonably take more risk because its ability to absorb losses had also grown. The manner in which the limits were periodically increased suggests that, ultimately, the limits were governed by the desire for growth rather than by risk assessment.

158 In late June 2007, RBS agreed to participate in what was at the time the largest leveraged finance deal in the world; it increased RBS's underwriting exposure by some £3.6bn. The deal did not ultimately complete, and no losses were suffered by RBS (although the exposure was carried on RBS's books for some months). The timing of the deal indicates that RBS was actively seeking to increase the size of its deals right up to the point when market sentiment shifted and it was no longer possible to distribute deals.

159 From July 2007, RBS began to encounter severe difficulties in completing and distributing leveraged finance deals. The leveraged finance market in effect shut down and trading became illiquid. RBS was left holding the exposures on its balance sheet and having to take mark-to-market losses as they arose.

160 RBS stopped all leveraged finance initiation at that time. The July and August Loan Underwriting reports provided to GBM and Group senior management noted that the total underwriting position was still within its limits (£39.8bn versus the £50bn limit and the £60bn temporary limit). Initially, RBS senior management believed that the problem was temporary and that deals would return to the market, albeit at a discount. By November 2007, however, it was apparent that credit appetite had deteriorated significantly and in December 2007 the market was still in effect closed.

161 Table 3.14 presents a monthly summary of leveraged finance exposures and mark-to-market losses from June 2007 through June 2008.

Table 3.14: Monthly summary of GBM leveraged finance exposures and mark-to-market losses June 2007 to June 2008[69]

Date (£m)	Exposure (Risk View)[b]	Mark[b] (%)	Month write-down[a]	YTD write-down
2007				
June 2007	13,805	100%[b]	-	-[b]
July 2007	13,327	100%[b]	-	-[b]
August 2007	12,592	99%[b]	-	-[b]
September 2007	12,644	98%[b]	108	108[b]
October 2007	12,573	97%[b]	-	108[b]
November 2007	12,756	97%[b]	66	174[b]
December 2007	15,183	96%[b]	113	287[b]
2008				
January 2008	15,372	96%[b]	207	207[b]
February 2008	15,013	96%[b]	137	344[b]
March 2008	15,225	92%[b,d]	271	615[b,d]
April 2008	14,109	88%[b]	635	1,250[b]
May 2008	13,869	93%[b]	(543)	707[b]
June 2008	12,086	92%[c]	156	863[c]
July 2008	n	92%[b]	132	995[b]
August 2008	n	n	36	1,031[b]
September 2008	n	91%[e]	(132)	899 [e]
October 2008	n	n	n	n
November 2008	n	n	n	n
December 2008	n	64%[f]	n	1,088[c]

[a] Calculated/derived from information provided or publicly available.
[b] Information provided by RBS – October 2009, 'Sheet 3 Leveraged Loans' (Prepared on request by RBS).
[c] RBS Annual Report and Accounts 2008, page 45; RBS June 2008 Interim Results Announcement, Appendix 2.
[d] Information provided by RBS – October 2009, 'Appendix 4 Reconciliation 2 – Comparison of Movements in Exposures. between year-end and April 2008' (Prepared on request by RBS).
[e] Prospectus for the Placing and Open Offer of October 2008; page 43.
[f] RBS Annual Report and Accounts 2008.
n = Number not available based on publicly disclosed information or information provided by RBS.

162 Mark-to-market losses for the leveraged finance portfolio totalled £287m and £1.1bn for 2007 and 2008 respectively and related predominantly to the RBS legacy business rather than the acquired ABN AMRO business.[70] The high level of losses was a direct result of the increased portfolio generated in the first half of 2007.

69 Information provided by RBS – October 2009, 'Sheet 3 Leveraged Loans' (Prepared on request by RBS); *RBS Annual Report and Accounts 2008*, page 45; *RBS June 2008 Interim Results Announcement*, Appendix 2; Information provided by RBS – October 2009, 'Appendix 4 Reconciliation 2 – Comparison of Movements in Exposures between year-end and April 2008' (Prepared on request by RBS); *Prospectus for the Placing and Open Offer of October 2008*; page 43; *RBS Annual Report and Accounts 2008*; information calculated/derived from information provided by RBS or publicly available.

70 The RBS Group Internal Audit report July 2008, Leveraged Finance section, page 6.

163 Overall RBS's strategy of growth in its leveraged finance business did not anticipate the sudden closure of the market that occurred in July 2007. RBS was left with relatively little room for manoeuvre because of its leveraged finance deal pipeline and found it very difficult to mitigate its losses. These issues are discussed in Section 1.11, which also explains why Enforcement Division did not proceed to take enforcement action.

1.11 The decision not to take enforcement action

164 The reasons why Enforcement Division decided not to proceed with enforcement action in relation to the growth of GBM are set out in paragraphs 165 to 189 and can be summarised as follows:

- Viewed without the benefit of hindsight, the strategy of growth adopted by GBM was not beyond the bounds of reasonableness because it was an extension of existing businesses in which it was a market leader and, at the time, a sharp and prolonged fall in the markets was not widely anticipated.

- While there were significant weaknesses in assessing, monitoring and reporting the risks associated with the expansion of the CDOs business and the retention of super senior CDOs on the balance sheet, it would appear these weaknesses were unlikely to have contributed materially to the level of the losses ultimately suffered. This is because it was reasonable, at the time, to assume the business was not high risk: the exposures made up only a very small proportion of GBM's balance sheet and were rated at the time as 'better than AAA' by credit rating agencies.

- RBS's decisions to continue to issue CDOs in January 2007 and not to fully hedge them in 2007 were not unreasonable. This is because the super senior CDOs were in early 2007 still rated better than AAA and opportunities for hedging were limited and increasingly expensive after Q2 2007.

- While there was a clear bias to optimism, which raises issues about the quality and balance of the judgements made, there was an absence of evidence that RBS's valuations of its super senior positions were outside the bounds of reasonableness during Q4 2007 and Q1 2008 and approaches to valuation were inevitably subjective because of market illiquidity.

- The mix of skills and experience across the GBM senior management was not inappropriate. This matter was examined because although the investigation was into Mr Cameron, it also raised the issue of whether Sir Fred Goodwin was right to delegate to him. Enforcement Division therefore considered whether it should take action against Sir Fred Goodwin. For the reasons set out in paragraphs 184 to 189 it concluded, however, this was not appropriate in the light of the overall mix of GBM staff, which included people with relevant market risk expertise.

1.11.1 The decisions to expand the structured credit and leveraged finance businesses

165 Enforcement Division found that in 2006 and 2007 GBM held a number of assumptions that were prevailing in the industry at that time. For example, GBM shared the belief of many commentators that the market would remain stable and liquid. GBM also shared a widely held view that it was inconceivable that super senior CDOs would suffer any loss as the tranching process had rendered them almost risk free.

166 These assumptions underlay the strategic focus adopted by GBM in 2006, which was one of consistent and ambitious growth in existing business areas in order to catch up with the leading market participants. While it is possible on the basis of macroeconomic analysis today to conclude that the entire development of US structured credit was creating severe risks, within the context of the dominant assumptions prevalent at the time the business decision to expand in the US and to increase either the structured credit or the leveraged finance businesses cannot be treated as so inherently flawed as to be subject to enforcement action. It was, however, an ambitious level of growth and therefore required careful risk assessment, monitoring and management.

1.11.2 The adequacy of risk control systems and the decision in January 2007 to continue to issue CDOs as conditions in the US housing market deteriorated

167 Enforcement Division considered, therefore, whether there was a case for enforcement action in respect of potential control weaknesses in RBS's assessment, monitoring and management of the risks arising from the growth of GBM. Overall, it decided there was not.

168 It is certainly true that GBM's ambitious pursuit of growth and its aggressive revenue and profit targets assumed continuing favourable market conditions at a time when it is now clear that the US housing markets and leveraged finance markets were reaching their peak. This strategy also required a substantial increase in RBS's risk exposure. While RBS believed in 2006 that it could achieve £200m in revenue from structured credit in 2007, in fact it suffered a loss of £659m on super senior CDOs in 2007 (as well as additional write-downs on associated monoline exposures). However, RBS was only one of a number of firms which issued CDOs in increasingly significant amounts during 2006 and early 2007 and which ended up retaining the loss-making super senior CDO tranches. For example, Barclays, UBS, Morgan Stanley, Merrill Lynch and Citigroup all reported large losses in 2007 and 2008 related to retained super senior CDOs.

169 At its peak in 2006, RBS's CDO business made up less than 9% of its overall structured finance activities by total issuance, and RBS's market share was less than 4%. RBS's CDO transactions were generally smaller than the market average; although in 2006 their average size increased to a level consistent with the top five participants in the CDO market. As at 31 December 2007, RBS's net exposure to retained super senior tranches of CDOs relative to RBS equity

was significantly less than some other market participants. While RBS considered its structured credit business as relatively small when compared to the total group, this reflected a failure to realise that it was taking on risks that could lead to much larger losses. There was a failure to think in balance sheet terms (though of course even in those terms the exposure was less than 0.5% of the total group balance sheet).

170 RBS's risk functions were involved in the final stages of the strategy-setting process. Their involvement included assessing the impact of the strategy on RBS's expressed risk appetite and its existing risk limits as part of the Annual Divisional Budget Risk Assessment Process. However, the risk functions' role in the earlier stages of the strategy formulation was very limited. There was no comprehensive risk assessment of the impact of the growth strategy at that stage; for example how changes to the assumptions underlying the strategy might increase RBS's risk profile. This was because the strategy primarily involved the expansion of existing business lines in what were viewed to be benign market conditions. Enforcement Division considered the extent to which it regarded this as a weakness, but as set out in the next paragraph it also considered its overall significance to the decision to expand CDO issuance.

171 Even if the RBS Board had been presented with such an analysis in June 2006, it is not clear that it would have made any difference to its assessment of GBM's strategy. RBS at that time shared the widely held view that it was very unlikely that any losses would affect any unsold super senior CDO tranches. It considered that any super senior exposures would make up only a relatively small proportion of GBM's balance sheet as a whole. It also took comfort from the 'better than AAA' rating of the super seniors by external credit rating agencies, another view that was shared by many in the financial services industry at the time. Indeed, a number of investment banks made large losses on super senior tranches of CDOs. The US Financial Crisis Inquiry Commission report published in January 2011 found that:

'…when the housing market went south, the models on which CDOs were based proved tragically wrong. The mortgage-backed securities turned out to be highly correlated — meaning they performed similarly. Across the country, in regions where sub-prime and Alt-A mortgages were heavily concentrated, borrowers would default in large numbers. This was not how it was supposed to work. Losses in one region were supposed to be offset by successful loans in another region. In the end, CDOs turned out to be some of the most ill-fated assets in the financial crisis. The greatest losses would be experienced by big CDO arrangers such as Citigroup, Merrill Lynch, and UBS, and by financial guarantors such as AIG, Ambac, and MBIA. These players had believed their own models and retained exposure to what were understood to be the least risky tranches of the CDOs: those rated triple-A or even 'super-senior,' which were assumed to be safer than triple-A-rated tranches.'[71]

172 In line with the above comments, RBS did not initially consider that the super senior tranches were sub-prime exposures, despite being based on sub-prime

71 Financial Crisis Inquiry Commission Report, January 2011.

ABSs, or that they might be of poorer credit quality than their ranking suggested. Although this assessment was ultimately wrong, there is nothing about RBS's assessment or approach which, within the context of the information then available, could reasonably be subject to an enforcement action (in particular, the failure to anticipate the unprecedented scale of the market losses that ultimately occurred and the extent to which the value of highly rated super senior tranches would be eroded).

1.11.3 GBM's exposure to monoline insurers

173 Similarly, RBS's assessment that the probability of monoline insurers defaulting was remote because of their very high credit rating was also a view that was shared by many in the financial services industry at the time. By the time it became apparent that insurers which had taken highly-rated risk were also vulnerable to adverse market conditions, it was too late for RBS to limit the losses that it had attempted to mitigate by purchasing of insurance. Even had RBS appreciated the risk of insurers defaulting earlier, it is unclear what difference it would have made to the scale of its super senior losses, beyond saving RBS the cost of its insurance premiums.

1.11.4 The decisions in January 2007 to continue to issue CDOs as conditions in the US housing market deteriorated and in mid-2007 not to hedge its CDO exposures to any significant extent

174 The widely held assumptions about the risks associated with super senior CDOs also informed the actions taken by RBS in 2007 to monitor and mitigate these risks.

175 Between April and October 2006 when the relevant CDO transactions were approved by GBM, the market was generally perceived as comparatively stable and liquid. However, during the relatively long period between approval and completion of the CDO transactions, the signs of a downturn in the US housing market began to increase. GBM's decision to continue to proceed with the CDO transactions in January 2007 as market conditions began to deteriorate was made by Mr Crowe and Mr Levine who understood the CDO business and were active in responding to the changing conditions. The strategy involved selling off the higher-risk tranches with the intention to sell the lower-risk super senior tranches when the market improved. However, by the time these CDOs had been completed, there was no market for the super senior tranches which were retained unsold by RBS and were mostly not covered by monoline insurance. Like the majority of market participants and commentators, RBS did not foresee in January 2007 that that US housing market was entering a period of sustained decline or predict the market events that subsequently unfolded in 2007 and 2008, which would have an impact on the super senior CDOs. Notwithstanding that this strategy was designed to reduce GBM's risk, GBM's exposure to super senior positions increased by £900m in the first half of 2007.

176 As the scale of the market volatility became more apparent in the second half of 2007, there were limited options available to RBS and others in the same position to contain the resulting losses. This was because hedging options were increasingly expensive and limited and decisions about how and when to hedge were very complex in a highly uncertain and illiquid market. RBS considered hedging its super senior CDO exposures in July and August 2007 but decided not to lock in its losses as it believed that the market would eventually recover. This demonstrates RBS's prevailing sense of optimism at the time that any downturn would be short-term and not widespread.

