Treasury Committee

Oral evidence: SME Lending

Tuesday 17 June 2014

Ordered by the House of Commons to be published on 17 June 2014

Watch the meeting

Members present: Mr Andrew Tyrie (Chair); Steve Baker, Stewart Hosie, Mr Andrew Love, Mr Pat McFadden, John Mann, Mr George Mudie, Mr Brooks Newmark, Jesse Norman, Mr David Ruffley, John Thurso.

Questions 392 - 656

Witnesses: **David Thorburn**, Chief Executive, Clydesdale and Yorkshire Banks, and **Debbie Crosbie**, Executive Director, Customer Trust and Confidence, National Australia Group Europe, gave evidence.

Chair: Thank you very much for coming to give evidence to us this morning. There is a good deal of concern about this issue, has been a good deal of concern not just on this Committee but more widely for some time, and there is quite a lot to get through in a short space of time. Can I begin by asking you, Mr Thorburn, what is the benefit to a customer of having a tailored business loan compared to a standalone interest rate hedging product?

David Thorburn: The difference was simplicity essentially. A standalone interest rate hedging product will have a separate ISDA agreement quite separate to the loan. The documentation associated with it is really complex and really extensive. A tailored business loan provides potentially a similar outcome to an interest rate hedging product but without the complexity so the documentation is much, much simpler. It was modelled on a domestic mortgage product to try to make it more understandable. In a nutshell that is the difference between the two.

Chair: Is it not going to be much more complex? Is it not much easier for the customer to be able to see that there are two quite distinct transactions taking place here of a very different nature, one a loan and the other a hedging product? Is not all logic pointing to exactly the opposite? Is not what you are offering something that is much more complex?

David Thorburn: It depends on the nature of the tailored business loan. If I might explain, a tailored business loan can mean many different things. It was a brand name for a range of products for us, so just to be precise about it.

Chair: We are talking about embedded swaps here.

David Thorburn: There is not an embedded swap in any of these products, and I can explain how this worked if it is of interest to the Committee but none of these products have an individual embedded swap.

Chair: Are you saying that none of the loans you have given contain a swap?

David Thorburn: Unless it was a very large loan—we are talking about £5 million, maybe £10 million, something of that nature—no. The products were sold by the wholesale division of our parent company, NAB. The average size of these transactions might have been £500,000, £700,000. NAB would simply take the interest-rate exposure of these collectively into its portfolio and intermingle it with its portfolio management activities in its wholesale bank. Almost without exception it would not have an individual hedge on the other side of these loans.

Chair: But from the customer's perspective what he has is a hedged product.

David Thorburn: From the customer's perspective for the period of the loan—and we are talking about fixed-rate tailored business loans because they were not all fixed-rate but that is probably the one that I would imagine you have in mind—what the customer got in that case is guaranteed payments for the duration. It is certainty of payments for the duration of the loan regardless of what happens with interest rates over that time.

Chair: What benefit is there to the bank?

David Thorburn: Pardon?

Chair: What benefit is there to the bank?

David Thorburn: The original concept of these products developed by our parent company was to give SMEs access to some of the hedging instruments—particularly to hedge against interest rate risks—that they did not previously have. That was the motivation. Clearly also it is a commercial endeavour. In selling these products there are profits and new customers. It was used to attract new customers to the organisation as well.

Chair: Have any customers asked you if they can see the hedging product separated out?

David Thorburn: I was never personally involved in the sale of these products at all so it is not something that we have recorded. It is not something I have ever heard asked.

Chair: Of course by being classified as a tailored business loan they do not come under the direct regulatory supervision of the FCA, is that correct?

David Thorburn: Yes that is correct.

Chair: Was that at any time a motivating factor in the decision to offer tailored business loans to your customers?

David Thorburn: I do not believe so. We have obviously—

Chair: Have you checked?

David Thorburn: Yes, I have. We have looked very hard, and are still looking very hard, at what went wrong with some of these products because something did go wrong with some of these products and that is a matter of great concern and regret to us. In looking back at the original motivation when the products were created in 2001 I have seen no evidence of people trying to avoid regulatory involvement.

Chair: If an investigation is launched and that investigation looks for e-mails on this issue they will find none. That is what you are telling us in evidence. As far as you are aware, because you have looked as you have just said a moment ago, they will find no e-mails that discuss internally the advantages to the firm of the avoidance of the regulatory perimeter?

David Thorburn: Our group audit function is currently investigating the background to all this to understand what went wrong. I do not think it is going into that degree of forensics looking for individual e-mails that would say that. The motivation here I think fundamentally was commercial and to provide a service to customers.

Chair: Is this not pretty basic? Is it not pretty basic to go looking to see whether your business was seeking—what your motivation was in seeking to offer tailored business loans as opposed to standalone products?

David Thorburn: I cannot guarantee there is not an e-mail where someone said something but looking back in time I do not believe that was the motivation at all. Indeed our parent company sold these through a regulated sales force even though the product was not regulated. These people were CF30s under the FCA and previously the FSA.

Chair: You said earlier that you had looked at this and you have corrected that a little just a moment ago to say that you have not gone into the forensic detail required to be able to give such an assurance.

David Thorburn: Not at this point. We have seen nothing that suggests that anyone had in mind in the design of these products avoiding regulatory oversight. As I say, although it was not required, the sales force that sold them were voluntarily regulated.

Chair: Are you still offering these products?

David Thorburn: No, we stopped the sale of these products in 2012.

Chair: Why?

David Thorburn: Because of the difficulties surrounding their sale.

Chair: What were those difficulties?

David Thorburn: In particular, for the more complex products, the fact that with the benefit of hindsight it was clear we were selling them to customers who did not always understand what they were getting into in a falling interest rate environment. That was a matter of great concern to us.

Chair: At the beginning you told me that it was simplicity that led you to offer these.

David Thorburn: Yes, we further simplified the products so we still offer a fixed-rate business loan, a simpler fixed-rate business loan, to our customers today but the more complex ones—the category A and B products, as the FCA describes them—have been off sale since this situation arose.

Chair: Back to the original question I asked you, which was question 1, do you think that, with the advantage of hindsight, it is simpler to offer these products as tailored business loans compared with offering them as a standalone products?

David Thorburn: Yes, I think it is a lot easier for the customer because they do not have to wade through an ISDA; they do not have to deal with the complexities of the standalone product.

Chair: You have now withdrawn these products knowing that that will lead to greater complexity.

David Thorburn: No, we still do the simple, straightforward fixed-rate business loan where they do not need a separate ISDA. We still sell that.

Chair: Can you just say that again?

David Thorburn: We still have a straightforward fixed-rate business loan that does not require a separate ISDA but we no longer sell the more complex products, the category As and Bs.

Chair: I must admit I am somewhat confused. Is this a simpler product or a more complex product? I am talking about tailored business loans.

David Thorburn: If I can explain, tailored business loans mean a great many different things. Most of the tailored business loans we sold were variable rate. A smaller proportion of them, around about 8,000, were fixed rate.

Chair: This is a matter of terminology.

David Thorburn: They are very different products.

Chair: We are talking here about those with a hedge embedded in them somewhere, are we not? We all know what we are really talking about, do we not, Mr Thorburn?

David Thorburn: Yes, we do. These products do not have hedges embedded in them. That is the problem.

Chair: Let us just concentrate on that. Can you give me the answer to that question? Are you now offering more complex products than you were?

David Thorburn: No.

Chair: You are offering simpler products as it were?

David Thorburn: Yes.

Chair: Are you offering products with the swap embedded or separated out?

David Thorburn: There is no individual swap associated with these loans. It goes into a portfolio that our parent company manages, hedged in its own balance sheet.

Chair: Are you offering hedging embedded as part of the loan or separated out?

David Thorburn: There is no individual hedge. I am not trying to avoid your question; I am trying to be precise in my answer to your question.

There is no individual embedded swap in any of these loans. The swaps are aggregated by a parent company as part of the broader balance-sheet management activities and funding.

Chair: We understand that but to the customer he is facing a product that may cost him money, is he not?

David Thorburn: Only in certain circumstances. If there is a break cost, yes.

Chair: He needs to know what the terms are and you have told us at the beginning that those terms were simpler, were better understood by a customer, when packaged together as part of the loan deal.

David Thorburn: Yes.

Chair: But you are now telling us that you have stopped selling these because you think they are complex.

David Thorburn: What I am saying to you is that the complex products were of the nature of structured collars, or individual collars, and are no longer sold. We still sell a straightforward fixed-rate loan. That is the distinction.

Chair: All right, I am going to move questioning on but I think there will be more exploration of this from colleagues.

John Thurso: Can I just follow on from some of the Chairman's questions and start first by asking about TBLs? For the purposes of my questions I am referring to the TBLs that are fixed rate that you have hedged out otherwise, so they have a break cost at the end if interest has gone the wrong way. I will use the phrase TBLs with that definition if I may.

When were these products first thought up and why were they brought out for sale?

David Thorburn: They were introduced in 2001 and as I mentioned earlier the wholesale division of our parent company was used to providing hedging instruments to corporate customers globally and felt at the time there was demand among the SMEs to access fixed-rate products and some of the other categories that we talked about earlier. It devised a way of hedging its interest rate risk and then providing these individual loans to SMEs. It was a commercial endeavour. It was to expand its customer base and provide a service to customers.

John Thurso: It would be fair to say therefore that this was a product that was driven by your parent, NAB, which had come up with it and said, “Hey, you guys, this is something we think is good. You should be going out and selling it”.

David Thorburn: That is correct.

John Thurso: In their treasury department, that would be a pretty lucrative and profitable product to have created.

David Thorburn: I would imagine it was for a time, yes.

John Thurso: So the motivation for the bank would be, “This is offering something for customers but this is a highly lucrative form of business and if we can push quite a lot of this, we will make more money”?

David Thorburn: It was an opportunity for a parent company with subsidiaries that did not have that degree of sophistication to make that available to its customer base and therefore our business grew in the UK on the back of that.

John Thurso: Who was the target customer in the UK?

David Thorburn: It was quite a broad range. It was anybody who wished to borrow initially over half a million pounds and latterly it came down to about quarter of a million pounds. It was a very broad range of SMEs.

John Thurso: If we look at SMEs these are people with very, very limited financial sophistication—you would accept that I am sure?

David Thorburn: Yes.

John Thurso: How was the sales process conducted with those target clients? What was said to them about the product they were being offered and encouraged to buy?

David Thorburn: There were a number of different components to the sales process. It would involve the relationship manager initially in discussion with the customer about lending opportunities, talking about the various risks that the customer might face including interest rate risks and introducing the concept of these products.

If the customer was interested in that, a representative from our parent company would come to a subsequent meeting, explain the range of products, explain the features of them and also issues such as break costs.

If the customer was interested, a strategy paper would then be prepared and submitted by the representative of our parent company, which set this out in more detail and gave a range of options but did not point to one. They did not recommend one. They gave a range of usually three options. There was usually a meeting and a further discussion at that point around the products. If the customer was interested in going further, it would become an offer letter normally, which again would include a separate flyer which set out the nature of the products and had an explanation of break costs. The final stage in the process, if the customer signed the facility letter—sorry, there were two more stages. One is that on the way through, we would say to the customer that they should take independent advice before they entered into these products. That was another part of the process. Then finally before the transaction was committed, there would be a phone call to either the representative or another representative of our parent company who would remind them of the risks of the break costs before they committed to the transaction. That is the normal process.

John Thurso: Just to unpick that, the first point is that the relationship manager would depend on assistance in the form of treasury, which implies that it is something of reasonable complexity. It is not something the relationship manager would normally deal with so you get the expert in.

David Thorburn: There is an element of that but it was to make sure the process was properly controlled and adhered to. That is all these people did, the representatives of our parent company. They were trained to sell this product range. They were regulated.

John Thurso: It was of sufficient importance that the normal relationship manager who might do your overdraft and your straightforward loan unassisted would want to be assisted by head office in the process of administering this sale.

David Thorburn: Yes that is particularly so because if you look at the full range of the tailored business loans, a subset of them were things like structured collars or collars. They are complicated, and they are beyond the ability of the relationship manager.

John Thurso: You would then go through the process that you have described with quite a lot of paperwork. We have agreed that these are pretty unsophisticated people so effectively they were receiving pretty full-on advice from the bank as to what might be best for their business.

David Thorburn: With the benefit of hindsight it was not good enough for structured collars, so we accept that fully. We regret that and have learned from that. But there was a really sincere attempt here to design a process with various break points and a recommendation of independent advice so that the customer had time to assimilate it and would understand what they were getting into.

John Thurso: In evidence to us a lot of people have stated they felt they were being advised by the bank and this was the best thing to do. Would you accept that most of these people felt they were being advised as to what was the appropriate course of action?

David Thorburn: My colleague, Ms Crosbie might like to come in because she is leading our work in the redressing programme, but some people have crossed that line—we can see from the correspondence, our staff have done that—and where they do, that is unacceptable and we will remediate it.

Debbie Crosbie: Yes, it might be helpful to make you aware that over that period, the 13-year period we are discussing, there were just over 8,300 loans, fixed-rate loans, the ones that you have focused on, sold. To date we have received 550 complaints about the sales process and on most occasions, we believe when we examine the case file the sale was conducted in a manner that was I think entirely fine. We absolutely accept though that there were a number of occasions where, because of the interest rate environment that we found ourselves in, the customers did not anticipate the magnitude of those break costs and that is why we have set up this specific review. Where customers feel that is the case, we have absolutely encouraged them to come and talk to us and we will make sure that if we find that to be the case we will put that right for them.

John Thurso: I think some of my colleagues will follow up on that with you but let me ask you this, and I will ask it of either of you: do you feel that Clydesdale or Yorkshire encouraged any pressure for sales to be made given that these are lucrative products as we have established. We are talking about pre-crash. Was there pressure put on managers to sell these products as opposed to other products?

David Thorburn: If I look back to that time, it was a period where the organisation was trying to grow quite fast, expanding into the south. There was a lot of organisational focus on doing more business with existing customers, attracting new customers, so to that extent, yes. It was an environment of growth and in the tailored business-loan product we felt that we had something that, because of its relative simplicity, was a bit different from some of the other banks. Therefore we put quite a lot of emphasis on introducing this service to customers. It should not have gone beyond that to anything associated with a pressurised sales environment. Sometimes staff overstepped the mark and when we find evidence of that, we will fix it for the customer. That is kind of a long answer but I just want to be open with you. It was a time of growth and we did focus on the product but it should never have crossed the line into being a pressurised sale from a customer perspective.

John Thurso: You are saying in effect that it was a good product in which you had faith?

David Thorburn: Yes.

John Thurso: You were in a competitive situation as a slightly challenger bank to win more?

David Thorburn: Yes.

John Thurso: You had a higher cost of capital because of the regulatory questions that we talked about before so there was quite a lot of perfectly understandable management emphasis on having strong targets for selling these products, believing them to be appropriate for the businesses. That would be a fair characterisation?

David Thorburn: Yes, I think so.

John Thurso: Do you believe now looking back on it that that process had sufficient checks and balances to ensure that the people making the sale genuinely made sure that the people purchasing the products understood the potential risks they were taking on?

David Thorburn: I think the heart of the matter here in what went wrong—and of course there are some individual behavioural aspects that are not acceptable as well—the key driver of most of the customer detriment here, which we very much regret and we will make redress to customers, is the more complex products. It is the structured collars. About 25% of the more complex tailored business loans we sold were structured collars and they were to SMEs where we now know people did not understand and we are in the process of putting that right. That is the key thing that stands out from this whole exercise for us and something we really regret.

John Thurso: A number of customers have written to this Committee both as part of NAB support group and individually, and I just pick three.

One says, "My Clydesdale business manager approached us with two treasury officials and advised it was in our best interest to assess our floating rate as bank interest rates were bound to rise, be better protected to fix all our loans. They bombarded us with phone calls, pushing like American salesman down on one knee".

Another said, "The main issue is that in 2009 the bank forced us into transferring a large proportion of the variable-rate loans we had on to three fixed-rate TLBs".

The third one is, "I think there has been clear deceit on their part, particularly with Clydesdale, in terms of what they said to me and what was delivered".

That is just a selection. That is pretty damning. Do you not think it would be better to have a full scale review of that sales process to ensure that the many customers out there who are complaining feel there is a real form of redress in the same way that the FCA are doing for the plain vanilla products?

David Thorburn: Those are unforgivable, those situations that occurred, and you have to take customer testimony on face value. That is unforgivable and has to be fixed and put right.

What we have found as we have gone through several thousand files with the interest-rate hedging product review and the voluntary review we are doing of the more complex tailored business loans—and we are going through these very thoroughly in accordance with the FCA's guidelines—is that there are some exceptions like that but that kind of behaviour is not widespread, I think it is fair to say. In the main, people were responsible and stuck to the process. Where we found people did not stick to the process that is unacceptable and needs to be sorted out. That has been our finding to date. We are still going through the tailored business loan review. If we find more and more examples of that, we will need to reconsider.

Chair: Martin Wheatley has said in evidence, and I am quoting, "A customer who has taken out a loan with an embedded interest-rate hedging product" that is a swap, "may be faced with exactly the same repayment features and exactly the same break costs as a swap". If it behaves like an elephant, looks like an elephant, is it not an elephant?

David Thorburn: You are right because the thing that matters here is the impact on the customer really, whether or not the swap is embedded.

Chair: For all practical purposes from the customer's perspective this is a swap, this is it not?

David Thorburn: You could regard it as that. The problem from the customer's—

Chair: Could you regard it as anything else but a swap?

David Thorburn: Pardon?