1.11.5 Monitoring and internal reporting of the structured credit exposures

177 Senior management's monitoring of the structured credit initiative was initially focused solely on profit and revenue. When problems did emerge, they were seen as issues of revenue shortfall rather than indicators of potential risk. GBM did not produce sufficient information to monitor the accumulation of super senior CDOs on its balance sheet until April 2007, because it did not initially recognise the significance of these assets' indirect exposure to the sub-prime market. Earlier reports received by the RBS Board in February and March 2007 did not mention the super senior CDOs. While the underlying financial data were held on GBM's systems, the lack of production and reporting of a regular and complete balance sheet together with supplementary analysis, disaggregated into the major exposures carried by GBM should be regarded as a major omission from the regular financial reporting information for an organisation of the size and complexity of GBM. However, it is not clear, even if there had been an earlier focus on the accumulation of super senior CDOs on RBS's balance sheet, that the action that RBS would have taken would have been very different from the actions it did take. At that time, the assessment of risk by RBS and more generally in the market was that super senior CDOs remained better than AAA rated and therefore were very unlikely to default. Furthermore, super senior CDOs represented only 0.4% and 0.3% of GBM's balance sheet at the end of 2006 and 2007 respectively.

178 RBS's monitoring of these exposures increased as the market turmoil intensified in 2007 and its exposures grew. In addition to the monthly Group Risk Management Reports from Group Risk, which set out the results of stress-testing on CDO holdings, the RBS Board received updates throughout July, August and September 2007 of the write-downs taken by RBS on the super senior CDOs. Risk reports and performance packs also commented on the losses sustained and the potential stress loss scenarios. The RBS Board discussed market turmoil on 24 August 2007 and again on 16 September 2007. However, although detailed analysis of market developments and their impact on the RBS Group was carried out by senior management, Enforcement Division saw no evidence of any of the papers on this matter being presented to the RBS Board.

179 As Enforcement Division's investigation focused on the conduct of Mr Cameron, it did not interview all members of the RBS Board to determine the extent of the discussions at these meetings (both meetings were held by telephone). However, it is likely that if the RBS Board had been presented with the written analysis

that had been carried out it would have given the RBS Board members a greater appreciation of the issues. The apparent absence of such a comprehensive written briefing at the RBS Board level at that stage therefore raises questions about the governance of this matter. It is not clear, however, that a more comprehensive written briefing and discussion at the RBS Board would have had any impact on ultimate write-downs because by that stage there were few actions available for management to take. In addition, the size of RBS's losses was not at that time so great as to have become a significant concern. For example, when super senior exposures were reported to the RBS Board in September 2007, the predicted losses were in the range of $220m to $290m, which was considered to be bearable in the context of RBS as a whole.

180 Overall, for the reasons set out above, Enforcement Division decided against taking enforcement action in relation to RBS's assessment, monitoring and management of the risks of expanding the GBM businesses.

1.11.6 Valuation and external reporting of the structured credit exposures

181 Enforcement Division further decided it was not appropriate to take enforcement action in respect of the valuation of RBS's super senior CDOs and other credit market exposures in the second half of 2007, including in its annual accounts for the year ending 2007 or during the early part of 2008. It factored into its analysis that it did not find evidence that write-downs were hidden from senior managers. Although there was a lack of clarity within RBS as to the correct valuations of super senior CDOs, and the Managing Director for Risk Management at RBS Greenwich Capital, Victor Hong, resigned over matters related to the pricing of super senior CDOs, this did not in itself indicate an actionable failure of controls. Enforcement Division took into account that there was very little market transparency during this period and it coincided with RBS's development, testing and ultimate implementation of the LSD model. Enforcement Division also considered that during this time the appropriate people in RBS were aware of the matter and engaged in a debate about the valuations, and that RBS's auditors Deloitte signed off on the 2007 year end accounts. Prior to doing so, Deloitte identified £200m as a further adjustment to bring the valuations within the range they considered appropriate. No adjustment was ultimately made as Deloitte agreed with the assessment of the Group Audit Committee that £200m was immaterial in the context of RBS's total operating profit of £10.3bn and profit after tax of £7.7bn. RBS subsequently made significant write-downs in March and April 2008.

182 While with hindsight it is undoubtedly the case that RBS was at the optimistic end of industry practice (and it proved to be over-optimistic in light of subsequent developments) there was not sufficiently strong evidence that the valuations were wrong during Q4 2007 and Q1 2008. Further, the market was highly illiquid and uncertain during these months, meaning that views as to the correct approach to valuation were quite subjective. Drawing comparisons with the marks taken by RBS's peers is difficult because of the different vintages and attachment points of the CDOs in the different banks' portfolios. To a certain extent, the ABX and the TABX indices are helpful in showing what the CDOs

market was doing during Q1 2008. However, benchmarking to the indices is not an exact science, as the assets are not the same and the risks are not precisely correlated. Enforcement Division concluded it would be very difficult to establish that a decline in the index in any particular month made it unacceptable for RBS not to take write-downs at that point, particularly because not all other institutions were taking such write-downs.

183 Overall, since no evidence was identified that the valuations adopted were outside the limits of what was plausible, the decisions made could not be said to be unreasonable and therefore could not be subject to enforcement action. As part of this assessment, Enforcement Division concluded that RBS's attempts to address the lack of visibility and its process for developing the LSD model were not materially unreasonable. In the absence of clear evidence that valuations were wrong, and in light of Deloitte's sign-off of the accounts, any case against RBS regarding its development of the LSD model would have been process based rather than substantive. Nevertheless, Enforcement Division's view remained that there was a bias to optimism by RBS senior management in its approach to CDO valuation issues at end-2007 and the start of 2008, and an acceptance of that optimism by RBS's auditors (albeit the auditors identified that an adjustment of at least £200m was required to CDO valuations proposed by RBS senior management) and the Group Audit Committee, which with hindsight is difficult to justify. Enforcement Division did not investigate the auditors' work and has, in line with its normal procedures, been in contact with the Accountancy and Actuarial Discipline Board (AADB) and has provided them with the investigation reports prepared by PwC. The AADB will consider what, if any, action it is appropriate to take in relation to the conduct of any accountancy firm or individual accountant.

1.11.7 GBM governance controls, roles and responsibilities

184 Enforcement Division considered if there was a case against RBS group's CEO Sir Fred Goodwin for failing to appoint suitably qualified individuals to run GBM. The FSA requires CEOs to ensure that senior management teams have the appropriate mix of skills and experience to run the businesses for which they are responsible.

185 Enforcement Division looked at action against Sir Fred Goodwin on this issue because its investigation identified that Johnny Cameron, who was appointed by Sir Fred Goodwin, had more of a credit rather than markets background. For example, a memorandum drafted for the purposes of reviewing Mr Cameron's remuneration states:

'...he [Mr Cameron] is not considered a true markets person who could run GBM without Brian [Crowe]. On this basis, the view from the recruitment consultants was that Johnny would not be a candidate for running major FM [Financial Markets] business at a competitor, particularly in relation to the management of market risk'.[72]

72 Memorandum – Chief Executive, Corporate Markets Remuneration, 2 June 2006, page 1.

186 At the time of its investigation work, the FSA was initially concerned that as a result of Mr Cameron's background there was an unreasonable risk that traded markets issues were not adequately managed and reported to the RBS Board. Enforcement Division therefore focused on whether the decision to appoint a Chairman (Mr Cameron) with a credit background rather than a markets background was reasonable. Ultimately, however, Enforcement Division decided this was not unreasonable.

187 In reaching its conclusion, Enforcement Division took account of the fact that, as chairman, Mr Cameron did not lead GBM alone. As the CEO of GBM, Mr Crowe had a significant role in the management of GBM and Mr Crowe and Mr Cameron had complementary skills: Mr Cameron focusing more on the external, particularly clients, media and regulators, while Mr Crowe had primary responsibility for the internal i.e. running the business day-to-day. The importance of Mr Crowe's role was reflected in his position alongside Mr Cameron on the GEMC. Enforcement Division also concluded that an arrangement whereby leadership of a Financial Markets business is split is not unique or unusual. Examples of similar recent arrangements include:

- UBS – Co-CEOs of the investment bank with Karsten Kengeter covering fixed income, currencies and commodities and Alex Wilmott-Sitwell responsible for major corporate clients; and
- Barclays Capital – Joint CEOs of the investment banking business with Rich Ricci covering operations and Jerry Del Missier responsible for Global Markets business covering trading, sales and research.

188 Enforcement Division also looked at the position when Mr Crowe was seconded to ABN AMRO in autumn 2007. At this time there was clearly a reduction in traded markets experience in the senior management team at GBM. Mr Crowe's secondment, however, came at a time when interview evidence shows that Mr Cameron had acquired a better understanding of structured credits and other staff were able to provide an acceptable level of skills and experience to compensate for Mr Crowe's absence. More generally, in making its decision not to pursue action against Sir Fred Goodwin, Enforcement Division factored into its analysis the fact that significant losses on credit trading occurred at several large investment banks which were run by staff with extensive traded markets experience. It was, therefore, far from clear that Mr Cameron's absence of traded markets experience was the cause of any losses at GBM or had any impact on their size.

189 Furthermore, an element of any case against Sir Fred Goodwin would have been a finding of Mr Cameron's lack of competence for the role. The FSA did not, however, make a finding that Mr Cameron was not competent judged by the relevant prevailing standards. The FSA did consider that Mr Cameron would not meet its current standards for a new approval, which reflects the more robust approach the FSA now applies to approving senior managers. More generally, the competence of RBS individuals can, and will, be taken into account in any future applications made by them to work at FSA-regulated firms.

2 The acquisition of ABN AMRO

2.1 Introduction

190 As part of its work, Enforcement Division also reviewed the process followed by RBS in considering the takeover of ABN AMRO. It focused on the due diligence undertaken by RBS, the involvement of the RBS Group Board and the processes used in RBS's decision-making.

191 On 17 October 2007, a consortium of banks made up of RBS, Santander and Fortis acquired ABN AMRO. The acquisition followed seven months of contested bid activity from March of that year, in which the consortium sought to acquire ABN AMRO against a competing bid from Barclays which the board of directors of ABN AMRO had recommended. The consortium's offer price of €71.1bn made it at the time the world's largest banking takeover.

192 The consortium's plan was to break up ABN AMRO with each member taking specific ABN AMRO businesses. RBS was the largest member of the consortium, contributing 38.3% of the offer price, equivalent to approximately 61% of RBS's reported Tier 1 capital at 31 December 2006.

193 It was well known to investors, regulators and observers at the time that the consortium *'conducted only a limited due diligence review of ABN AMRO'*.[73] As is normal for a contested bid for a publicly owned company, ABN AMRO allowed RBS and its consortium partners only extremely limited access to confidential information.

194 From the outset the RBS Board accepted that it was likely that they would only receive limited information from ABN AMRO. Notwithstanding the limitations, RBS concluded that nothing emerged from its due diligence which undermined the commercial rationale of the bid and decided to proceed with the acquisition.

195 Approximately a year after the consortium acquired ABN AMRO, the rescue of RBS by the UK Government was announced on 13 October 2008. Losses and capital strain suffered as a result of the acquisition were a substantial contributing factor to RBS's vulnerability to failure. The losses suffered by ABN AMRO businesses acquired by RBS are set out in Table 1.6 in Part 1 of this Report.

196 The acquisition of ABN AMRO was a misjudgement with catastrophic consequences. At the annual general meeting of shareholders of RBS on 3 April 2009, the then Chairman of RBS, Sir Philip Hampton, said:

'… I don't think there can be any doubt that the key decision that led RBS to its difficulties was the acquisition of ABN AMRO. That is the painful reality that we can now do nothing to change. With the benefit of hindsight it can now be seen as the wrong price, the wrong way to pay, at the wrong time and the wrong deal.'[74]

197 Given the importance of the ABN AMRO acquisition to RBS's failure, Enforcement Division decided to review whether there were any aspects of the

73 The Offer Memorandum and Listing Particulars, 20 July 2007, page 15.
74 RBS press release, 'Royal Bank of Scotland Group PLC - Annual General Meeting/General Meeting,' 3 April 2009.

decision-making processes adopted by RBS or the governance of those processes which should and could be subject to a successful enforcement action. PwC was commissioned to assist with this review. The PwC report on this matter looked both at the due diligence conducted by RBS, and whether there existed rules, codes or practice standards against which to judge whether the process followed was in any way deficient.

198 Having reviewed PwC's report of the ABN AMRO acquisition, Enforcement Division concluded that:

- The due diligence that RBS conducted on ABN AMRO was insufficient in its scope and depth and inappropriate in relation to nature and scale of the acquisition and the risks involved.
- All of the RBS Board were responsible for the several decisions to go ahead with the deal and all were aware of the level of due diligence carried out and were unanimous in their decisions. There was thus no indication of a failure of formal governance processes.
- While clearly insufficient, the level of due diligence carried out was in line with standard practice for contested takeovers and there were no defined standards against which to judge before an independent tribunal whether it was appropriate. Any case would therefore have required Enforcement Division to consider the prevailing approach and to conclude the Board's decision to go ahead with the takeover was not just a bad decision but one which, viewed at the time, was beyond a range of reasonable responses. There was therefore not a basis for bringing an enforcement case with a reasonable chance of success.
- Any attempt to sanction the due diligence as unreasonable would have to take into account the degree to which the extent of the due diligence conducted and the limitations to which the transaction was subject were transparently communicated to investors, the FSA and the general public.

199 This section of the Report therefore:

- Explains the governance arrangements relating to RBS's decision-making on the ABN AMRO acquisition.
- Considers the quality of RBS's decision-making at four key points in the process, namely:
  - the initial decision in March 2007 to attempt an acquisition;
  - the decision in May 2007 to make the initial offer for ABN AMRO (including LaSalle);
  - the decision in July 2007 to make an offer for ABN AMRO without LaSalle; and
  - the decision in September 2007 to proceed with the acquisition in the face of market deterioration.