Chair: Could you regard it as anything else but a swap?

David Thorburn: It is a bit of an academic exercise really because it is the impact on the customer that matters. That is why we have a voluntary review of tailored business loans—which are not regulated—

which mirrors the interest rate hedging product review because we do not want to hide something like that.

Chair: I do not think it is an academic issue, but if it is, it is one that the Committee will probably want to pursue. I suppose occasionally we have to get into academic issues as well.

From the customer's perspective is this a swap or not?

David Thorburn: It is not a swap but it has many of the effects of a swap.

Chair: Martin Wheatley is saying it has; "may be faced with exactly the same… features… as a swap". Do you agree with that?

David Thorburn: In terms of break costs, potentially that is correct.

Chair: Why did you say to me in evidence a moment ago tailored business loans do not contain a swap?

David Thorburn: Because they do not have an embedded swap, a mirror-image swap, that we have used to create the product. They are in a broad portfolio of aggregated hedging.

Chair: It is true that they are aggregated up, they always are, but that, to be frank, is somewhat misleading, is it not, as evidence?

David Thorburn: No, there is no intention to mislead at all. Our concern in all of this is that regardless of how NAB hedged its interest-rate risk position, it is the impact on the customer that matters. When a customer does not understand the break costs, that is our concern here, not if it was engineered.

Chair: If a customer got as far as grasping any of this and he asked a simple question, "Am I getting a swap here?" was your bank answering yes or no?

David Thorburn: I am speculating, I do not know whether that question was asked and what people would say

Chair: What do you think the correct answer should be?

David Thorburn: I think the correct answer should be, "You are getting a tailored business loan that gives you certainty of interest over that period of time but has break costs associated with it".

Chair: If I may say so that reply sounds like a bit of a hedge.

Steve Baker: Ms Crosbie, you mentioned in passing that the magnitude of the break costs was a consequence of the interest environment. Could you just briefly explain how?

Debbie Crosbie: Yes. The question was referring to our fixed-rate business loans and our fixed-rate tailored business loans operate in a way whereby when the customers agreed the deal with the bank, the payment does not change. It is an agreed payment for a fixed duration which is why we believe these products are more simple than the more complex ones that you were referring to. When the customer decides that they want to terminate the contract early, what we look at is the difference between the interest rate that is prevailing at the moment and when the interest rate was set, and for the remaining period of time, the customer is charged the difference effectively of those interest rates.

Steve Baker: Is it the case that monetary policy has directly exaggerated the height of these break costs?

Debbie Crosbie: I think what you can absolutely see is that because we have had an interest rate fall and it has stayed very, very low for very long periods, for customers who bought into these contracts when interest rates were 4.5% to 5%, what you can see is a level of magnitude of course that I do not think that customers could reasonably have anticipated.

Steve Baker: I think we can look forward to raising that with Government.

Mr Newmark: I am fascinated with your title, Debbie. It looks like something created in the BBC's W1A: Executive Director, Customer Trust and Confidence.

Debbie Crosbie: Yes.

Mr Newmark: Why do you think your institution decided to create a particular title called Executive Director of Customer Trust and Confidence? What led to that? I have not seen another bank around that has created that title.

Debbie Crosbie: I think there are two aspects that are important in my job. David has already outlined that there is no doubt that there are things that have happened in the past that the bank regrets. We are committed to putting those right. My division is responsible for making sure that where things have gone wrong we look at why they went wrong and how we make sure we avoid those problems in the future.

Second, we absolutely recognise that the industry needs to rebuild customer trust and confidence. I do not think that is a simple thing to do and I think you have to have very focused effort and David has created a division for that. I am a board director. I report to the board every month on what we are doing to make things simpler and more straightforward for customers, and it is to create that focus around that.

Mr Newmark: So the title came about because there was a recognition there was a problem, right?

Debbie Crosbie: I think we recognised the banking industry has a lot to do to repair its reputation and we believe we are an important part of that.

Mr Newmark: David, I may be flogging a dead horse here but I am really fascinated by this.

What is the difference between the break-cost calculation of a standalone fixed-rate interest-rate hedging product and a fixed-rate tailored business loan because there seems to be some sort of difference between the two?

David Thorburn: No, there is no difference. They are one and the same.

Mr Newmark: There is no difference? There seems to be from some of the calculations that I have seen. You are saying that the break cost for both should be identical.

David Thorburn: Yes.

Mr Newmark: If there are cases in which they are not, that should give rise to concern.

David Thorburn: As long as it is for the same loan for the same duration broken at the same point in time and entered into at the same point in time it should be the same.

Mr Newmark: Okay. The FCA director of supervision, Clive Adamson, said that if there was no understanding of break costs given to the customer and if there was a poor disclosure of exit costs then it was highly likely there would be a mis-sale. Would you agree with that statement?

David Thorburn: Yes, I think it would, yes.

Mr Newmark: Then how did Clydesdale ensure customers understood the potential scale of break costs involved with these tailored business loans?

David Thorburn: It was the process I described to Mr Thurso earlier on. I am happy to repeat it if you like, but various interactions with the treasury salesperson; strategy papers; a flyer that set out the nature of the products. I gave a worked example of the break-cost process.

Mr Newmark: I say this because I have a quote here. Again, I am trying to understand this. Did your sales team understand the potential size of the break costs involved because they are the people who are at the front end of what seemed to be a lot of the problems with these tailored business loans?

David Thorburn: Yes, they did and they were able to give worked examples.

Where this went wrong and where we did not foresee potentially the scale of break costs was in a situation where interest rates fell sharply from a relative high to a historic low and stayed there for a long period of time. That exaggerates the break costs required for customers caught at that moment in time.

Mr Newmark: You are saying that they did understand what they were selling.

David Thorburn: Yes, they did, but no one foresaw that interest rate movement that exaggerated the break costs.

Mr Newmark: A property developer wrote to the Committee saying, "In breaking news to me my relationship manager was visibly stunned by the magnitude of the break cost and evidently had fully not understood what he had been involved in selling to me a year earlier". Does that surprise you?

David Thorburn: It must have been one of the examples I am talking about. In normal circumstances the break costs were relatively predictable on a normal interest rate cycle. When the emergency rate was brought into place and held for a long time, all of a sudden everybody was surprised at the scale of the break costs. I am sure that is why that relationship manager reacted that way.

Mr Newmark: Looking forward, Debbie, with the role that you have now, do you think that you have effectively fixed the problem on two sides, first of all with respect to giving satisfactory redress to your customers so that they have confidence in the institution?

Second, whether it is this particular instrument that we are talking about or a new instrument—because people are always trying to come up with instruments to protect customers from volatility, which I assume what this was about, but end up hurting a number of people—there was a lot of mis-selling of swaps—not just by your institution but just generally in the industry—and these customers are not sophisticated people. These are people who are running ordinary, small businesses on the whole and it ended up destroying what were otherwise very healthy businesses. Do you think institutionally at least you guys now have it right so that this really could never happen again, on the redress side and then going forward?

Debbie Crosbie: Yes. First, on the redress side, David has already outlined that we are fully participating in the FCA review. He has also outlined that voluntarily we have opted in our complex TBLs and they are governed and redressed in exactly the same way as the FCA's formal review. We deal with the independent review and the skilled person in the same way so we believe that with the external perspective we absolutely can make sure that customers get fair-redress outcomes.

On the fixed-rate loans, to which Mr Thurso referred, we have also undertaken a review of our past complaints. I have said we have about 550 past complaints. We are well advanced in reviewing those complaints. Yet again I would say if any other customer has a problem we are very happy to look at that on a case-by-case basis. In terms of redress we think we are very well advanced and we think we have a fair process.

The other thing I would add is that the redress programme that we are running for fixed rates has been fully informed by any adjudications we have had from FOS and we have made sure that our processes line up with what FOS expects us to do.

Looking forward we have also undertaken a pretty sizeable review of the sales process. We absolutely accept, and we regret, that there are a number of customers who have been less sophisticated and have not been able to properly understand those more sophisticated products which is why we no longer sell them.

You have talked about the break costs. Again we understand that customers want to have more certainty in the process so while it will present more risk to the bank we are looking at introducing a cap on our break costs to make sure that while customers are in the position—

Mr Newmark: Sorry to interrupt. The cap is fine. The problem seemed to be a lack of transparency and clarity to the customers so they understood that if there was a break this is the potential cost to you, and spelling it out really clearly rather than it being hidden in small print or using waffly words.

Debbie Crosbie: We understand that and we have looked quite hard at the way in which we describe that. As David has outlined, for any deals that we do now, we provide specific examples—calculations that are relevant to customers—so that they can understand.

Mr Newmark: All right, so they understand that, if it breaks under these circumstances, this is how much it is going to cost you?

Debbie Crosbie: That is exactly right, and as I say the cap is a very important way of making the customer understand the limit of their exposure over the longer period.

Chair: Have you been taking instructions or strong guidance from your parent company, National Australia Bank, with respect to this type of lending?

David Thorburn: No, the control is with the board of the Clydesdale bank. Our parent is very interested in what has gone wrong here but the decision making is driven by our board here in the UK.

Chair: You have had no guidance from National Australia Bank on the decisions that you have been taking with respect to commercial lending in this area?

David Thorburn: You mean the recent redress exercises or since 2001? Over what period of time?

Chair: In the last two or three years; over the period in which this has become a concern.

David Thorburn: Okay. That is clear. We have driven this. Obviously we report to our parent company. Both Ms Crosbie and I regularly present to, for example, the group risk-management committee what has happened here. They have a lot of concern and interest in it but the strategies we are pursuing to sort this problem out and go forward have been developed by us and our parent has been informed of them. They have not been developed by the parent.

Chair: That is not quite the question. I am going to have one more go. The question is: have you been given guidance by your parent company on what strategy to pursue with respect to these loans?

David Thorburn: Not really, other than they hear what we propose to do and give us feedback.

Chair: You are not getting out of this because you had guidance or an instruction from them to do so?

David Thorburn: No.

Chair: On the contrary, you are saying you came to them and said, "We'd like to get out. What do you think?"

David Thorburn: Yes.

Chair: Correct?

David Thorburn: Yes.

Mr McFadden: Good morning. Mr Thorburn, you will have read the standard tailored business loans terms and conditions that the bank issued. Do you think these would pass any kind of plain English test?

David Thorburn: No. I think the standard terms and conditions were unfortunately the usual bank terms and conditions, which customers do not find very easy to understand. There were other documents that were used in this process, such as the flyer that accompanied the facility letter, which I think is pretty plain English. The terms and conditions themselves, no, they were not. That is one of the things we have learned, that that kind of language is unhelpful to customers.

Mr McFadden: Let's just clarify that. The terms and conditions letter, which you issued with the loans, you acknowledge, would not pass a plain English test?

David Thorburn: Yes.

Mr McFadden: You referred in one of your earlier answers, to the Chairman I think it was, to these products as being modelled on a domestic mortgage product. Could you give me an idea of the comparison of the break costs with a domestic mortgage product with the kind of break costs that your customers were incurring with these products?

David Thorburn: Yes. There are a couple of differences there so I cannot give you a precise number, a worked example, but one of the differences between the two main areas is that although someone may have a 25-year mortgage, they would tend to fix the term for two, three, maybe five years maximum, whereas some of these business loans were fixed for up to 20 years, so you have a huge difference in the break costs because of the different term of them. The other one is that the standard practice in this country is to have a cap on mortgages for domestic customers and, therefore, there is a limit beyond which the customer's break costs cannot go. For a business mortgage, that was not the case. There was a full economic cost recovery within—

Mr McFadden: What would be a typical break cost for somebody who wanted to pay off their mortgage early? This is usually written in. What is the typical break cost for doing that?

David Thorburn: Somewhere in between—I do not know exactly, I am kind of guessing—1% to 3% of the capital loan perhaps.

Mr McFadden: Break costs on these loans could be 25%?

David Thorburn: Yes.

Mr McFadden: That is a massive difference. It is not small differences.

David Thorburn: That is right. It is not quite apples with apples. When break costs get up to 25% you are looking at a long-term loan typically that has normally been taken out in a higher interest-rate environment and then broken in the environment we find ourselves in today.

Mr McFadden: Do you think many of your customers would have thought the break costs would be similar to a mortgage and then found out they were massively different?

David Thorburn: That is possible. There was a worked example in the documentation the customers were given that set out—a pretty straightforward example—a 10-year loan for £1 million and so on and gave an example of the break costs. So it should have been fairly obvious that it wasn't the same as a mortgage. Customers do not always read what you give them, so it is possible.

Mr McFadden: How could it be obvious to the customer if your sales staff did not know what the break costs were?

David Thorburn: Are you referring to that earlier example we were talking about?

Mr McFadden: Yes, and facilities like it.

David Thorburn: The sales staff had access to all this information, so they knew in a normal interest-rate cycle what the break costs would be. What nobody anticipated is what would happen to break costs when rates came down to the emergency rate that we are still at today, 0.5%.

Mr McFadden: We have had evidence from one of your customers who says that the bank said to them, "We told you there were breakage costs so you should have understood" and he concludes, "The bank understood what it was selling and relied upon the fact that I did not". Doesn't that quote get to the heart of the trust problem between the massive levels of information available to a bank, when it is selling these products, compared with the information available to the customer? This is at the heart of the trust problem with every mis-selling scandal.

David Thorburn: Obviously, I hate to hear examples of that; when a customer feels like that. That should never been the case and, as Ms Crosbie said earlier, in the redesign of the products and the process, we are trying to make absolutely sure that cannot happen again.

Mr McFadden: You have entered into a review of these products because you say they were unregulated and you are doing a parallel review to the FCA?

David Thorburn: Yes.

Mr McFadden: Why does that include only 2,000 of 11,000 products that were sold?

David Thorburn: The parallel review that we entered into was for complex tailored business loans that had the same characteristics as interest-rate hedging products within the Financial Conduct Authority's review. What we excluded from it were variable-rate tailored business loans and fixed-rate tailored business loans that do not have the same characteristics as the more complex interest-rate hedging products, like structured collars.

Mr McFadden: Have you had customer complaints about the products that are excluded from your review?

David Thorburn: Yes. As Ms Crosbie said, we have had 550 over the last 13 years.

Mr McFadden: These are the ones that are excluded from your review?

Debbie Crosbie: Those are the excluded ones, yes, but we are undertaking a voluntary review of complaints to make sure that those 550 people get the same level of redress and treatment where they believe the sales process did not work for them.

Mr McFadden You have referred to the break costs as being dictated by what happened, but surely that is no reason not to explain them. In fact, it seems to me to be a reason to look back and to explain them in more detail, given that basically you are saying, “We couldn’t envisage the reality”. But it is the reality that your customers are putting up with. Again, we have had evidence from one customer who said, “If the bank had told me, ‘Do you understand that on day one you have break costs in excess of £1 million related to a £3.9 million loan?’ do you honestly think I would have said, ‘That’s acceptable’?”

Debbie Crosbie: We are listening to that evidence with interest and we have a different view of those numbers, but I don’t think it is perhaps helpful to go into the detail of that. We believe we did try to explain to customers what the break costs were. We absolutely accept the language we used and that we can improve that process that we have outlined. I would say again that we are in dialogue with that customer. If that customer believes that the process was not adequately explained to them we will absolutely look at that complaint and we are very keen to reach an agreement with that customer.

Mr McFadden: The letter with your standard terms and conditions says you cannot tell the customer what the break costs would be but they might be substantial. Do you honestly think that the word “substantial” is going to lead someone to the understanding that it might be 25% of the value of the loan?

David Thorburn: There was also a worked example given in the flyer that was attached to the facility letter, which gave them an idea in certain interest rate circumstances for a £1 million loan of what the break costs might be. In a normal interest rate cycle, that was a reasonable attempt to illustrate what the costs would be. Where that fell down was that interest rates did something none of us anticipated and all of a sudden, the break costs were much larger. For people caught up in this review of complaints, we are going through it with them to try to help customers with that issue and put that right as much as we can.

Mr McFadden: I come back time and again in looking at this to the information imbalance. I am not sure you quite knew what you were selling and I am pretty sure that the customers in many cases did not know what they were getting into, and I think that the fact that you had such an information imbalance between the bank and a customer here has led people to be in a situation and be faced with bills that they could not possibly have envisaged. If that is the case something has gone very, very badly wrong, do you not agree?

David Thorburn: On the information imbalance, there is always that issue that the bank has a lot more information and sophistication compared with the customer, so I understand that and the process should be designed to close that gap and help the customer understand what they are getting into. That process was carefully thought through and there was an honest endeavour to do just that. Where it fell down is that it did not anticipate the situation of interest rates going from 4.5%, 5% to 0.5% and staying there for a long time. So when we illustrated to people potential break costs, we did not see that scenario coming because that had never happened in history. So I do not think that is an information balance as much as an unfortunate set of circumstances that occurred that no one had ever experienced before and that exaggerated the break costs for a number of our customers. We are trying to help with that right now with this review.

Mr McFadden: I will just finish with this. In terms of the regulator, they have launched their review with standalone products and, as you have said, it does not cover yours. As a bank, do you have any objection if—either by ministerial decision or through Parliament—the terms of that review are extended to include products which would include yours and others where the swap is effectively embedded in the loan? Because, from the customers' point of view, there is no difference.

David Thorburn: If a review like that is mandated by the regulator and by Parliament, we will go along with that. Of course we will. We will always comply with something of that nature.

Mr McFadden: Thank you.

Chair: You are agreeing though, aren't you, Mr Thorburn, that it was a mistake to sell these products?