200 The following material summarises the key issues covered in the underlying report prepared by PwC. A list of the chapter headings to that report is set out at Appendix 3A.

2.1.1 Governance processes during the acquisition

201 The acquisition was considered in two principal fora at RBS Board level: the RBS Group Board of Directors and the Chairman's Committee. Although the RBS Board was the ultimate decision-maker in the process, the core forum in which the acquisition was considered was the Chairman's Committee. The Chairman's Committee operated under delegated authority from the RBS Board and was responsible for exercising all the powers of the RBS Board without limitation as it deemed necessary in the event of emergencies or in respect of material matters that required an immediate decision. For the purpose of the acquisition, the Chairman's Committee was in effect the RBS Board: notwithstanding that the Chairman's Committee required fewer attendees than the RBS Board to be quorate, it was considered by RBS Board members to be no different from a Board meeting and generally attended by most RBS Board members throughout the period of the acquisition. The Chairman's Committee was also the RBS Board forum that received the due diligence findings.

202 At the senior executive level, the main forum in which the acquisition was considered and managed was the Deal Committee, a subset of GEMC which met every morning. However, all of the key decisions made in the acquisition process were made by the RBS Board or the Chairman's Committee.

203 The RBS Board and the Chairman's Committee met regularly between March and October 2007 to consider the acquisition. The Chairman's Committee met 12 times to discuss it between 11 April and 24 September 2007 and the RBS Board met seven times between 28 March and 26 September 2007.

204 The minutes of these meetings reflect the fact that the RBS Board was, at all stages, unanimous in its decisions to proceed with the acquisition. The minutes are the official record of its meetings and they contain limited detail of the extent of debate and challenge that occurred at the meetings (as is common with board minutes). Accordingly, as part of Enforcement Division's investigative work, it interviewed a number of former RBS Board members to obtain additional information as to the nature of the RBS Board's engagement in the acquisition process.

205 During the course of Enforcement Division's investigation it took account of a memorandum dated 15 July 2008 from RBS's Head of Group Internal Audit to the RBS Group Chairman which (as referred to in Part 2, section 2.2.3) suggested the RBS non-executive directors had concerns regarding their ability to discuss, challenge or influence decision-making in respect of strategy or risk. However, according to the RBS Board members interviewed by Enforcement Division, the RBS Board was closely involved with the acquisition throughout the process and had a high level of interaction with, and access to, executive management. In particular, the non-executive directors had the opportunity to raise any concerns that they had regarding the acquisition both during these

RBS Board meetings and outside them, in meetings with the Chairman of the RBS Board and lower levels of management when senior executives were not present. Enforcement Division found no evidence of such concerns having been raised or that executive management sought to circumvent or undermine the decision-making process at RBS Board level.

2.2 Key decisions taken by RBS in relation to the acquisition

2.2.1 The decision to attempt an acquisition

206 RBS had grown over the previous decades through the acquisition of a number of other banks, most significantly Citizens Financial Group (Citizens) in 1988 and NatWest in 2000. RBS became the second largest banking group in the UK following the acquisition of NatWest. Following the acquisition of Charter One Bank by Citizens in 2004, RBS became the eighth largest bank in the US.

207 As part of its regular assessment of its strategic options, RBS had reflected on the merits of a potential merger with, or acquisition of, ABN AMRO for a number of years but had not pursued this in any detail. Barclays' announcement on 19 March 2007 that it was in exclusive preliminary discussions with ABN AMRO concerning a potential merger was a catalyst for RBS to consider an acquisition more seriously. The RBS Board considered a bid at an RBS Board meeting on 28 March 2007.

208 RBS's stated strategic rationale for a bid focused on acquiring a number of ABN AMRO's businesses:

- The North American business unit, largely LaSalle, which was considered a particularly attractive opportunity for RBS as it was a good fit for RBS's existing US business, Citizens, and the combination of the two banks would mean that RBS would become the fifth largest bank in the US by asset size.
- The global clients and wholesale banking business. It was felt that ABN AMRO's geographical network and broad client base would provide an opportunity for RBS to accelerate its existing GBM and wholesale strategy and to realise significant synergies.
- ABN AMRO's global payments system.
- ABN AMRO's international retail banking operations. It was thought that ABN AMRO's branch networks in Asia and the Middle East would provide opportunities for growth.

209 The minutes of the RBS Board meeting on 28 March 2007 recorded that the RBS Board was told that the acquisition was not seen as a *'must do'* deal. It was also advised that *'execution risk would be high'* and *'that any bid for [ABN AMRO]... and subsequent integration would be more difficult than previous transactions'*.[75]

75 Continuation of Minutes of a Meeting of the Board of Directors of the Royal Bank of Scotland, 28 March 2007.

210 RBS saw LaSalle, at least initially, as the primary focus for its bid and its focal point for value creation. This strategic rationale was put at risk when ABN AMRO announced on 23 April 2007 its agreement to sell LaSalle to Bank of America. However, on 3 May 2007, a Dutch Court granted the Dutch Investors' Association a provisional injunction which prevented ABN AMRO from proceeding with the sale of LaSalle without ABN AMRO shareholder approval.

211 The minutes of the Chairman's Committee meeting on 24 April 2007 recorded that the RBS Board noted that *'The sale of [LaSalle] was in itself however a significant negative'*.[76] As explained in Sections 2.2.2 to 2.2.3, RBS moved quickly to make an alternative offer for LaSalle. When that offer was rejected and the injunction overturned, RBS was then faced with the decision whether to proceed with the acquisition without LaSalle.

2.2.2 The decision to make the initial offer for ABN AMRO (including LaSalle)

212 Based on the strategic rationale outlined above, the Chairman's Committee unanimously decided on 11 April 2007 that the consortium should notify ABN AMRO of its intention to make an offer and request the same information that had been made available to Barclays.

213 The RBS Board and the senior executive understood at this stage that ABN AMRO would likely provide only a small amount of information. Market practice in respect of bids for large listed companies had developed so that even where a takeover approach was not hostile, target companies would often cite the possibility of takeover rules (for example, Rule 20.2 of the City Code in the UK) being invoked, as a reason for limiting the information they were prepared to make available for due diligence.[77] As a consequence, the due diligence on targets that are large public companies tends to proceed with little information being provided by the target. While there was no equivalent rule in the Netherlands, Enforcement Division understands that the same practice was followed there.

214 In these circumstances, neither the RBS Board nor the senior executive set out specific high-level objectives that they were seeking to achieve in the due diligence exercise. Instead, the RBS Board expected the executive to be as demanding as possible and to carry out as much due diligence as it could while realising that little information might be forthcoming. As Enforcement Division established in interviews with former RBS Directors, the RBS Board relied on executive management to determine what approach should be taken to the due diligence based principally on the prior acquisitions made by RBS. Senior personnel with prior deal experience were deployed on the acquisition.

76 Continuation of Minutes of a Meeting of the Board of Directors of The Royal Bank of Scotland Group plc held at Gogarburn, Edinburgh, 24 April 2007, page 1, paragraph 3.

77 Rule 20.2 (Equality of Information to Competing Offerors) states that '*Any information given to one offeror or potential offeror, whether named or unnamed, must, on request, be given equally and promptly to another offeror or bona fide potential offeror even if that other offeror is less welcome. This requirement will usually only apply when there has been a public announcement of the existence of the offeror or potential offeror to which information has been given or, if there has been no public announcement, when the offeror or bona fide potential offeror requesting information under this Rule has been informed authoritatively of the existence of another potential offeror.*'

215 The RBS Board took comfort from the fact that ABN AMRO was a regulated, public entity, in particular that it was registered with and subject to the regulatory regime of the US Securities and Exchange Commission. Before gaining access to ABN AMRO's confidential information, RBS reviewed publicly available information on ABN AMRO. This included legal and regulatory filings (including prospectuses); interim and annual accounts and associated presentations; company announcements and other investor relations material; equity analyst and ratings agency coverage; company, legal and property searches; and industry records covering, for example, transaction participation (for example league tables).

216 RBS submitted a detailed information request to ABN AMRO on 26 April. On 29 April ABN AMRO provided two lever arch folders and one CD ROM of information to the consortium and stated that this was the same information that had been provided to Barclays. This material was in addition to information on LaSalle which was provided via an online data room. The information provided did not satisfy RBS's detailed request. RBS was largely unsuccessful in its attempts to obtain further information. Between 30 April and 3 May, RBS reviewed the information and met ABN AMRO personnel. While these meetings provided a means of obtaining additional clarification and some comfort to RBS, only limited additional information was provided.

217 RBS's due diligence exercise focused on validating the cost saving synergies that could be derived from the acquisition. This drew on its experience of merging businesses. Mr Cameron said of the RBS Group CEO in interview that:

'*Fred had a well-honed approach to acquisitions and it all revolved around those two things – what are the revenue synergies and what are the cost synergies*'[78], '*it's sort of once the boat had been launched and you said these are the cost and revenue synergies, there was a bit of tidying up around the edges, but not a lot to be done*'.[79]

218 RBS did, however, also set out to investigate ABN AMRO's balance sheet risks and exposures. A number of specialist teams from RBS (including those tasked with reporting on global and wholesale clients, risk and finance operations) included in their due diligence objectives the verification of balance sheet positions. The due diligence objectives set by the risk workstream (which focused on credit, market, regulatory and operational risk) included two areas which proved to be key contributors to the subsequent losses incurred by RBS as a consequence of the acquisition. These were (a) the valuation assumptions in respect of provision for impairment losses of credit portfolios, and (b) profit and loss volatility arising from market risk. The analysis that RBS was able to perform on the balance sheet was, however, severely limited by the restrictions on access to relevant risk information. For example, it was not possible properly to assess as part of due diligence whether there were any significant deficiencies in ABN AMRO's key risk management practices, the quality of the assets in its structured credit portfolios or the valuation of those positions.

78 Compelled interview with Mr Cameron, 27 July 2009, Part 1 of 6, lines 679-681.
79 Compelled interview with Mr Cameron, 27 July 2009, Part 1 of 6, lines 703-705.

219 In relation to the adequacy of the information received by the risk workstream, RBS Group Chief Financial Officer Guy Whittaker stated in interview:

'I'm not aware that the Risk teams would've had access for instance, to the detail of the leveraged loan portfolio or the structured credit portfolios within ABN, but as, as you well know we had leveraged loan portfolios and structured credit portfolios, within RBS and, and in fact at the time, structured credit was a, an area which the Global Banking and Markets division was keen on trying to grow. So the fact that it existed there, it existed on our balance sheet, it was not an asset at the time which we were unduly concerned about. So, no is the answer, we didn't have specific detail on those things. I don't know to what extent that would have raised concerns at the time, given that we had those assets on our own balance sheet and at the time we are not concerned about the performance of those assets.'[80]

220 Based on its review of the limited information provided by ABN AMRO as well as its review of publicly available information, the risk workstream included the following findings in respect of credit and market risk in its due diligence report:[81]

- ABN AMRO's global client businesses were thought *'to be high quality'*.
- Assumptions in respect of ABN AMRO impairment losses *'appear adequate'*.
- ABN AMRO provision numbers *'benefit from substantial use of credit derivatives and other portfolio management techniques'*.
- *'Levels of trading book risk (quantified by VaR and stress-tests) in [ABN AMRO] during 2006 were similar to those in RBS'*.
- Based on ABN AMRO's risk systems, an October 1987 stress scenario with equities at the maximum variance at risk exposure implied losses of up to €500m.
- ABN AMRO had *'large AFS [Available for Sale] investment portfolios (€117bn)'* which *'give rise to significant volatility'* but ABN AMRO management had indicated that these were predominantly liquid assets such as European government and covered bonds.
- ABN AMRO's market risk management processes were less reliable, as reconciliations were required between risk systems and source data.

221 In summary, although RBS had set out to conduct a more thorough due diligence exercise, it was unable to perform more substantive due diligence work because of limitations on information and access (and indeed it was not surprised when it did not get access). Nevertheless, the executive management concluded from the due diligence that they had found nothing that should dissuade RBS from proceeding with the acquisition. Clearly, a question could be asked whether it was reasonable to reach that conclusion based on the very limited information available.

80 Compelled interview with Mr Whittaker, 27 May 2010, part 1 of 6, lines 528 to 539.
81 Project Arran Due Diligence Findings Group Executive Presentation: Risk, 2 May 2007, slides 3 to 4 and 6 to 17.

222 In interview, Johnny Cameron characterised the due diligence and its limitations as follows:

'One of the things that went wrong for RBS was that, and I say this to many people, we bought NatWest as a hostile acquisition. We did no due diligence. We couldn't because it was hostile. After we bought NatWest, we had lots of surprises, but almost all of them were pleasant. And I think that lulled us into a sense of complacency around that. The fact is that the acquisition of ABN was also hostile. We got bits and pieces of information but fundamentally it was hostile. There's this issue of did we do sufficient due diligence. Absolutely not. We were not able to do due diligence that was part of doing a hostile acquisition.'[82]

2.2.3 The assessment of information gathered by due diligence

223 Having received information from ABN AMRO on 29 April 2007, the due diligence findings were presented to the Board on 3 May at the Chairman's Committee. The time constraints under which RBS was operating at this stage were dictated by certain deadlines in the LaSalle sale and purchase agreement between ABN AMRO and Bank of America. This agreement included a provision that permitted ABN AMRO, for a period of 14 days ending on 6 May, to enter into an alternative agreement for the sale of LaSalle with another bidder, provided that (among other things) the alternative acquisition proposal was a 'superior proposal' from a financial point of view.

224 As the consortium wished to make an offer for LaSalle that was linked to and conditional on the acceptance of the offer for ABN AMRO, the consortium needed to provide details of its proposed offer for ABN AMRO at the same time as the bid for LaSalle. The RBS Board therefore needed to consider the due diligence of ABN AMRO on 3 May 2007 in order to decide whether to proceed with the offer for LaSalle and the price to be offered.