David Thorburn: It depends on which products you are talking about. The complex ones, yes, definitely. The fixed-rate ones, most of our fixed-rate tailored business loans no longer exist because they have run their course; they have done what the customer wanted them to do. They have been repaid. The best part of two-thirds of these fixed-rate tailored business loans are a matter of history now. That is a product that does what it says on the tin, in the same way that a fixed-rate mortgage does when you buy a house or a personal loan for a car. The shortcoming on that product was when we illustrated the break costs we did not foresee the interest rate circumstances that took place between 2008, 2009 and today. I think the product actually works but we didn't see that scenario playing out, and that is why we are doing this complaint review now to try to help customers deal with it.

Stewart Hosie: Mr Thorburn, sorry if this is slightly repetitive but I think it is worth going over this again. You have been at pains to stress that many of these TBLs did not have embedded swaps. You described the fact though that this was hedged against in aggregate form, as you put it, by the parent company doing its normal balance sheet management. However you have accepted that the impact on the customer is the same, particularly in relation to break costs. These loans were hedged against. There was a swap against them, whether it was embedded or not. Do you understand how frustrated customers, the public and many of us feel when the first point of reference from Clydesdale is that these were not embedded swaps; there were no embedded swap products, when we all know the products were swapped against. They were hedged against even if it was at an aggregate level. Do you understand the frustration we have with that?

David Thorburn: Yes. Apologies. I was trying to answer the question precisely and we have ended up going down a path on that which, from a customer's point of view, is neither here nor there. I accept the point you are making that the effect on customers is the same and the important thing from our point of view is the customer impact rather than what you call it or the hedging that your parent may have entered into to make these products available. So apologies for that; that was creating some frustration. It was not intentional.

Stewart Hosie: No, it is not just today; this has been going on for some years.

But, given the TBLs were hedged against, and hedging was the bank's way of ensuring its own balance sheet, you have said—and indeed in that last answer I think you said—no one could foresee interest rates falling. Of course that is true, but why should the customer be paying for the failure of the bank properly to ensure its own balance sheet because that is the effect of this?

David Thorburn: The effect of these products, we enter into a contractual arrangement with the customer where they have certainty of payments over the term of the loan but in the event that they want to terminate that loan earlier than that contract, there will be break costs, which we do our best to explain to them. That is a real economic cost to our group, so effectively the contract is that we will pass on the economic costs if they terminate this loan early. That is what is going on—

Stewart Hosie: But that economic cost to the bank is clearly the whole point. It is impossible for you to have known what the break cost would be and, therefore, utterly impossible for the customer to have known what the break cost would be because the hedging you took out to ensure your balance sheet failed spectacularly when interest rates changed. Is that not correct?

David Thorburn: That is not correct. First, the bank did not do any of the hedging. Our parent company did the hedging, and nothing has failed in relation to their own interest rate hedging as such. It is simply the case that there is an economic cost to our parent if someone terminates one of these loans early and that is what is passed back to the customer. You cannot be precise because you do not know when the customer may break early, so you give an illustrative example.

Stewart Hosie: But that is the whole point. You do not know what the economic cost would be, not just because of when the customer may break but because you do not know what the interest rate will be at that time.

David Thorburn: That is correct, yes.

Stewart Hosie: You might be right that it worked for the company, that you were protected, but it certainly did not work for the customer that the hedging delivered such an economic cost, which is passed on to the customer in certain circumstances in relation to interest rates. Is that not correct?

David Thorburn: Yes, that is correct.

Stewart Hosie: Let’s move on to the review you are undertaking then. Do you think there are common characteristics of mis-selling between the review of standalone interest rate hedging products and certain tailored loans? Do you think the nature of the mis-selling was the same?

Debbie Crosbie: What we found—and today we are only part way through the complaints review—is the mis-selling that we see and the lack of understanding through the sales process that was evident in standalone review, we do not see that mirrored. What we do see is that customers did not understand and in many cases anticipate the magnitude of break costs that they got into, but that wasn't about the sales process in the first place. In the fixed-rate tailored business loans that we have sold, we believe that most customers understand how the product works. They understand that it is for an agreed period of time. They pay a fixed payment for an agreed period of time. What we have seen, though, is that customers have not anticipated the magnitude of break costs. That is why when that is the case, and we find that we did not disclose them in enough detail, we have paid redress.

Stewart Hosie: That is extremely helpful because it goes back to the description David had earlier of the sales process; a long, complicated process with a number of meetings and interventions by the parent company including you said, I am sure, another meeting and a phone call where the customer was warned of the break costs. If a customer is able to identify that that process did not happen, that that warning was not explicit, that would count as a mis-sell would it, in terms of your review?

Debbie Crosbie: We believe that once you examine that process, and find that it had not been carried out in accordance with what we had agreed is appropriate, we would absolutely redress a customer and we have done so on a number of occasions. There are a number of customers we have already reached settlements with.

Stewart Hosie: Indeed. You have agreed to include certain tailored business loans in the review of the standalone interest-rate hedging products.

Debbie Crosbie: Yes.

Stewart Hosie: How were those ones, the ones that are being considered within the scope, determined?

Debbie Crosbie: The FCA standalone review detailed a set of products and they refer to them as category A, B and C. We accepted that a number of our tailored business loans had very similar characteristics, in that they would also be categorised as A, B and C. Where we found that to be the case we have opted all of those products in, which includes the 2,127 that you have referred to. Any products that have been excluded from that review are fixed-rate products and we believe they are different, simpler to understand because the customer gets a fixed payment for a fixed period of time and that payment will never change as long as the customer does not want to terminate the agreement early.

Stewart Hosie: I am conscious of time, so I will not come back on that specific point just now but one final question. If I have understood it, some 19% of the TBLs you have are included in this?

Debbie Crosbie: Yes.

Stewart Hosie: Can you give the Committee a categoric assurance that the remainder have not been excluded because of the size of the portfolio, the potential exposure, if mis-selling was identified?

Debbie Crosbie: Yes. I can absolutely assure you of that. The reason why products are excluded is because they have different characteristics. We shared with our regulator the products that we believe displayed similar characteristics. We worked closely with them and they agreed with us and I may add that we did that voluntarily because we absolutely accept that—as in David's earlier point—regardless of how we call these products, if it feels the same to the customer, we believe it was right to put them in the review, which is why we have those products there.

Stewart Hosie: Thank you.

Mr Mudie: Just one question arising from Mr Hosie's questions. Did you supply customers—tailored business loan customers—with written figures for break costs at any time in the sale process?

David Thorburn: Yes, we did.

Mr Mudie: What did you provide them with, what figures? Because you have been saying to the Committee that the interest rate fall took the bank by surprise, took everybody by surprise, and so it was impossible. Do you have figures? Can you demonstrate that each of your customers who took out one of these loans had what you would expect to give a normal customer seeking a mortgage or seeking a loan away from the commercial side?

David Thorburn: Yes, I think the thing you were referring to, there was a double-sided flyer that was attached to the offer letter and it talked about the nature of the product and it gave a worked example of the break costs. It was based on a £1 million loan over 10 years and an interest rate fall of 1%, and it set out what the break costs would be in those circumstances, which was fine for a normal interest rate cycle but a 1% fall is not what happened in 2008/2009.

Mr Mudie: No, so what example did you use when you gave that flyer? What was the interest rate used?

David Thorburn: From 5.25% to 4.25% from memory, the ordinary rate.

Mr Mudie: You never envisaged it going either way. Do you have a breakdown at the bank of when you gave these loans since 2002?

David Thorburn: Yes, we do.

Mr Mudie: So you would be able to tell the Committee how many were given after 2007 and 2008?

David Thorburn: Yes, we could. Yes, we could write to the Committee.

Mr Mudie: Did the flyer change?

David Thorburn: The process changed many times over those years.

Mr Mudie: No, did the flyer change?

David Thorburn: I can't remember whether it did or it did not.

Mr Mudie: But that was crucial, wasn't it? It is one thing to say in 2002 it was 4% or 5% and who would envisage it changing much; but in 2008 and 2009, we all knew what was going on.

David Thorburn: Yes.

Mr Mudie: And you cannot remember. Do you think you could check and tell the Committee?

David Thorburn: Yes, we would be happy to write to the Committee and confirm that.

Mr Mudie: Going back to the interest rates, what is the difference between the individual fixed-rate hedged loans and the tailored bank loan fixed rate? What is the difference between the two?

Debbie Crosbie: I think the question you are asking is what is the difference between the more complex ones that look and feel the same as the review, and the fixed rates?

Mr Mudie: No, I am sorry, when you say the "most complex" there are two loans that are described to the FCA and one loan is the individual freestanding—

Debbie Crosbie: Standalone, right, okay.

Mr Mudie: Standalone and the other is a tailored business loan. What is the difference between the two? First, if I came to you for a fixed-rate loan, would I have to take a swap? Is that bank policy?

David Thorburn: No, you would just get a tailored business loan, which had a very similar effect.

Mr Mudie: No, no, if I came for an individual loan; I wasn't coming for a tailored bank loan. I wanted a loan of a million quid and was a fixed rate available to me?

Debbie Crosbie: Yes.

David Thorburn: Only as a tailored business loan, yes.

Mr Mudie: No, no, no, if I came in and I wanted to borrow a million quid and I said, "I'd like it at a fixed rate", was it ever available since 2002?

David Thorburn: Just as a fixed-rate loan?

Mr Mudie: Yes.

David Thorburn: We did not call them that.

Mr Mudie: What did you call them?

David Thorburn: A fixed-rate loan that any other bank does and a tailored business loan that we do that would be the same thing. The same thing, it is just a name.

Mr Mudie: So when did fixed-rate loans end as far as being just a fixed-rate loan? I came, you knew the score, and I knew the score. I could get out of it by just saying, "I'm coming out of it". You can't remember?

David Thorburn: I can only go back to 2001, and since 2001 we always called them tailored business loans. It is just a brand name that our group uses for these products.

Mr Mudie: Okay, so take your tailored business loan and your individual standalone, what is the difference?

David Thorburn: Between a fixed-rate tailored business loan and a standalone—

Mr Mudie: A standalone.

David Thorburn: A standalone product: the closest to that would be a swap; coming back to an earlier conversation, it would be. Standalone could also be a collar or it could be a cap. It could be a—

Mr Mudie: No, no, I accept that but if I got a standalone, I would take a swap. I would get my loan and that would be explained to me. What you explained to the Chairman was you seemed to suggest that the tailored business loan was better because it was less complex. The further explanation to that was because the other one was individual, separate from the loan but linked, but it was a separate swap—

David Thorburn: Yes.

Mr Mudie: —you had to explain the complexities but you did not have to do this with a business loan.

David Thorburn: That is right.

Mr Mudie: Why not? That suggests if Andy here goes in for a standalone you tell him all the details of the swap. I come in and get a business loan, you think it is much simpler just to sell me the loan and briefly explain the—yes?

David Thorburn: Yes, because the standalone is a regulated product you are required to go through a certain process, uses the documentation, which is very complex. That was something we did not need to put our smaller business customers through. If they wanted a loan that was fixed for a period of time we didn't need to put them through all that. We could with our parent company create this product that made it more straightforward.

Mr Mudie: Which one are you talking about there?

David Thorburn: That is the tailored business loan.

Mr Mudie: The tailored loan. It was still the same risk, the same breakage costs. It was the same loan but you sold it as a part embedded or hidden in the business loan and you did not feel the need to explain it. Why is that not mis-selling?

David Thorburn: We felt we explained the features and benefits and risks of the product as well as we could. There was no intent to mislead or otherwise in all this.

Mr Mudie: Did I get the same flyer, however out of date?

David Thorburn: The process was enhanced on the way through, so for most of the time there was that flyer. I cannot remember whether the contents of the flyer changed.

Mr Mudie: So, you cannot tell me, when I took that business loan, when you sold those 11,000 business loans, that each and every individual got a flyer, however out of date?

David Thorburn: I cannot guarantee that.

Mr Mudie: You cannot guarantee that?

David Thorburn: No.

Mr Mudie: So why then, when you cannot guarantee that, have you not automatically included or why have you included only—what is it?—19% of the business loans as an automatic review, and the other 81% have to complain? As you said earlier—what was it?—25% or 30% of them have disappeared.

David Thorburn: Over 60%.

Mr Mudie: Over 60% have disappeared?

David Thorburn: Have been repaid. They have run their course.

Mr Mudie: If 60% then, it is not such a great task. The remaining difference between—20%—you are so worried about your customers, why were they not automatically thrown into the review? You cannot say it is logistics. It is only, what, 2,000 or 3,000 additional loans. So why weren't they? What is your caring bank's excuse for treating them differently?

David Thorburn: Because there is no pattern of complaint from the customers over the whole 13 years this product range has existed. 550 customers have complained about the fixed-rate tailored business loan so if there was stronger evidence of shortcomings in the sales process we would do that but that hasn't been so thus far.

Mr Mudie: There is no legal reason? This is just your decision; there is no legal reason for not including them in the review?

David Thorburn: That is correct. It is just a judgment at this point and that judgment is always open to change as we go through these reviews.

Chair: Do you think it is a reasonable principle of lending that you should ask the customer to take on risks, all the risks that the customer and you, between you, can reasonably foresee?

David Thorburn: With these products we were trying to help customers hedge their exposure to interest rate risks, but if they were not able to see the contract through to completion, there was a cost associated with that. With these products, we were looking to be fully indemnified from that cost. With the benefit of hindsight today, with new products going forward we would like to take a different approach. That was the approach at the time and it was—

Chair: Can I just ask the same question? I don't know whether you want me to repeat it, but was that a "Yes" or a "No" to the question that the customer can be reasonably expected to take on risks that you and they can, between you, foresee?

David Thorburn: For products of this nature in the main I think that is the case—

Chair: Right, and—

David Thorburn: —but what we want to do, if I may finish, is to cut their exposure to break costs in future and we are trying to work out what represents a reasonable risk for us going forward in relation to that.

Chair: Do you think it is unreasonable to expect a customer solely to bear the risk in a product that neither you nor they could reasonably foresee at the time the contract was signed?

David Thorburn: I think specifically none of us could reasonably foresee the fall in interest rates that occurred over that period, and that is why we are proactively reviewing—

Chair: This is an exception, an unusual risk and I think we are all agreeing with you that that is what it is.

David Thorburn: Yes.

Chair: But the question I am asking is: given this huge left-field risk, is it reasonable for that to lie in your contract terms with the customer rather than the bank?

David Thorburn: Yes, I think in a normal interest rate cycle it is. What we need to guard against is—

Chair: But this is not a normal interest rate cycle.

David Thorburn: —a not normal interest rate cycle.

Chair: I will ask the same question again. Given the exceptional nature of this risk that has materialised, which was, therefore, a risk that could not reasonably have been foreseen by either party. Is that something that should usually lie—where there is this huge difference of information and understanding, as Pat McFadden was suggesting—with the customer or the bank?

David Thorburn: In these exceptional circumstances we want to look at the cases where the customer has complained to us and feels that cost was excessive and not properly explained and try to help them deal with that cost.

Chair: Okay. Could I just have an answer to the question: do you think it is reasonable that in those circumstances the risk should lie with the bank or with the customer?

David Thorburn: We are trying to find a balance in these exceptional circumstances. The time of the extreme fall in interest rates, we are trying to find a balance through there where the bank shares some of that.

Chair: Your view is that it should not lie with the bank but be shared?

David Thorburn: That is what we are trying to do. We are trying to strike a balance in our complaint handling.

Chair: We have got to an answer. It has taken a bit of time.

Jesse Norman: Ms Crosbie, I want to get some numbers out, if I may, about the complaint system that you have. How many complaints have you received directly regarding the sale of fixed rate?

Debbie Crosbie: Fixed rate, 550 complaints.

Jesse Norman: So 550, you said out of 8,000?

Debbie Crosbie: 8,372.

Jesse Norman: Loans offered?

Debbie Crosbie: Of the fixed rate.

Jesse Norman: And made, yes.

Debbie Crosbie: Yes.

Jesse Norman: How many of those complaints have been upheld?

Debbie Crosbie: We are working our way through that. While we might not uphold them all, on evidence to date, we expect that something in the order of 60% of our customers who have complained will receive some form of redress. That is mainly aligned to the situation we have all discussed around break cost.

Jesse Norman: That implies a little over 300; 323—

Debbie Crosbie: As I say, we are working our way through it. We are only half way through that so that is a forecast.

Jesse Norman: You have gone through about 250 complaints so far?

Debbie Crosbie: Roughly. I don't have the precise number of where we are. We are about 50% through that.

Jesse Norman: What are the characteristics of a mis-sale of a fixed-rate tailored business loan?

Debbie Crosbie: A number of these complaints are not about the sales process. As I said, in most of the complaints we review, the customers were keen to protect themselves from a rising interest rate environment. I think that is one of the things that is quite important for the Committee to understand. We do see a demand for customers who are in business, they want certainty over the period that they have contracted the loan for. They want certainty in terms of what they are paying. What we do find, though, when customers' circumstances have changed and they want to break the contract earlier than they originally anticipated they wanted to hold the contract for, is that there are some customers who are surprised at the level of break-cost charges. That is where we are working with customers to redress them and on many occasions waive those break costs.

Jesse Norman: If I may digest that, when you have had a mis-sold TBL that you have been able to see one reason has been the selling process—

Debbie Crosbie: We have occasions where—yes.

Jesse Norman: —and another reason has been break costs?

Debbie Crosbie: That is correct.

Jesse Norman: Have there been any other reasons for mis-selling?

Debbie Crosbie: Sometimes people complain about the general level of services, for example. There is a range of issues. Sometimes the complaint can start in one particular area and then the customer can widen it. So we look carefully at all the reasons.