225 The Chairman's Committee met on 3 May in order to decide whether the consortium should submit a formal offer for ABN AMRO and LaSalle. Some RBS Board members were unable to attend in person but participated by telephone. The RBS Board members Enforcement Division interviewed could not recall what due diligence information was provided to them before the meeting, for example whether they were provided with copies of the due diligence findings. However, a slide presentation was made at the meeting and the discussion that followed lasted a number of hours.

226 The minutes recorded that the Chairman's Committee was informed that *'nothing had emerged from the [due diligence] process which undermined the commercial rationale of a bid for [ABN AMRO]. Functional due diligence indicated, however, that the control environment within [ABN AMRO] was less effective than RBS.'*[83]

82 Compelled interview with Mr Cameron, 27 July 2009, part 1 of 6, lines 748-757.
83 Continuation of Minutes of a Chairman's Committee of the Board of Directors of The Royal Bank of Scotland Group plc (held by telephone), 3 May 2007, page 1 paragraph 3.

227 The Chairman's Committee was informed that, for the majority of the due diligence workstreams, there were *'no show stoppers'*[84]: based on the limited due diligence it had conducted, executive management had concluded there was nothing to contradict the initial view of ABN AMRO's business (formed from published information) and to dissuade RBS from continuing with the acquisition. The limitations in the information received for the due diligence exercise were confirmed to the Chairman's Committee in the slide presentation.

228 Following its review of the limited due diligence findings, according to the minutes of the Chairman's Committee, *'the unanimous view of all Directors present was that the Consortium should submit a formal offer for [ABN AMRO] and [LaSalle], on the basis outlined by the Chairman earlier in the meeting'*.[85]

229 On 5 May, the consortium submitted a proposal for LaSalle valued at $24.5bn. The proposal was conditional on the completion of a proposed public offer for ABN AMRO and set out an indicative price of €38.40 per ABN AMRO share. Although the consortium's proposal for LaSalle was higher than Bank of America's price of $21bn, ABN AMRO determined that the consortium's offer was not superior to Bank of America's existing offer, due to the inter-conditionality of the proposal with the proposed public offer and it rejected the proposal on 6 May.

230 On 15 May, ABN AMRO, Bank of America and Barclays filed separate appeals in the Supreme Court of the Netherlands to request that it overturn the provisional injunction that had been in place since 3 May, which had prevented ABN AMRO from proceeding with the sale of LaSalle without shareholder approval. With the appeal still to be heard, the RBS Chairman's Committee met on 24 May and unanimously agreed that the consortium should announce its intention to make an offer for ABN AMRO. The minutes of the meeting recorded that RBS's various advisers were comfortable with the transaction and that it had received advice from its lawyers, Linklaters, on the issue of whether the RBS Board had given the proposed transaction proper consideration.[86]

231 The consortium held press and investor conferences on 29 May to announce details of its offer, the key terms of which included:

- €30.40 in cash plus 0.844 RBS ordinary shares for each ABN AMRO ordinary share (including €1.00 in cash for each share to be retained pending resolution of the situation with respect to the sale of LaSalle); and
- a valuation at €38.40 per ABN AMRO ordinary share, giving a total price of €71.1bn.

232 Of the total price, €56.2bn was offered in cash (79%) with the remaining €14.9bn offered in RBS shares (valued at €9.48 a share). RBS's contribution amounted to €27.2bn (around £19bn).

233 This offer was at a 13.7% (€8.6bn) premium to the value of Barclays' proposed offer. However, the proposed offer was conditional, among other things, on the

84 Project Arran Due Diligence Findings Group Executive Presentation: Risk, 2 May 2007, slide 5.
85 Continuation of minutes of Chairman's Committee meeting, 3 May 2007, page 5, paragraph 5.
86 The substance of the legal advice is subject to legal professional privilege and cannot be referred to in this Report. Enforcement Division took account of the fact that legal advice had been sought we well as the content of the advice.

Dutch Supreme Court upholding the provisional injunction granted on 3 May and ABN AMRO shareholders voting to reject the sale of LaSalle.

234 Although the consortium and ABN AMRO maintained intermittent contact during June to clarify aspects of the proposed offer, no substantive additional due diligence was carried out or made available to the Board after 3 May.

2.2.4 The decision to make an offer for ABN AMRO without LaSalle

235 The Dutch Supreme Court overturned the provisional injunction on 13 July, ruling that ABN AMRO could sell LaSalle without shareholder approval. This decision enabled Bank of America to complete its acquisition of LaSalle and presented RBS with an opportunity to reconsider its bid. Despite the importance of LaSalle to its bid, RBS had already begun to assess the prospect of the acquisition without LaSalle ('Plan B'). The executive management considered that the financial and strategic merits of the acquisition even without LaSalle were such that the consortium should continue bidding for the remainder of ABN AMRO. It was thought that combining ABN AMRO's global wholesale businesses with GBM's business remained a sound strategic proposal.

236 The Board's 2007 annual strategy session, held on 20 June, fell during the course of the ABN AMRO acquisition. In addition to the normal matters dealt with at that meeting, there was a substantial discussion of the merits of proceeding with the acquisition excluding LaSalle.

237 On the same day that the Dutch Supreme Court ruling was published (13 July), the consortium confirmed its intention to make a revised offer, conditional on there being no further disposals by ABN AMRO of a material part of its business or assets. The minutes of the Chairman's Committee on 15 July recorded:

'the Directors confirmed that all were in favour of proceeding under Plan B in principle' and *'the Committee approved the terms of the revised offer and the content of a draft announcement by the Consortium which would be issued the following morning'*.[87]

238 Later that day, the consortium confirmed to ABN AMRO that its offer would remain at €38.40 per ABN AMRO share. It announced the terms on 16 July and the offer documents were subsequently published on 20 July. The key terms of the offer included:

- €35.60 in cash plus 0.296 RBS ordinary shares for each ABN AMRO ordinary share; and
- valuation at €38.40 per ABN AMRO ordinary share, with a total value of €71.1bn.

239 Although the overall price did not change, the proportion of the consideration to be paid in cash increased substantially under Plan B. The cash element of the consideration increased from €56.2bn (79%) to €66.1bn (93%). RBS was able to increase the proportion of the offer to be paid in cash because it intended to

87 Continuation of Minutes of a Meeting of the Chairman's Committee of the Board of Directors of The Royal Bank of Scotland Group plc held on Sunday 15 July 2007.

use the proceeds from the sale of LaSalle, which it was entitled to receive under the terms of the Consortium Shareholders Agreement between the members of the consortium, to pay down short-term debt (i.e. RBS would receive cash in place of LaSalle and finance the difference in the meantime through bridging loans). Although the RBS Board meeting minutes do not record whether the RBS Board considered the impact of this offer on its capital and liquidity, there is evidence to show that information on the group's post-acquisition capital ratios was provided to the RBS Board before the offer was made. Table 3.15 summarises RBS's share of the initial and final offer price and how this was split between cash and RBS shares.

Table 3.15: Summary of RBS's share of the initial and final offer price[88]

€ billions	Initial offer price	Final offer price
Cash	12.3	22.0
Shares	14.9	5.2
Total RBS consideration	**27.2**	**27.2**

240 The offer documents included the following disclosure in the Risk Factors section:

'The Banks have conducted only a limited due diligence review of ABN AMRO and, therefore, RBS may become subject to unknown liabilities of ABN AMRO, which may have an adverse effect on RBS's financial condition and results of operations. In making the Offers and determining their terms and conditions, the Banks have relied on publicly available information relating to ABN AMRO, including periodic and other reports for ABN AMRO, filed with or furnished to the SEC on Form 20-F and Form 6-K. The Banks have also conducted a due diligence review of limited additional information about ABN AMRO. This information in relation to ABN AMRO has not been subject to comment or verification by ABN AMRO or the Banks or their respective directors. As a result, after the completion of the Offers, RBS may be subject to unknown liabilities of ABN AMRO, which may have an adverse effect on RBS's financial condition and results of operations'.[89]

2.2.5 The decision to proceed in the face of market deterioration

241 From 20 July RBS and the consortium were committed to proceeding with the acquisition subject to the conditions of the offer being met. From that point onward, it became increasingly apparent that market conditions were deteriorating, with market data showing credit spreads widening. However, the full extent of the financial crisis became evident only after the acquisition of ABN AMRO was completed on 17 October.[90]

242 The only ways that the consortium could have withdrawn after 20 July were either to have exercised the Material Adverse Change (MAC) condition or the

88 Investigator analysis.
89 The Offer Memorandum and Listing Particulars, 20 July 2007, page 181, paragraphs 8 to 9.
90 The offer was declared unconditional on 10 October 2007 and the acquisition completed on 17 October 2007.

Regulatory Approvals condition in the offer document or if any of the consortium members had been unable to obtain the approval of their shareholders.

243 The consortium sought legal advice on the exercise of these clauses in August and September 2007. In RBS, although there was still unanimity in wishing to proceed with the acquisition, the RBS Board considered exercising the MAC condition as a means of reducing the offer price. Enforcement Division established in interviews with former RBS Directors that the RBS Board was advised by Linklaters at a meeting as to whether there had been a material adverse change.[91]

244 In an analysis prepared for RBS on market conditions and ABN AMRO's wholesale business in August 2007, Merrill Lynch concluded that at that time and based on public information, it could not see any immediate impact from the market deterioration on ABN AMRO's liquidity or credit position and therefore no immediate impact on its asset quality. From a short-term perspective, however, Merrill Lynch considered it was possible that there could be an impact on ABN AMRO's earnings given stress on short-term liquidity and mark-to-market losses on selected assets.

245 The RBS Board was also informed by its senior executives at the Chairman's Committee meeting on 24 August that, following recent meetings with counterparts at ABN AMRO, all of whom were confident about its position, there were no material concerns regarding the impact of recent market conditions on ABN AMRO given its '*advanced control structure*'.[92]

246 ABN AMRO issued a Trading Statement on 17 September which confirmed its profit estimate. On the same day, the Dutch Central Bank (the DNB), ABN AMRO's principal regulator, and the Dutch Ministry of Finance issued a 'Declaration of No Objection' regarding the acquisition.

2.3 The decision not to take enforcement action

247 As previously described, the due diligence conducted in relation to the ABN AMRO acquisition was insufficient and inadequate in relation to the risks involved. Nevertheless, Enforcement Division decided not to proceed with enforcement action. The reasons why it decided this are set out in paragraphs 248 to 257 and can be summarised as follows:

- It did not identify material failures in the processes followed by the Board to govern its decision-making during the acquisition or instances where knowingly inaccurate or unreliable due diligence information was presented to or withheld from the Board.
- It did not find evidence that Board members were pressured by the executive or that the executive had acted inappropriately to push through the decision to proceed with the acquisition.

91 The substance of the legal advice is subject to legal professional privilege and cannot be referred to in this Report. Enforcement Division took account of the fact that legal advice had been sought as well as the content of the advice.

92 Continuation of Minutes of a Meeting of the Chairman's Committee of the Board of Directors of The Royal Bank of Scotland Group plc ('the Group') held by telephone on Friday 24 August 2007, page 1, paragraph 5.

- The RBS Board received legal advice as to whether it had given the acquisition proper consideration and whether the amount of due diligence undertaken was in line with generally accepted practice.[93]
- When it became apparent that the market conditions were deteriorating in 2007, RBS sought legal advice on its ability to withdraw from the acquisition or reduce the price.[94]
- There are no rules, codes, or practice standards which define the appropriate and required level of due diligence in a takeover. In the absence of such rules, codes or practice standards, the decision to proceed with the takeover would have to be so obviously wrong at the time that it was clearly outside the bounds of reasonableness.
- The degree to which the extent of the due diligence conducted and the overall limitations of the transaction were transparently communicated to investors, the FSA and the general public meant in this case that the deficiencies in the due diligence could not in themselves be the basis for a successful enforcement action.

248 In its investigation work, Enforcement Division did not identify material failures in the processes followed by the Board to govern its decision-making during the acquisition that provided a basis for bringing enforcement action. The RBS Board met on a regular basis throughout the acquisition process and had a high level of interaction with, and access to, executive management. Enforcement Division did not find any instances of knowingly inaccurate or unreliable due diligence information being presented to, or information being withheld from, the Board. Although many of the RBS Board presentations were of a high level, more detailed materials were available on request and some non-executive directors told it that they had sufficient opportunity to make enquiries of the executive management if they wished to pursue any matter in further detail.

249 Enforcement Division did, however, identify that the RBS Board's review of the due diligence on 3 May 2007 was subject to time pressure caused by the sale of LaSalle. It is unclear whether the non-executive directors had sufficient opportunity to review the due diligence findings before the meeting and some of the RBS Board members did not have the benefit of the full slide presentation at the meeting as they attended by telephone. Enforcement Division did not consider, however, that this represented a breach of the FSA's requirements.

250 The non-executive directors considered executive management best placed to lead the due diligence. It was ultimately for the RBS Board, and in particular its non-executive members, to consider the merits of the acquisition and, in particular, the due diligence from an independent perspective. The non-executive directors did not perform a detailed review of the executive management's work or perform any detailed work of their own but rather considered the high-level findings and conclusions of the executive's work. Using an independent adviser

93 The substance of the legal advice is subject to legal professional privilege and cannot be referred to in this Report. Enforcement Division took account of the fact that legal advice had been sought as well as the content of the advice.
94 The substance of the legal advice is subject to legal professional privilege and cannot be referred to in this Report. Enforcement Division took account of the fact that legal advice had been sought as well as the content of the advice.

with experience of performing due diligence using only publicly available information might have provided the Board with perspectives on the risks of the acquisition in addition to those developed by the internal due diligence team. However, the approach taken by the Board was not unusual and was consistent with normal market practice.

251 Both in the context of considering whether to take enforcement action in respect of the ABN AMRO takeover, and in its wider assessment of RBS's conduct, Enforcement Division also took into account various allegations reported in the media of intimidation of the relevant non-executive directors by executive directors. In April 2009 it carried out a separate exercise specifically to investigate these allegations, for which it contacted all the non-executive directors who sat on the RBS Board in 2007 and 2008 (the relevant non-executive directors). It asked them to respond in writing to the following questions:

- Over the period of your tenure as a non-executive director of RBS have you been hampered in any way in the performance of your duties by the behaviour or intervention of any senior executive of RBS?
- Over the period of your tenure as a non-executive director of RBS have you been subjected to or felt concerned by intimidation, bullying or coercion of any type by any senior executive of RBS, regardless of whether this had an impact on fulfilling your duties?
- Have you ever heard of bullying, intimidation or coercion of any other non-executive directors by any senior executive of RBS?
- Were you ever led to believe by words or behaviour that you would not be reappointed as a non-executive director of RBS if you asked probing/searching questions?
- Did you hear of other non-executive directors of RBS who have been led to believe, by words or behaviour, that they would not be reappointed if they asked probing/searching questions?

252 Enforcement Division decided in the first instance to write to all the relevant non-executive directors with the above questions, rather than interview them in person. This was in order to establish quickly and effectively whether there was anything of substance to the media allegations. It was important for Enforcement Division to understand whether any of the relevant non-executives would provide tangible evidence on which an enforcement case could be based in order to guide its ongoing work. Had such evidence been forthcoming, Enforcement Division would then have proceeded to interview the individuals in person. However, the responses given to the questions by the relevant non-executive directors did not support the media allegations. Some individuals gave additional information to confirm that the senior executive team was open in its dealings with the RBS Board and that they felt free to challenge and question senior executives. The responses supported other evidence Enforcement Division collected which showed that the RBS Board was engaged in the ABN AMRO acquisition. It therefore concluded that the evidence did not justify further action being taken against any individuals.

253 In subsequent interviews with the Review Team, held for the purpose of preparing this Report rather than as part of an enforcement investigation, some of the non-executive directors expanded on the answers they had given to the questionnaire. This new information did not, however, provide the necessary evidence of intimidation of the relevant non-executive directors by executive directors to provide a basis for bringing enforcement action against any individuals.

254 Enforcement Division considered that the key decisions made by the RBS Board were its decisions to proceed with the acquisition following very limited due diligence both before and after LaSalle formed part of the acquisition. Its work on this included analysis of the rationale for continuing with the transaction without LaSalle and it concluded that the processes followed by the firm suggested the decision to proceed was not unreasonable.

255 Enforcement Division concluded that the due diligence that RBS actually conducted on ABN AMRO was insufficient in scope and depth and hence inappropriate in light of the nature and scale of the acquisition and the major risks involved. Notwithstanding ABN AMRO's status as a listed company operating in a regulated industry and subject to considerable investor scrutiny, the circumstances of this bid – namely the scale and complexity of ABN AMRO's widespread international operations, its substantial scale relative to RBS, and the fact that the offer was substantially funded by debt rather than equity – pointed towards the need for a more, rather than less, comprehensive due diligence exercise.

256 However, this conclusion did not lead to a finding that the FSA's requirements, including its FSA's Principles for Businesses or its Statements of Principle for Approved Persons, were contravened. It had to be considered in the context of the following matters:

- The due diligence performed by an acquiring company's management on a target business is subject to little direct regulation and limited generally accepted standards and guidance exist in respect of what is due diligence. The level of due diligence conducted by RBS was not therefore so far outside of the range of reasonable actions prevailing at the time as to give rise to an actionable enforcement case.

- The regime for public contested bids did not and does not typically provide a forum for information-sharing which would have allowed RBS to conduct more thorough due diligence. The market practice in the UK and other European countries for public contested bids did not then and does not now differentiate between standards required in the case of banks and other non-bank corporates with regard to acquisitions. While not determinative of whether a regulatory breach had occurred, Enforcement Division also looked at the potential impact of the low level of due diligence on RBS's decision to proceed with the acquisition. It concluded that it is not clear that further work would have forecast losses of such a size as to prompt RBS to reconsider the acquisition. This assessment is based on two factors. First, the acquisition occurred just before one of the largest economic and financial crises. RBS, like many other market participants, did not foresee it – Barclays had also made an offer for ABN AMRO and RBS had the support of its institutional shareholders. The severity of the crisis eventually exposed weaknesses in the balance sheets of many banks across the world. In the context of an enforcement action it would be inappropriate to apply current knowledge about what subsequently occurred with the benefit of hindsight to the actions of firms and individuals during the crisis. Second, many of the assets held on ABN AMRO's books, which lost large amounts in 2007 and 2008, were similar to assets held by RBS, on which RBS was not expecting large losses. It is, therefore, unlikely that, even if RBS had had access to a greater level of information, due diligence would have led it to produce estimates of future potential losses anywhere near the losses that actually arose, or even that it would have produced materially important loss estimates. More information on the composition and risk profile of ABN AMRO's assets may, of course, have identified areas where losses were likely. Overall, however, it is impossible to say if the identification of such losses in certain parts of the balance sheet would have had any impact on RBS's assessment of the strategic merits of the acquisition.

257 RBS tried to conduct a more extensive due diligence exercise, but as it had expected, very little information was actually received from ABN AMRO. The RBS Board took the approach that there was nothing in the limited due diligence findings to dissuade it from continuing with the acquisition and decided to take the risk of proceeding with the acquisition. Enforcement Division has not seen anything in its investigation work to indicate that the RBS Board separately considered the limitations in the due diligence or that the RBS Board had a minimum level of due diligence in mind or a clear point at which they would have walked away from the acquisition. However, it noted that before agreeing at a Chairman's Committee meeting on 24 May 2007 to make the offer for ABN AMRO, the RBS Board received legal advice from its lawyers who were present at the meeting as to whether it had given the acquisition proper consideration. Further, when it became apparent that market conditions were deteriorating RBS sought, and received, legal advice on its ability either to withdraw from the acquisition or to reduce the price by exercising the MAC condition in the offer document.[95]

95 The substance of the legal advice is subject to legal professional privilege and cannot be referred to in this Report. Enforcement Division took account of the fact that legal advice had been sought we well as the content of the advice.

3 Investment circulars

258 Enforcement Division's investigation work also looked at the processes that RBS followed in making the following disclosures in connection with the acquisition, the Rights Issue and the Placing and Open Offer, including:

- The Class 1 circular issued by RBS dated 20 July 2007 to its shareholders, among other things to obtain their approval for the acquisition of ABN AMRO (the ABN AMRO Class 1 Circular) and the prospectus issued by RBS dated 20 July 2007 in connection with the offer of new RBS ordinary shares as part of the consideration for ABN AMRO (the ABN AMRO Acquisition Prospectus).
- The (combined) prospectus and circular issued by RBS dated 30 April 2008 to its shareholders, among other things to obtain approval for the directors to allot relevant securities as required to satisfy the rights issue (the Rights Issue Prospectus and Circular).
- The prospectus and circular issued by RBS dated 4 November 2008 in connection with the placing and open offer of new RBS ordinary shares (the Placing Prospectus and Circular).
- The additional circular that RBS was required to publish following the acquisition containing a working capital statement for the enlarged group (the so-called '28-day circular'). This additional circular was required because the working capital statements in the ABN AMRO Class 1 Circular and the ABN AMRO Acquisition Prospectus related solely to RBS before the acquisition of ABN AMRO.

259 PwC was commissioned to assist with this investigation. Its work involved an assessment of the accuracy and reliability of the information contained in the investment circulars. The principal matters that emerged from PwC's review of and report on the investment circulars were the processes followed by RBS in the preparation of the working capital statements contained in these documents and issues surrounding the timing of preparation of the 28-day circular.

260 RBS and its directors were assisted in preparing and issuing the investment circulars by RBS's Sponsors and Reporting Accountants. Enforcement Division's work focused solely on the responsibilities of RBS and its directors in issuing the investment circulars, and it did not reach any conclusions on the roles of the Sponsor or the Reporting Accountants as part of this work.

261 In summary, Enforcement Division concluded that whilst PwC identified some significant deficiencies in the processes that RBS followed in issuing the investment circulars, for the reasons that follow, it did not consider that these deficiencies provided a basis for bringing successful enforcement action:

- In making the working capital statements in the ABN AMRO Class 1 Circular and the Rights Issue Prospectus and Circular, RBS relied on existing processes which it had in place to analyse and consider the state of its capital and liquidity. There was no evidence that the Board specifically considered whether these were the right measures or whether other measures might have been better. It is permissible, however, under the regulatory regime to use the existing processes and Enforcement Division concluded that it was unlikely that a case based on the absence of evidence to demonstrate RBS's decision to use existing processes to support its working capital statements would be successful. In reaching this conclusion, it considered that it was unlikely that, had a reasonable worst case scenario been specifically prepared for the ABN AMRO Class 1 Circular and the ABN AMRO Acquisition Prospectus in July 2007, it would have anticipated the full severity of ensuing market events. In addition, RBS was closely monitoring its capital and liquidity in the build-up to the Rights Issue in April 2008.

- There was no evidence to suggest that the delay in the preparation of a 28-day circular following the acquisition was due to any concerns on RBS's part about disclosing any further credit market write-downs towards the end of 2007 and start of 2008. The delay was caused by the scale and complexity of the integration of ABN AMRO. Any case relating to the delay would have little prospect of success, particularly as there is little accepted practice as to what constitutes an acceptable timeframe for completing 28-day circulars in respect of large, complex and hostile takeovers.
- The Placing Prospectus and Circular did not contain a working capital statement. Consequently, RBS's directors were under no obligation to prepare projections to support such a statement or to commission a working capital report from the Reporting Accountants.

262 The material in the sub-headings that follow summarises the key issues covered in the underlying report prepared by PwC. A list of the chapter headings to that report is set out in Appendix 3A.

3.1 Regulatory framework and Directors' responsibilities

263 Throughout the period Enforcement Division reviewed, RBS's securities were admitted to listing on the Official List and to trading on the Main Market of the London Stock Exchange. Consequently, RBS was obliged to comply with a range of legal and regulatory requirements, most notably those imposed by the Prospectus Rules, Listing Rules and Disclosure Rules and Transparency Rules.

264 In the UK, the Prospectus Directive has been implemented through the Prospectus Rules (part of the FSA's Handbook), which apply to all public offers of securities and where securities are being admitted to trading on a regulated market such as the Main Market of the London Stock Exchange. These Prospectus Rules govern the format and content of UK prospectuses.

265 The Listing Rules apply to all companies admitted to the Official List, including those admitted to the Main Market of the London Stock Exchange. The Listing Rules contain specific chapters for different types of security such as equity shares, debt offerings and depositary receipts. The Listing Rules deal, among

other things, with the requirements for listing equity securities, the UK sponsor regime and significant transactions such as acquisitions.

266 The Committee of European Security Regulators has issued guidance on the implementation of certain parts of the Prospectus Rules (CESR Guidance), including the following important principles for issuers in relation to the preparation of a working capital statement:[96]

- *'Working capital should be considered as an issuer's ability to access cash and other available liquid resources in order to meet its liabilities as they fall due.'*
- *'Present requirements should be considered to be a minimum of 12 months from the date of the prospectus.'*
- *'Issuers should ensure that there is very little risk that the basis of such a statement is subsequently called into question.'*
- *'When giving a working capital statement issuers are expected to have undertaken appropriate procedures to support the statement that is being made. Such procedures would normally include… assessment of whether there is sufficient margin or headroom to cover reasonable worst case scenario (sensitivity analysis).'*

267 The Prospectus Rules further state:

'In determining whether Part 6 of the Act [FSMA], these rules and the PD Regulation [Regulation 809/2004 of the European Commission] has been complied with, the FSA will take into account whether a person has complied with the CESR recommendations.'[97]

3.2 Working capital statements in the ABN AMRO Acquisition Prospectus and the ABN AMRO Class 1 Circular

268 The working capital statements prepared by RBS in connection with the ABN AMRO acquisition confirmed that RBS (and, on its behalf, the directors) was of the opinion that RBS Group had sufficient working capital to meet its requirements at the time, that is for at least 12 months from the date of the relevant investment circular.

269 RBS relied on the exemption provided in Listing Rule 13.4.3(R)(3) to make a working capital statement solely in relation to the RBS group (i.e. the existing group pre-acquisition) in the ABN AMRO Class 1 Circular. RBS was permitted to use this exemption on the basis that the acquisition was not a recommended offer and therefore it had been provided with only limited non-public financial

96 CESR's recommendations for the consistent implementation of the European Commission's Regulation on Prospectuses no. 809/2004.

97 Further, Appendix 2 to Standards for Investment Reporting ('SIR') 1000: '*Investment reporting standards applicable to all engagements in connection with an investment circular*' notes that: '*The Prospectus Rules also make it clear that the FSA expect 'CESR's recommendations for the consistent implementation of the European Commission's Regulation on Prospectus no. 809.2004 ' to be followed by issuers when preparing a prospectus.*'

information and did not have the requisite knowledge to make the enlarged group working capital statement.

270 The application of established working capital procedures for trading companies to banks is complex: trading companies typically use future trading cash flows and then compare these with available cash and bank facilities, whereas banks operate a model of matching anticipated funding needs with funding sources. Banks are also subject to ongoing regulatory requirements in relation to the maintenance of capital and liquidity.

271 Market practice, to the extent it existed at the date that RBS issued the investment circulars, focused on regulatory capital and liquidity as a basis on which banks assessed working capital for the purposes of a UK investment circular.

272 In common with other banks of its size and nature, RBS had processes to analyse and consider the state of its capital and liquidity. The RBS Board delegated the responsibility for identifying, managing and controlling the group balance sheet risks to the Group Asset and Liability Management Committee (GALCO). GALCO sought to manage these risks by setting limits and controls for capital adequacy, funding and liquidity, intra-group exposures, and non-trading interest rate, equity and foreign currency risk. GALCO was also responsible for monitoring and reviewing external, economic and environmental changes affecting such risks. Part of GALCO's remit was the review of periodic stress testing of the Group's capital adequacy position and liquidity position. GALCO reported directly to RBS's Group Executive Management Committee.