Jesse Norman: So, based on the half of the complaints you have had so far, you think about 60%. That is around about 300-something of the 550 will prove to be upheld?

Debbie Crosbie: They will receive some kind of redress. That might be that we believe the sales process was adequate but the customer does not believe it was the case, and we accept, because of the exceptional circumstances we have all discussed, that it is appropriate to provide some level of financial redress.

Jesse Norman: Of the 250 that you have assessed, how many actual outcomes have been received?

Debbie Crosbie: In terms of final letters?

Jesse Norman: Final settlements agreed, redress and all that stuff.

Debbie Crosbie: In the fixed-rate review—I would need to check—I think it is approximately between 50 and 60.

Jesse Norman: Fifty and 60. So would it be fair to say that you have found then 60% of the 250 you have done so far have been upheld? Is that what you said?

Debbie Crosbie: No. We consider it upholds—sometimes we don’t agree with all elements of the customer complaint, but we do believe, because of the circumstances, it is appropriate to pay financial redress, so the number I am referring to is where we have agreed to pay some form of financial redress to the customer.

Jesse Norman: How many of the 250 you have worked through so far have you agreed with the customer or agreed that there is some form of redress owing?

Debbie Crosbie: We have come to decisions on roughly about 250 but obviously we have to have discussions with the customer. We have to explain our outcome and we have to agree a settlement, and we are keen to do that. So I think to date we have managed to achieve that in roughly 50 cases but we are working through them.

Jesse Norman: What I am trying to get a handle on is: of the 250 you have worked through, for how many have you come out with a view, “We were right and the customer was wrong” and how many have you come out with a view, “The customer is right” and then there is a further question as to how you give them redress.

Debbie Crosbie: In about 60% of the cases, we believe there is some form of redress due to customers.

Jesse Norman: It is about 150 then of the 250—

Debbie Crosbie: That would be about right.

Jesse Norman: —of which you have processed and handled about a third?

Debbie Crosbie: Yes.

Jesse Norman: And you have been going for how long?

Debbie Crosbie: This review started in earnest in late January.

Jesse Norman: In late January. So when do you expect you will have worked through all these cases?

Debbie Crosbie: We expect to complete all the review of the files by September this year, and obviously we are reliant on discussions with customers to settle.

Jesse Norman: Do you think it is possible that, of 550 that you have received, having worked through them, you will identify further cause for concern in the other 7,500?

Debbie Crosbie: An important part of our process is to continually look at what we discover on the way through, and I think it is possible that we may discover more on the way through that may ask us to look at more files.

Jesse Norman: So you acknowledge the possibility that there could be more than the 550?

Debbie Crosbie: Absolutely.

Jesse Norman: Even though only 550 have complained?

Debbie Crosbie: Have complained. Yes, we do.

Jesse Norman: That is helpful. How much redress has been paid out to customers with a fixed-rate TBL?

Debbie Crosbie: I think the number is quite low. I would have to confirm the number but, as I said, we are in the process of going through those files. So it will climb when we settle with clients but I would have to check the number for you.

Jesse Norman: Quite low, less than £10 million, less than £100 million?

Debbie Crosbie: It would be less than £10 million for fixed rates.

Jesse Norman: So it is a very modest amount. What is the total capital value of the 8,000 TBLs that you made?

David Thorburn: Most of them don't exist now so it is not a number we would have.

Jesse Norman: Sorry?

David Thorburn: Most of them don't exist now. They have been repaid.

Jesse Norman: What was the total asset value of them, so we can get some sense as to what your rate of payout is?

David Thorburn: I have no idea, I am sorry.

Debbie Crosbie: We would have to come back. A number of them roll into other loans, so while—

Jesse Norman: If you could give us that information, I think it would be helpful to know what percentage, your payout.

Debbie Crosbie: Yes. We will submit it in writing.

Jesse Norman: Some of these customers obviously have gone to the Financial Ombudsman Service. How many have made that appeal?

Debbie Crosbie: Sorry?

Jesse Norman: How many of your customers have gone to the Financial Ombudsman Service?

Debbie Crosbie: In total, of the 550 complaints we think roughly half of them took up their rights with FOS.

Jesse Norman: How many cases have been upheld by the Ombudsman?

Debbie Crosbie: We have had 67 adjudications to date, not all of them upheld. I think roughly—I need to check the final number of cases upheld. What I would also say is that, regardless of whether customers have FOS rights, and there are a number of our customers in that 550, we will still deal with them in the same fashion. So whether they are time-barred or excluded for any other reason we are dealing with them in the same fashion.

Jesse Norman: Have the Ombudsman's adjudications been at a higher percentage rate than the ones that you have adjudicated or—

Debbie Crosbie: No, that is not the case. We find that our decisions are very closely mirroring the Ombudsman's decisions. In fact, we meet the Ombudsman very regularly. We discuss the adjudications and where we see evidence that there is any deviation in the way that we make decisions we make sure our methodology is reviewed to include those outcomes.

Jesse Norman: Thank you for that. A final question or question and a half. The law firm Carter-Ruck said that your complaint-handling conduct was "Extraordinary and wholly at odds with the approach taken by every other institution with which we are dealing". Tim Murphy, from Seneca Banking Consultants, said to this Committee, "We have no faith in the internal procedures now. We just do not get anything out of internal bank procedures". Why should customers have confidence in the complaints procedures that you have or that you have outlined today?

Debbie Crosbie: The voluntary review that we have opted in our more complex products, as I have outlined, is overseen by the skilled person. So that deals with that. The fixed-rate review, we are absolutely committed to making sure that the outcomes we deliver are lined up with FOS, and as I have covered, we find that our judgments are very similar to FOS. The other thing I would say is that the FCA talk to us very regularly about our complaints handling in this area. We update them on the voluntary review on a weekly basis, and I also update both the board and the FCA on all our complaint handling in regard to this matter very regularly.

Jesse Norman: Have you looked at strengthening the credibility of the complaints procedure in order to address some of these issues?

Debbie Crosbie: We very carefully look at our complaints procedure, and I would say that if any customer is unhappy with the procedures with this review, I would be very happy to look at the case again.

Jesse Norman: You have both accepted that these TBLs have the functional equivalent of embedded swaps within them. So is there any reason why you should not recognise that formally and invite the FCA to adjudicate on the swap issues from their regulatory perspective?

Debbie Crosbie: We have shared all our plans with the regulator very regularly. I update them personally very regularly and they seem to be satisfied with what we are doing to date. If the regulator—

Jesse Norman: Would you be happy with that formal extension because that would obviously give a lot of comfort to potential complainants?

Debbie Crosbie: If the regulator was keen to do more with us of course we would co-operate as we do with them on all other matters.

Jesse Norman: The same for you, Mr Thorburn?

David Thorburn: Yes.

Jesse Norman: Thank you very much. Thank you, Mr Chairman.

Chair: Have you made a lot of money operating outside the regulatory perimeter prior to the compensation you are going to start paying?

David Thorburn: If you are talking about this product range, this would have been a profitable product range over the period up until this all began, yes.

Chair: As a proportion of your total lending, what kind of profitability on commercial lending are you talking about?

David Thorburn: The whole tailored business loan range, most of the revenue, somewhere between 90%, 75%, in fact went to the parent.

Chair: Sorry, I wasn't able to catch that. Can you say that again?

David Thorburn: The bulk of the revenue on the sale of these products went to the parent. It did not go to Clydesdale Bank.

Chair: But it has been good business, hasn't it?

David Thorburn: Yes, it has. Yes.

Chair: Thank you very much for coming to see us—what is now almost this afternoon. It has taken slightly longer for us to go through the areas we wanted to cover. We may have more questions that we will want to put in writing and we are very grateful for the evidence you have provided.

Examination of Witnesses

Witnesses:, gave evidence.

Chair: Thank you very much for coming to see us this morning. I am sorry that the beginning of the hearing has been a bit delayed by the previous session we just had, which overran a little.

Why is it that there is still a net reduction in lending for Q1 2014 on top of the £2.4 billion reduction seen in the last nine months of 2013? Mr Sullivan?

Chris Sullivan: Primarily that is caused because of the rundown of the poor-quality lending book of the pre-2008 period.

Chair: Sorry, for the pre—

Chris Sullivan: The pre-2008 period where RBS lent excessively, well above its market share, in particular around property. We have been trying to make the bank much more balanced and safe and, therefore, running down the property-related lending of particularly poor quality. So some £2.3 billion was taken out of that particular portfolio, which obviously caused a net reduction in total RBS charge, although you would look at normal lending and you would see that RBS is still the biggest lender of new loans in the UK.

Chair: This shrinkage is caused entirely by what one might call the Goodwin overhang?