273 In addition, the capital and liquidity positions of the RBS Group were subject to regulatory oversight as part of the FSA's regulatory regime. The FSA required banks to prepare various types of forecasts in relation to capital adequacy and liquidity, and to stress-test those forecasts. The form of stress-testing usually involved identification of 'downside' scenarios, some of which would be mandated by the FSA for its regulatory purposes.

274 Such testing completed for regulatory purposes may provide relevant bases for the directors in formulating a 'reasonable worst case scenario' for the purposes of a working capital exercise. Although there is some overlap, these processes relating to capital and liquidity do not directly address the obligations of the directors in respect of working capital in the context of an investment circular. Therefore, the directors were required to assess the extent to which the forecasts and stress-testing carried out for regulatory purposes were appropriate for the different purpose of supporting the working capital statement in an investment circular. Enforcement Division would expect the RBS Board appropriately to document this assessment, including the rationale for the decisions made by the RBS Board.

275 Enforcement Division's review identified that RBS relied on the forecasts and stress-tests carried out for regulatory purposes in the period leading to the ABN AMRO acquisition for the purposes of making the working capital statements in the ABN AMRO Acquisition Prospectus and the ABN AMRO Class 1 Circular. This approach did not necessarily fall short of FSA requirements in itself because there is no absolute requirement to prepare a specific 'reasonable

worst case scenario' as long as an issuer has undertaken appropriate procedures overall to support the working capital statement. However, Enforcement Division considered it a weakness that it found no evidence (for example, in Board minutes) that RBS considered and was satisfied that these existing processes on which it relied were sufficient to assess whether there was *'sufficient margin or headroom to cover reasonable worst case scenario.'*

276 RBS relied on the results of various stress-tests that it had conducted between 4 and 21 months previously as part of its ongoing regulatory obligations prior to the ABN AMRO acquisition. These stress-tests considered three scenarios: mild recession, 1990s recession and severe recession (i.e. 1 in 100 years). RBS considered that it was appropriate to use these stress-test results as a 'reasonable worst case scenario' because it had assessed that the economic environment had not materially altered in the intervening period. Enforcement Division, however, found no evidence to suggest that the directors had specifically considered this point. The severity of events that subsequently unfolded during the financial crisis, particularly within the US mortgage market and the subsequent severity of market volatility, was not covered in the range of these stress-tests. Nevertheless, it concluded that the stress-tests carried out by RBS were not unreasonable for the purpose of supporting the working capital statement and it took account of the fact that few firms predicted the full extent of market events in 2007 and 2008.

3.3 Working capital statement in the Rights Issue Prospectus and Circular

277 Due to credit market conditions affecting both the legacy RBS and ABN AMRO businesses amid a worsening economic outlook, RBS was required to accelerate its plans to rebuild its Core Tier 1 capital ratio (which had been reduced following the acquisition of ABN AMRO) and undertook a fund raising in April 2008.

278 RBS did not prepare a specific 'reasonable worst case scenario' for the purposes of making the working capital statement in the Rights Issue Prospectus and Circular. As with the ABN AMRO Class 1 Circular, there is no evidence that a 'reasonable worst case scenario' was specifically considered by the Board for the purposes of making the working capital statements in the Rights Issue Prospectus and Circular.

279 Instead, the Board considered the impact of various 'sensitivities' on the capital raising. For the working capital exercise, RBS actively considered the impact of significant 'sensitivities' on Total Capital ratios, including further estimated credit write-downs of £4.3bn in 2008 (in addition to the credit write-downs of £2.1bn booked in March 2008).

280 There were also regular discussions at Board level of RBS's capital adequacy throughout the first quarter of 2008, and this parallel work informed the directors' ability to make the working capital statements. During the period, various papers were also put to the RBS Board that covered key risks to the capital plan and included the results of additional stress-tests. The regulatory

capital position and projections (including Tier 1 and Core Tier 1 ratios) were regularly monitored by the RBS Board. The papers provided to the RBS Board and GALCO also dealt with the issue of rebuilding RBS's capital base. In addition, GALCO continued closely to monitor the working capital of the RBS Group on an ongoing basis as required under FSA's supervisory oversight.

281 An RBS Board memorandum regarding working capital, together with the working capital report and supporting papers, was provided to a RBS Board committee on 29 April 2008 when the Rights Issue was approved.

282 Further, in the run-up to the Rights Issue, RBS and the RBS Board closely monitored the liquidity of the Group. The working capital report prepared by the Reporting Accountants also considered liquidity in detail and included an analysis of liquidity stress-tests which concluded that the stress-tests demonstrated that the group had access to adequate resources to meet its current funding requirements. In addition, at the time of the Rights Issue, the RBS Board specifically considered the effect of various stress-tests on the Group's funding capacity. Relevant RBS Board papers note that the RBS group had *'continued to successfully manage its liquidity during this difficult period and remains fully able to meet its funding needs'*.[98]

3.4 Working capital statement in relation to Placing Prospectus and Circular

283 The directors' working capital statement in the Rights Issue Prospectus and Circular covered the period of 12 months to April 2009. As explained in Part 1 of this Report, RBS was required to undertake a further fund raising during this period, being the placing and open offer in November 2008.

284 The Placing Prospectus and Circular set out the reason for the placing and open offer:

'Earlier this year, the Board concluded that the Group needed to strengthen its capital base and, to accomplish this, it concluded a £12 billion rights issue which was completed in June 2008. At the same time we announced higher target capital ratios for the Group. We reported good progress against those targets in our interim results. However, within a matter of weeks [of the Group's interim results], another severe deterioration in financial market conditions prompted a re-appraisal of capital ratios in the banking sector in Europe and the United States, and an expectation by market participants and governments that these should be strengthened further.'[99]

285 The Placing Prospectus and Circular went on to state that:

'HM Treasury and the Bank of England have announced a comprehensive scheme to support bank funding and capital. Your Board has decided that it is

98 RBS Group Internal Audit report July 2008 Memorandum.
99 Placing Prospectus dated 4 November 2008, page 33; Placing Circular dated 4 November 2008, page 6.

necessary for RBS to take the opportunity this provides to strengthen significantly the Group's capital position.'[100]

286 The Placing Prospectus and Circular did not contain a working capital statement. Page 90 in Part V of the Placing Prospectus included the following disclosure regarding working capital:

'... the global markets for short and medium term sources of funding on which banks rely to support their business activities have undergone a period of unprecedented upheaval, which has led to direct intervention by HM Treasury and the Bank of England to directly supplement existing sources of funding and create the environment for an improvement in the availability of other traditional sources of funding. Due to this dislocation and government intervention, the United Kingdom Listing Authority has agreed that a statement regarding the adequacy of working capital for at least the next 12 months should not be required in this document. There is therefore no working capital statement in this document.'[101]

287 Consequently, RBS's directors were under no obligation to prepare projections to support such a statement or to commission a working capital report from the Reporting Accountants. However, the UKLA still insisted on RBS providing a detailed disclosure on RBS's capital and liquidity position in the prospectus.

3.5 28-day circular

288 The Listing Rules recognise that it may not be possible for the listed entity to comply with a number of the obligations in the Listing Rules at the date a Class 1 circular is issued, where its offer has not been recommended by the offeree's board or the listed company has not had access to due diligence information on the offeree at the time the Class 1 circular is published.[102]

289 In those circumstances, the listed company must prepare and publish the working capital statement on the basis that the acquisition has not happened. If the acquisition is successful, the working capital statement for the enlarged group must, in the absence of exceptional circumstances, be prepared and published and sent to shareholders within 28 days of the offer becoming or being declared wholly unconditional. The circular issued to shareholders before the acquisition must state that the statements on a combined basis will be made available as soon as possible.[103]

290 RBS relied on this exclusion: the working capital statement in the ABN AMRO Class 1 Circular and the ABN AMRO Prospectus related solely to RBS. However, the enlarged working capital statement was not issued within 28 days of the Offer being declared wholly unconditional (which in this case happened on 10 October 2007). It was instead made six months later as part of the Rights Issue Prospectus and Circular in April 2008.

100 Placing Prospectus dated 4 November 2008, page 34; Placing Circular dated 4 November 2008, page 6.
101 Placing Prospectus dated 4 November 2008, page 90.
102 Listing Rule 13.4.3(R)(2).
103 Listing Rule 13.4.3(R)(3).

291 This extended period of delay was unprecedented. Given the unusually lengthy period, the FSA required RBS on a number of occasions to provide justification as to why such a period was necessary and to agree a timeline towards the issue of a 28-day circular. In July 2007 (before the ABN AMRO Class 1 Circular and the ABN AMRO Prospectus were published), RBS informed the FSA (via its sponsor Merrill Lynch) that it anticipated it would need three to four months to produce the 28-day circular (i.e. until January or February 2008), *'assuming reasonable quality of information received in respect of ABN AMRO and no material unexpected complicating factors'*.[104] RBS also stated that timing was particularly difficult to predict given that access to ABN AMRO had not yet been granted. The FSA agreed that in the circumstances of the acquisition it would be reasonable if it ended up taking RBS longer than the normal 28-day period which RBS estimated as three to four months, but still expected RBS to complete the 28-day circular as soon as reasonably practicable.

292 Enforcement Division's investigation work found that RBS did not formulate a plan to prepare a 28-day circular as soon as reasonably practicable following the acquisition other than to finalise its 2007 accounts before preparing the working capital statement. Following the acquisition, RBS had to consolidate the entire ABN AMRO Group into its Group Financial Statements. This required an evaluation of ABN AMRO's pre-existing accounting policies and reconciling any differences with RBS Group's own accounting policies. RBS considered that the work it needed to carry out in order to complete the 2007 accounts needed to be carried out before, and would inform, the preparation of the 28-day circular.

293 During the period following the ABN acquisition, there were frequent discussions and correspondence between RBS, Merrill Lynch and the UKLA in relation to the issue of a 28-day circular. In February and March 2008 RBS (via Merrill Lynch) informed the UKLA that the ongoing delay was due to the complexities of restructuring ABN AMRO following the acquisition. During these discussions, RBS represented that the earliest point at which it could produce the 28-day circular was the end of May 2008. UKLA was updated periodically by RBS's sponsor and challenged the reasons for the delay on a number of occasions. These discussions eventually led on 28 March 2008 to the agreed deadline of the end of May 2008 for the preparation of the 28-day circular.

294 The production of the 28-day circular was overtaken by RBS's realisation around 4 April 2008 that it needed to raise more capital. RBS was able to prepare a working capital statement for the enlarged group within 18 working days, this was included in the Rights Issue Prospectus and Circular and published on 30 April 2008. RBS therefore met its obligation with regard to the production of a 28-day circular on 30 April 2008.

3.6 The decision not to take enforcement action

295 While PwC identified some significant deficiencies in the processes that RBS followed in issuing the investment circulars, for the reasons that follow,

104 FSA document comment sheet, 3 July 2007, reference SC019, point 5.

Enforcement Division determined that these deficiencies did not provide a basis for bringing successful enforcement action:

- RBS relied on existing processes which it had in place to analyse and consider the state of its capital and liquidity in making the working capital statements in the ABN AMRO Acquisition Prospectus and Class 1 Circular and the Rights Issue Prospectus and Circular. While it is acceptable for an issuer to adopt an existing process for preparing a reasonable worst case scenario rather than develop a bespoke methodology, it is important that the issuer can demonstrate that it has considered and is satisfied that the existing process is appropriate to support the working capital statement. The FSA considers that the CESR Guidance provides issuers with an important framework in circumstances in which they are required to prepare working capital statements. There is no clear positive evidence that the Board did in fact consider explicitly whether existing processes were adequate to support their working capital statements. However, Enforcement Division concluded that it was unlikely that a case based on the absence of evidence of such consideration would be successful. In reaching this conclusion, it considered two points: first, that RBS was, using other processes, closely monitoring its capital and liquidity in April 2008; and second, that it was unlikely that a reasonable worst case scenario specifically prepared for the ABN AMRO Class 1 Circular in July 2007 would have anticipated the full severity of ensuing market events.
- On the basis of the information it reviewed, Enforcement Division found no evidence to suggest that the delay in the preparation of the 28-day circular containing a working capital statement for the enlarged group was due to any concerns on RBS's part about disclosing any further credit market write-downs towards the end of 2007 and start of 2008. The delay in preparing the 28-day circular was caused by the scale and complexity of the integration of ABN AMRO following the acquisition. RBS's plan to produce the 28-day circular consisted of firstly completing the 2007 accounts which would inform the preparation of the 28-day circular. Enforcement Division considered that RBS could have begun work on elements of the circular sooner (in line with UKLA's expectations). It also noted that RBS – having completed its 2007 accounts in February 2008 and given the UKLA in March 2008 a further time estimate of end May 2008 – was able to produce a working capital statement for the enlarged group as part of the Rights Issue at the end of April 2008. However, it concluded that a case relating to the delay would have little prospect of success. In particular, there is a lack of accepted market practice as to what constitutes an acceptable timeframe for completing 28-day circulars in respect of large, complex and hostile takeovers involving businesses that span a number of different jurisdictions and many different business types.

Appendix 3A Chapter headings of the PwC investigation reports

A) PwC investigation report into Mr Cameron

1) Executive Summary
2) Introduction
3) Overview of the GBM organisation
4) Apportionment of roles and responsibilities
5) Strategy
6) Oversight of Greenwich
7) Exposure to the US Housing Market
8) Structured Credit
9) Valuation
10) Monolines and Credit Valuation Adjustment
11) Leveraged Finance
12) Risk Reporting, Limits and Stress-testing
13) Goodwill
14) Mr Cameron

B) PwC investigation report into the ABN AMRO acquisition

1) Executive Summary
2) Introduction and scope of work
3) Approach adopted and process followed for the Review
4) Background to the Acquisition
5) Existence of due diligence regulations, standards and guidance
6) What due diligence should encompass
7) Due diligence performed by RBS on ABN AMRO
8) Conclusions

C) PwC investigation report into the investment circulars

1) Introduction
2) My assessment
3) The investment circulars
4) The UK regulatory framework for capital markets transactions
5) Responsibilities, verification and due diligence
6) Working capital
7) 28-day circular
8) Financial reporting procedures
9) Other Disclosures

General appendices

Appendix A
FSA Chairman's letter of 15 December 2010 to Chairman of Treasury Select Committee

Financial Services Authority

From the Chairman
Adair Turner

FSA

15 December 2010

Our Ref: CW

Andrew Tyrie MP
Chairman, Treasury Select Committee
House of Commons
Westminster
London
SW1A 0AA

Dear Andrew

Thank you for your letter relating to the publication of a report into the failure of RBS.

I very much agree with the Committee that it would be desirable if there were a public account of the reasons for the failure of RBS, and as both Hector Sants and I have stressed over the last week, the present situation, in which we are unable to release the results of the investigation so far conducted is extremely unsatisfactory. I therefore believe that a way should be found both to create a more appropriate regime for the future, and to allow the publication of a report into RBS specifically. I set out below:

1) The present situation and the constraints under which we operate.

2) A proposed long term reform.

3) A proposed way forward which would allow the FSA to publish (by March), a report on the events at RBS. To produce this we need RBS' permission for the FSA to draw on information gathered in the course of the supervisory investigations now concluded. At present we do not have this consent.

1. The present situation and constraints.

Following the financial crisis, the FSA published a detailed critique of its own failings in the supervision of Northern Rock and a detailed review of the inadequacies of the past regulatory regime (The Turner Review). In addition, we launched supervisory investigations into events at a number of firms to establish whether there had been conduct by executives which breached FSA rules and which were therefore potentially subject to enforcement action. These supervisory investigations are not intended to look at any FSA failings (in process or overall approach) but at the conduct of the firms and their executives. The investigations have reached several conclusions and are at various stages of progress.

- In relation to Northern Rock, we found evidence of breaches of rules, and we have imposed fines on three executives, and issued notices to that effect.

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- In relation to RBS, we concluded one case via a negotiated settlement (announced in June) with Johnny Cameron, previous Chairman of Global Markets. We have now also concluded investigations into the ABN Amro takeover and into a series of investment disclosures. We find that, while there are undoubtedly instances of highly questionable judgement, there was not behaviour which could be subject to a successful enforcement action.

- A number of other enquiries are still at various stages of progress and subject to confidentiality constraints.

I have absolute confidence the investigations have been conducted with the same rigour in each case, and that the same criteria have been applied in deciding whether to bring enforcement action. As you know, the FSA's Enforcement Division has developed a greatly more robust approach over the last three years and aggressively pursues breaches of rules wherever these are identified.

The legal position on publication of reports or documents generated in the course of such investigations is clear. In those cases where a decision is made not to progress with an enforcement action, we are not permitted to release them without the consent of all involved. Until now RBS has made it plain that it does not wish to provide consent. This regime – set out in FSMA and in relevant Single Market Directives – is designed both to ensure maximum flow of information, and to protect the legal rights of people under investigation.

2. Proposed regime for the future.

We believe and have already publicly argued that this legal regime is inappropriate in instances where a bank has been resolved or has been rescued to prevent failure (as was the case with RBS). This is because, quite separate from the issue of whether there was individual conduct which breached current rules, there is a legitimate public interest in simply knowing the story of what occurred and why tax payer rescue was required.

We therefore recommend that Government and Parliament should consider the case for introducing into the forthcoming legislation, provisions which would enable the PRA to conduct and publish full analysis of the causes of any bank failure or rescue, drawing openly on supervisory investigation material which would normally be subject to confidentiality constraints. Confidentiality constraints would continue, however, to apply in the case of investigations into executives or firms which have not failed or been resolved.

3. Proposed summary report into RBS failure.

While such arrangements would equip the PRA to produce publishable reports in future they would not make it possible to satisfy the legitimate public interest in understanding the events which led to the failure of RBS and rescue. The FSA would ideally like to be in a position to produce a publishable report. Such a report would ideally cover the lessons to be learned both from the decisions made by the RBS Board and Executives, and from any failings of the FSA supervisory approach in place at that time. While many of the lessons learned in relation to FSA pre-crisis supervisory approach have already been openly described in the Northern Rock Internal Audit report, we believe that there would be merit in describing clearly the approach that the FSA previously took then to the supervision of a bank engaged in an aggressive take-over, an approach we have now radically changed. There might in addition be some resulting proposals for changes in the legislative framework which would equip us better to intervene in future.

We would therefore like to be able to produce a report which combines a review of both FSA processes and of RBS Board and management decisions. In relation to the latter a useful report would need to be able to draw upon information which was gathered in the course of the investigation analysis. We do not believe it appropriate to publish these in full, but now propose that we ask RBS whether it is willing to give its permission for the FSA to use the information gathered as a key input to the development of a report. It would be useful if the Treasury Select Committee and Government could express support for this course of action.

In order for this exercise to be useful, we would need to be free to use this information as a basis for expressing judgements about the quality of the decisions which the Board and management took.

We would need permission from RBS (and we expect from a number of third parties in addition) to do this notwithstanding the wording within the Act which you quote in your letter drawn from Section 348 (4) (b) of FSMA. This section of the act allows the FSA to make public information but only where we do it in such way that a person can not be identified, but with the legal meaning of 'persons' covering firms as well as individuals. It would not therefore allow us to put out a report on RBS, as RBS would, of course, be identified. This provision therefore can only used by us when making general statements from which it is not possible for particular firms or individuals to be identified; for example, as part of an industry wide review we may say several firms need to improve their controls.

We do not envisage a detailed blow-by-blow account, but a clear description of any key failings, whether related to FSA supervisory processes or to the decisions made by the Board and Executives of the Bank. We would suggest delivering the report to the Government and The Treasury Select Committee by the end of March.

I am putting this letter into the public domain.

Yours sincerely,

Adair Turner

Adair Turner

Appendix B
Glossary of main terms, other abbreviations and other acronyms

Advanced Measurement Approach (AMA)

A set of operational risk measurement techniques proposed under Basel II capital adequacy rules for banks, building societies and investment firms. Under this approach, firms are allowed to develop their own empirical models to quantify required capital for operational risk. The use of this approach by firms is subject to regulatory approval.

Alternative A-paper Mortgage (Alt-A)

A type of US mortgage that is considered a greater risk than A-paper, or ('prime'), but less than sub-prime, the category with greatest risk. Alt-A interest rates, which are determined by credit risk, therefore tend to be between those of prime and sub-prime.

Approved Person

A person who has been approved by the FSA to perform a controlled function (relating to the carrying on of a regulated activity by a firm).

ARROW (Advanced Risk Responsive Operating Framework) Framework

The FSA's operating framework for risk-based supervision. For definitions of a number of the main elements of the framework, see the Glossary of ARROW Terms in Part 2, Section 3 'Supervisory approach, priorities and resources'.

Asset-Backed Commercial Paper conduit (ABCP conduit)

Asset-backed commercial paper (ABCP) conduits issue short-term commercial paper (CP) backed by a pool of assets. In order to ensure it can pay the CP as it falls due, the conduit has liquidity facilities provided by a bank or banks, as well as credit enhancement. Where the bank originates the loans/assets purchased by the conduit, the conduit is referred to as an 'own-asset' conduit; otherwise the assets are purchased from a third party. A 'securities arbitrage' conduit seeks to benefit from the difference between short-term funding costs and long-term asset returns. Where the assets are purchased by the conduit from one originator, the conduit is referred to as a 'single seller' conduit; 'multi-seller' conduits have pools of assets purchased from multiple originators.

Asset-Backed Security (ABS)

A security whose value and income payments are derived from and collateralised (or 'backed') by a specified pool of underlying assets.

Asset Protection Scheme (APS)

A scheme created by HM Treasury to enable the UK Government to provide participating institutions with protection against future credit losses on defined portfolios of assets in exchange for a fee. The APS was announced in January 2009.

Available For Sale (AFS)

One of the measurement categories used for financial assets under international accounting standards. Assets held as available for sale are measured at fair value on the balance sheet, and fair value changes on AFS assets are recognised directly in equity. The cumulative gain or loss that was recognised in equity is recognised in profit or loss when an AFS asset is derecognised or impaired.

Banking book

In order to calculate regulatory requirements, institutions classify their assets and off balance sheet items into those in their banking books and those in their trading books. The banking book is the default approach for all positions, with entry criteria determining positions that should be included in the trading book (for a definition of Trading Book, please see below). The majority of assets held by UK banks and building societies are held in the banking book.

Basel requirements

The Basel Committee on Banking Supervision is the international body which provides a forum for regular cooperation on banking supervision matters, and develops international guidelines and supervisory standards. It has developed three principal sets of international capital standards:

– **Basel I**: The original Basel Accord was agreed in 1988 by the Basel Committee on Banking Supervision. The 1988 Accord, now referred to as Basel I, helped to strengthen the soundness and stability of the international banking system as a result of the higher capital ratios that it required.

– **Basel II**: The Basel II framework, initially published in June 2004, introduced the concept of three 'pillars'. Pillar I sets out the minimum capital requirements firms will be required to meet for credit, market and operational risk. Under Pillar 2, firms and supervisors assess whether a firm should hold additional capital against risks not covered in Pillar I and must take action accordingly. Pillar 3 aims to improve market discipline by requiring firms to publish certain details of their risks, capital and risk management.

– **Basel III**: The crisis in financial markets in 2008 and 2009 prompted a strengthening of the Basel rules to address the deficiencies exposed in the previous set of rules. The Basel III rules, originally published in December 2010, seek to strengthen the regulatory regime applying to credit institutions in the following areas: enhancing the quality and quantity of capital; strengthening capital requirements for counterparty credit risk resulting in higher Pillar I requirements; introducing a leverage ratio as a backstop to risk-based capital; introducing two new capital buffers: one on capital conservation and one as a countercyclical capital buffer; and implementing an enhanced liquidity regime through the Net Stable Funding Ratio and Liquidity Coverage Ratio. The changes followed the substantial increase in trading book capital arising from the July 2009 revisions to the market risk framework (sometimes referred to as 'Basel 2.5').

Board Effectiveness Review

A review of the effectiveness of a company's board of directors, undertaken either by the company itself (with or without the assistance of an external facilitator), or by an external party.

Capital

A bank's capital comprises equity and certain other instruments that absorb losses ahead of claims by depositors and other creditors. Regulators require banks to hold minimum amounts of capital relative to their (risk-weighted) assets.

Capital Adequacy Directive (CAD)

Directive 2006/49/EC of the European Parliament and Council on the capital adequacy of investment firms and credit institutions.

Capital Requirements Directive (CRD)

Directive 2006/48/EC of the European Parliament and Council relating to the taking up and pursuit of the business of credit institutions and Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions.

Collateral

Assets pledged as security against money owed.

Collateralised Debt Obligation (CDO)

A type of structured Asset Backed Security whose performance, value and payments are dependent on a portfolio of referenced underlying securitised assets. Assets are typically corporate loans and bonds, but can include Mortgage-Backed Securities, Residential Mortgage-Backed Securities or any other type of Asset-Backed Securities.

Collateralised Loan Obligation (CLO)

Similar to a Collateralised Debt Obligation, except that it is created by securitising loans.

Commercial Mortgage-Backed Security (CMBS)

A type of mortgage-backed security backed by mortgages on commercial real estate.

Commercial Paper (CP)

An unsecured, short-term debt instrument issued by an entity, typically for the financing of accounts receivable, inventories and meeting short-term liabilities.

Core Prudential Programme (CPP)

A programme introduced by the FSA to provide intrusive and intensive supervision for the largest high impact firms in the banking sector. Refer to Box 2.7 in Part 2, Section 3, Supervisory approach, priorities and resource.

Credit Default Swap (CDS)

A derivative contract that transfers credit risk in return for a series of payments.

Credit Guarantee Scheme (CGS)

The CGS forms part of the UK Government's measures to assure the stability of the financial system and to protect ordinary savers, depositors, businesses and borrowers. The scheme became operational on 13 October 2008 and closed to new issuance on 28 February 2010.

Credit spread

The difference in premium paid for borrowing between one security or issuer and another, often a government or 'risk free' rate; as such it represents a measure of creditworthiness.

'Crisis Period'

In this Report, the period starting on 9 August 2007, in which conditions in the financial markets deteriorated significantly.

Current Status Indicator (CSI)

The FSA collected CSI liquidity data twice-weekly from RBS and other major banks and building societies from September 2007 to August 2008, to supplement the liquidity data collected under the Sterling Stock Regime. These data were used as an interim monitoring tool for liquidity risk. The CSI report was not a formally required regulatory return, nor was it used to set regulatory limits. Firms completed the CSI reports on a 'best efforts' basis.

Due Diligence

The examination of a potential target for merger, acquisition or similar corporate finance transactions normally by a possible buyer.

Emergency Liquidity Assistance (ELA)

In exceptional circumstances, central banks can act as 'lender of last resort' to financial institutions in difficulty in order to prevent a loss of confidence spreading through the financial system as a whole.

Fair value

Under international accounting standards, the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Goodwill

Goodwill is an intangible asset that usually arises when a company buys another business. When a company purchases a business, it usually pays for the actual costs of all assets and liabilities listed on the selling company's balance sheet. Any amount given to the selling company above the value of balance sheet items represents goodwill.

Individual Capital Guidance (ICG)

Guidance given by the FSA on the amount and quality of capital resources which the FSA considers that a firm needs to hold. Firms are expected to maintain financial resources at or above the level specified in the ICG at all times.

Investment Circular

A document issued by an entity pursuant to statutory or regulatory requirements relating to securities on which it is intended that a third party should make an investment decision. The term includes prospectuses, listing particulars and circulars to shareholders or similar documents.

Leverage

The relationship between a firm's total assets and its capital base. A firm with significantly more debt than equity is considered to be highly leveraged.

Leveraged finance

Funding a company or business unit with more debt than would be considered normal for that company or industry implying that the funding is of greater risk, and therefore more costly, than normal borrowing. As such, leveraged finance is commonly used to achieve a specific, often temporary, transaction for example to make an acquisition, effect a buy-out, repurchase shares or fund a one-time dividend.

Listing Rules

A set of regulations applicable to any company listed on a UK stock exchange, subject to the oversight of the UK Listing Authority (UKLA). The Listing Rules set out mandatory standards for any company wishing to list its shares or securities for sale.

Liquidity

Liquidity refers to a business's ability to repay its debts and obligations as they fall due through its ability to convert its assets to cash easily and at a minimum loss of value.

Liquidity Coverage Ratio (LCR)

One of the two Basel III minimum liquidity standards (the other being the Net Stable Funding Ratio), published in December 2010. This standard promotes short-term resilience of a bank's liquidity risk profile by aiming to ensure that it has sufficient high-quality liquid assets to survive a significant stress scenario lasting for one month.

Material Adverse Change Condition (MAC Condition)

A clause in many merger and acquisition contracts that allows the acquiring company to withdraw from a deal if an event or set of circumstances occur, which have a significant negative effect on the target's prospects. What constitutes an event or set of circumstances significant enough to constitute a material adverse change may vary between different jurisdictions.

Marks

The value at which a firm has priced its positions.

Mark-to-Market (MTM)

Accounting terminology referring to assigning a value to financial instrument position based on the current fair value of the instrument or similar instruments.

Minority Interest

A significant but non-controlling ownership of a company's shares by either an investor or another company.

Monoline Insurer

An insurance company that guarantees the timely repayment of cash flows on debt instruments (e.g. bonds), in effect transferring the risk of default from the bond holder to the insurance company.

Mortgage-Backed Security (MBS)

An asset-backed security where the pooled loans that secure the underlying cash flows of the bond are made up of mortgages.

Over-The-Counter (OTC)

An OTC derivative is one type of derivative that is entered into directly between two parties, without going through an exchange.

Preference Share

Share on which shareholders are paid out in preference to, i.e. before, ordinary shares. In the event of a company bankruptcy, preferred shareholders have a right to be paid company assets first. Preference shares typically pay a fixed dividend, whereas ordinary shares do not. And unlike common shareholders, preference share shareholders usually do not have voting rights.

Probability of Default (PD)

Parameter used in credit risk models to calculate the regulatory capital requirement under Basel II. It is a measure of the likelihood that a loan will not be repaid and as a result the default of the party to which the loan was made.

Prudential Regulation Authority (PRA)

The proposed future public authority of the UK Government to be formed as one of the successors to the Financial Services Authority. The PRA will be part of the Bank of England and will carry out the prudential regulation of banks, building societies, credit unions and investment firms.

Regulatory Approvals Condition (RA Condition)

A Regulatory Approvals Condition permits a firm to withdraw from a deal in the event of regulatory intervention. The exact nature of what constitutes a 'trigger' regulatory event is decided on a case by case basis under the relevant jurisdiction.

Regulatory Dividend

Refer to Box 2.6 in Part 2, Section 3, Supervisory approach, priorities and resource.

Repo

A repurchase agreement or 'repo' is the sale of a security with an agreement to repurchase it at a fixed price at a specific future date.

Residential Mortgage-Backed Security (RMBS)

A type of mortgage-backed security backed by mortgages on residential real estate.

Reverse repo

A reverse repo is the purchase of a security with an agreement to resell it at a fixed price.

The 'Review Period'

For this Report, the period between 1 January 2005 to 7 October 2008.

Rights Issue

A rights issue is a way in which a company can sell new shares in order to raise capital. Shares are offered to existing shareholders in proportion to their original holding. The price at which the shares are offered is usually at a discount to the current share price.

Risk Mitigation Programme (RMP)

Refer to 'Glossary of ARROW Terms' in Part 2, Section 3, Supervisory approach, priorities and resource.

Sarbanes-Oxley

The Sarbanes Oxley Act of 2002. This US legislation set new or enhanced existing standards for all US public company boards, management and public accounting firms.

Section 166 Report

A report required by the FSA to address a particular regulatory need identified by the FSA relating to a regulated financial services business under Section 166 of the Financial Services and Markets Act 2000.

Securitisation

A financial transaction in which assets are pooled and securities representing interests in the pool are issued.

Secured funding

Liabilities and general obligations that are collateralised by legal rights to specifically designated assets owned by the borrowing institution in the case of bankruptcy, insolvency, liquidation or resolution.

Senior debt

Debt that takes priority over other debt owed by the issuer. In event of bankruptcy of the issuer, senior debt must be repaid before other debt from proceeds of liquidation.

Senior Independent Director (SID)

An independent non-executive director appointed by the board to provide a sounding-board for the chairman and to serve as an intermediary for the other directors when necessary. The senior independent director should be available to shareholders if they have concerns which contact through the normal channels of chairman, chief executive or other executive directors has failed to resolve or for which such contact is inappropriate.

Short selling

A trading strategy aimed at taking advantage of an expected fall in prices. An investor, normally via a broker, sells shares that are not actually owned but have been borrowed from another investor or broker. The shares have to be bought back so they can be returned to the lender.

Significant Influence Function (SIF)

The most senior controlled functions within FSA authorised firms. For example, the Chairman, Executive and Non-Executive Directors, the CEO and the Head of Compliance.

Special Liquidity Scheme (SLS)

A scheme introduced by the Bank of England in April 2008 to improve the liquidity position of the banking system by allowing banks and building societies to swap their high quality mortgage-backed and other securities for UK Treasury Bills for up to three years. The Scheme was designed to finance part of the overhang of illiquid assets on banks' balance sheets by exchanging them temporarily for more easily tradable assets. The drawdown period for the SLS closed on 30 January 2009.

Sterling Stock Regime (SSR)

During the Review Period the prevailing FSA quantitative regulatory liquidity standard for large retail banks (referred to as sterling stock banks). It was originally implemented in 1996 and applied on a consolidated basis. The SSR sought to ensure that, for its sterling business, a bank had enough unencumbered highly liquid eligible sterling assets to cover wholesale net outflows and a 5% retail outflow for the first week (five business days) of a liquidity crisis, without recourse to the market for renewed wholesale funding. The liquidity of the sterling stock banks was measured by the Sterling Stock Liquidity Ratio. The SSR has been replaced by the FSA's new liquidity regime.

Stress Testing

A technique used to assess the potential loss of a portfolio of assets through market, credit or operational risks e.g. historical stress tests and scenario analysis. Macroeconomic stress testing is conducted based on changes in macroeconomic variables, such as changes in inflation or unemployment, and the effect that such changes would have on a firm or portfolio.

Structured credit

Products comprising tranches of portfolios of credit instruments or exposures. Structured credit products include cash Collateralised Debt Obligations and synthetic Collateralised Debt Obligations.

Sub-prime mortgage

Loan to a sub-prime borrower, typically having a weaker credit history that includes payment delinquency, court judgement or bankruptcy. These loans generally carry higher interest rates and pre-payment penalties.

Supervisory Enhancement Programme (SEP)

A programme of radical reform of the FSA's approach to the supervision of high impact firms, launched in April 2008, which incorporated the findings of the FSA's Internal Audit Report into the failure of Northern Rock. It was further intensified in response to the findings of *The Turner Review* in March 2009, and following international regulatory reviews of appropriate supervisory standards. Please also see CPP.

Super senior

Super senior notes are the most senior piece of a Collateralised Debt Obligation or other structured credit capital structure, which is the part least likely to bear losses from the underlying portfolio.

Threshold Conditions

The threshold conditions are set out in Schedule 6 of the Financial Services and Markets Act 2000. The threshold conditions represent the minimum conditions which a firm is required to satisfy, and continue to satisfy, in relation to all the regulated activities for which it has applied for permission. The FSA is obliged to ensure that applicants for permission satisfy the threshold conditions on a continuing basis.

Tier 1/Tier 2 Capital

Classification of different types of regulatory capital. Tier 1 capital comprises common equity, retained earnings and some types of debt instruments that convert into equity or can be written down. Tier 2 capital comprises other types of debt instruments that convert into equity or can be written down.

Trading book

A trading book consists of positions in financial instruments and commodities held either with trading intent or in order to hedge other elements of the trading book. To be eligible for trading book capital treatment, financial instruments must either be free of any restrictive covenants on their tradability or be able to be hedged completely. In addition, positions should be frequently and accurately valued, and the portfolio should be actively managed.

Tripartite Authorities

The three UK authorities who shared responsibility for the UK's financial stability during the Review Period: HM Treasury, The Bank of England and the FSA.

Unencumbered Asset

An asset which is not pledged (either explicitly or implicitly) to secure, collateralise or credit-enhance any transaction.

Value-at-Risk (VaR)

A category of risk metrics that measures the market risk of a trading portfolio based on probability. The VaR measure estimates the extent of losses on a portfolio that may occur due to adverse market movements.

Walker Review

A review by Sir David Walker of corporate governance in UK banks and other financial industry entities. Published in November 2009.

Write-down

An accounting treatment that reduces the book value of an over-valued asset.

Full names of institutions referred to

Royal Bank of Scotland (RBS)	Royal Bank of Scotland Group plc and its subsidiaries.
ABN AMRO	ABN AMRO Holdings NV. Acquired by the consortium including RBS in October 2007.
Charter One	Charter One Financial Inc, a US bank acquired by Citizens in 2004.
Churchill	Churchill Insurance Company Ltd, a member of the RBS Group.
Citizens	Citizens Financial Group Inc, a US bank acquired by RBS in 1988.
Coutts	Coutts & Co, a private bank wholly owned by RBS.
Direct Line	Direct Line Insurance Ltd, a member of the RBS Group.
Fortis	Fortis NV, a member of the ABN AMRO bid consortium.
Greenwich/Greenwich Capital	Greenwich Capital Holdings Inc, and its subsidiaries. Acquired by RBS as part of its acquisition of NatWest in 2000.
NatWest	National Westminster Bank Plc, acquired by RBS in March 2000.
RFS	RFS Holdings B.V., the consortium company formed by RBS, Fortis and Santander to acquire ABN AMRO.

Santander	Banco Santander S.A, a member of the ABN AMRO bid consortium.
Ulster Bank	Subsidiary of RBS based in Ireland.

Abbey National	Abbey National plc
ACA	ACA Capital Holding Inc
AIG	American International Group
B&B	Bradford and Bingley plc
Banca Antonveneta	Banca Antonveneta S.p.A
Banca Monte dei Paschi di Siena	Banca Monte dei Paschi di Siena S.p.A
Bank of America	Bank of America Corporation
Bank of China	Bank of China Limited
Barclays	Barclays plc
Bear Stearns	Bear Stearns Companies Inc
Calyon	Calyon Financial
Citigroup	Citigroup Inc
Credit Suisse	Credit Suisse Group AG
Deloitte	Deloitte LLP
Deutsche Bank	Deutsche Bank AG
DNB	De Nederlandsche Bank N.V. The Dutch Central Bank, ABN AMRO's principal regulator.
Glitnir	Glitnir hf.
Goldman Sachs	Goldman Sachs Group Inc
HBOS	HBOS plc
HSBC	HSBC Holdings plc
JP Morgan Chase	JP Morgan Chase & Co
KSF	Kaupthing Singer & Friedlander
Landsbanki	Landsbanki Islands hf
LaSalle	LaSalle Bank Corporation
Lloyds TSB	Lloyds TSB Bank plc
Merrill Lynch	Merrill Lynch International
Rabobank	Rabobank Group
Société Générale	Société Générale S.A
Standard Chartered	Standard Chartered plc
UBS	UBS AG
Wachovia	Wachovia Bank
Washington Mutual	Washington Mutual Inc

Other acronyms and abbreviations used

ABX	Asset Backed Securities Index
APER	Statements of Principle and Code of Practice for Approved Persons
BCD	Banking Consolidation Directive
BIPRU	Prudential sourcebook for Banks, Building Societies and Investment Firms
BoE	Bank of England
CESR	Committee of European Securities Regulators
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CRIM	Contact Revenue and Information Management Department
CRO	Chief Risk Officer
DTAs	Deferred Tax Assets
EVCA	European Venture Capital Association
ExCo	Executive Committee
'Fannie Mae'	Federal National Mortgage Association
FHFA	Federal Housing Finance Agency
FMC	Firms and Markets Committee
'Freddie Mac'	Federal Home Loan Mortgage Corporation
FSMA	Financial Services and Markets Act 2000
FSR	Financial Stability Report
GAC	Group Audit Committee
GBM	Global Banking and Markets
GEMC	Group Executive Management Committee
GENPRU	General Prudential sourcebook
GIA	Group Internal Audit
'Ginnie Mae'	Government National Mortgage Association
GRM	Group Risk Management
GRR	Group Regulatory Risk
G-SIB	Global Systemically Important Bank
HoD	Head of Department
IAS 27	International Accounting Standard 27
IFRS	International Financial Reporting Standards
ILAS	Individual Liquidity Adequacy Standards
IMF	International Monetary Fund
LAAC	Listings Authority Advisory Committee

MD	Managing Director
MI	Management Information
MRGD	Major Retail Groups Division
NAV	Net Asset Value
NEDs	Non Executive Directors
NPV	Net Present Value
P&L	Profit and Loss
PwC	PricewaterhouseCoopers LLP
QuaRC	Quantitative Research Function of RBS
SEC	Securities and Exchange Commission
SIFI	Systemically Important Financial Institution
SME	Small or medium sized enterprise
SYSC	Senior Management Arrangements, Systems and Controls
TCF	Treating Customers Fairly
TSC	Treasury Select Committee
UKLA	United Kingdom Listings Authority