Chris Sullivan: It is not entirely that. There has been a situation over the last five years or so where customers have repaid consistently more than they are contractually obliged to. We have seen increases in our deposit accounts during this time, so there is a bit of a flight to safety with some customers. Although you are seeing some very encouraging signs now of lending starting to move upwards. So many steps that we have taken to encourage people to take loans responsibly, showing I think a 20% improvement year on year as we speak.

Chair: With all that risk aversion there must be some cracking good business opportunities out there.

Chris Sullivan: We have never been averse to taking appropriate risk and I think the problem—

Chair: No, the risk aversion among the customers. If you can—

Chris Sullivan: That was primarily why we asked Sir Andrew Large to come in and look at us and say, "What could we do to improve customers' opportunities to borrow from us?"

Chair: Yes, which brings us to the Clifford Chance review as well. You have described that as independent. Doesn't Clifford Chance do business for RBS, other business?

Chris Sullivan: Derek, do you want to answer that?

Derek Sach: Yes, we do business with all the large corporate lawyers. You have to choose somebody of stature. In the case of Clifford Chance, they provided a partner with relevant experience who has never done any work for RBS. You have to presume that people such as that do have integrity. Having seen the report, I have no reason to believe that they did not exercise complete independence and even the FCA has commissioned them to do a similar piece of work for themselves.

John Mann: How many drafts of the report were submitted to you?

Derek Sach: I have no idea because I had no part in it, being the subject of the report. All I was asked to do at the very end—

John Mann: Mr Sullivan?

Chris Sullivan: I have no idea either. I never saw a single draft.

John Mann: So you have no idea of the drafts of the report?

Chair: Before we move on from that question, are you confident that drafts were not seen by—

Derek Sach: Drafts were certainly fact checked by the organisation because, obviously, when you prepare a lengthy document there are going to be errors of fact that need to be corrected.

John Mann: How do you know that, Mr Sach?

Derek Sach: I was asked to check some aspects of the numbers that were used here and there in the report.

John Mann: So there were drafts that were seen?

Derek Sach: There was certainly one but whether there were more I don't know.

John Mann: Was anything altered in the drafting process?

Derek Sach: So far as I am aware, only errors of fact.

Chair: It might be helpful if we have that confirmed in writing; it would be of some value to us.

Derek Sach: Yes, sure.

Chair: Thank you.

John Mann: You have been with GRG for a long time, Mr Sach. How much has it contributed to the bank's profits?

Derek Sach: It does not contribute to the bank's profits at all. Our main objective is to restore the customers' health and strength and—

John Mann: You are saying GRG makes no money for the bank?

Derek Sach: In total, if you look at what GRG achieved over the five-year period in question, the customers that we looked after in this particular area—the SME area—lost £2.1 billion for the bank.

John Mann: My question is: what does GRG make in terms of profits for the bank?

Derek Sach: It does not make a profit for the bank. It has income in the form of fees. It sometimes has equity realisations if it has taken an equity stake in the past in something, but against that, you have the cost of running it and also these connections there are the impairments.

John Mann: So GRG runs at a loss is what you are saying for the bank?

Derek Sach: If you look at the portfolio we look at, yes, it runs at a loss.

John Mann: I am talking about GRG as an institution within the bank.

Derek Sach: It runs at a loss.

John Mann: It runs at a loss?

Derek Sach: Yes.

John Mann: Has that loss increased or decreased over the last 10 years?

Derek Sach: Increased dramatically if you do it year by year in 2009, 2010, and it is starting to come down now because the impairments are falling.

John Mann: How do you calculate the fees that you charge?

Derek Sach: The fees are related to a number of factors: the amount of work that people are doing on a particular connection; the increase in risk that may be apparent in any particular transaction.

John Mann: Why is it that in the Clifford Chance report they could not work out how the fees were calculated?

Derek Sach: I think, yes, that is a reasonable criticism that it is not as transparent as ideally it would be for customers. It is something that we have been working on since 2012 to try to improve people's understanding of the fees we charge and to make the fees less onerous for them. We have always wanted to be very much at the leading edge of restructuring and I was a founder member of that sort of movement in the 1990s in the UK when we—

John Mann: Clifford Chance cannot work out how much the fees are but you say that the fees are not calculated to make a profit for the bank?

Derek Sach: No. The fees are there partly to offset the costs that we incur, but also very often to compensate us for the additional risk.

John Mann: They are compensating you for risk, so you are making a profit out of the fees then?

Derek Sach: No, because unfortunately a number of the customers who come to us do cause losses for the bank. We lose capital, so overall there is a loss.

John Mann: But they do not all choose to go into GRG and you choose the fees but, according to Clifford Chance, no one can work out where the fees come from. The Clifford Chance report identified that some perfectly profitable businesses were going into GRG. Why is that?

Derek Sach: I do not think the Clifford Chance report said that profitable businesses were coming into GRG.

John Mann: Clifford Chance identified a number of cases where no event of default had occurred.

Derek Sach: That would be correct because an event of default is when a customer cannot pay his interest or his capital repayment and yes he could still be profitable; I acknowledge that. But they are transferred to us because there is a belief that we can manage them better than the frontline.

John Mann: And make a profit out of them.

Derek Sach: No, our objective is to restructure them. We restructured in each of the difficult years numbers like 850 customers that we reorganised. If I could give you an example: something called CFN in Skegness, a manufacturer of polythene bags, lost a major customer and had some difficulties. We helped them recruit a new CEO. We introduced them to someone who worked alongside him to help him develop a new strategy. We lent them some more money, and 70 jobs were saved in an area that is probably quite difficult for employment.

John Mann: How come Clifford Chance identified that in your appraisal system you particularly highlight cases where individuals have generated strong revenues in your section?

Derek Sach: People have a balance scorecard, and, yes, strong revenues would be something that perhaps someone has done. But along that, they would have restored probably half a dozen customers back to health and strength and—

John Mann: It sounds to the small business community, and the rest of the world, that this is a profit centre within the bank whereby you are maintaining your profits at the expense of small businesses, some of which are perfectly viable, to which you give no choice. You are exploiting the lack of competition in the market, aren't you, and the lack of choice for small businesses and that is what you are about in your section?

Derek Sach: We are not about that. We are very much about helping businesses. Our main focus is not only on restructuring their finances but helping them restructure the business, and this is happening on a large scale for these SMEs. During the period we handled something like 10,000. Less than 10% of them end up in insolvency.

John Mann: The Clifford Chance report says that the GRG training manual suggests threatening to remove distressed businesses' overdrafts as a way of gaining leverage. It also says that your internal valuations were not carried out in accordance with best practice. Despite that, it is a report that you have commissioned, and you have had drafts of it, it is a pretty damning report and the impression it gives is that GRG is there to boost up the bank's profits at the expense of the small business customers who are stuck because they cannot go somewhere else. That is a reasonable summary, is it not?

Derek Sach: No, I do not think it is. If you take the two points you have raised, on the training point I would acknowledge there is an unfortunate phrase in a 50-page document that is pre-reading for a training course. I agree with you that the way it is written is unfortunate because it seems to indicate that, as you say, an overdraft should be used to threaten someone. The intent is if there are no defaults but you can see that someone is headed for difficulty. Bear in mind that these are restructuring specialists who also have been involved closely with people who restructure big companies like Thomas Cook where we save companies at short notice; 30,000 jobs saved because we put up £25 million more than our share. It was intended that you should draw to the customer's attention that the overdraft in due course would be hitting its limit and we would not be minded to increase it unless they made some changes to the way the business was operating. That particular phrase has been changed.

On the question of valuations, the valuations Clifford Chance are referring to are valuations that are used informally as opposed to any that are used formally where outside valuers are instructed.

John Mann: That is what SMEs are complaining about. Has anyone from GRG met any Government Ministers in relation to its performance and its role with SMEs in the Treasury or the Business Department over the last two years?

Derek Sach: Not that I can immediately recall but I have certainly been consulted personally by people from the Treasury, the Bank of England and BIS on things like the Business For Growth organisation and are there other ways of increasing and improving lending to businesses.

John Mann: But nobody has met, or been asked—I am not suggesting you would be running to meet as it would be a Minister's responsibility—no one from the Business Department, no Treasury

Ministers have been to meet you after the kerfuffle following the Tomlinson Report?

Derek Sach: No, definitely not since then.

Chris Sullivan: I have met many Ministers and Treasury officials over the last five years and discussed a number of people who have been in GRG and various other parts of the bank. It is worth noting that—

John Mann: And on GRG?

Chris Sullivan: Yes. I have spoken to members of this particular Committee about constituents who have been in GRG.

John Mann: No, I am talking about Government Ministers in the context of Tomlinson specifically.

Chris Sullivan: In terms of Tomlinson, we did an independent report via Clifford Chance and I have done a number of other independent reports around allegations from Mr Tomlinson. Those reports have all proved the allegations to be fallacious.

John Mann: I am only trying to clarify that neither the Business Secretary and his Ministers nor the Chancellor and his Ministers have come and met you and asked questions in relation to this, and you are saying that they have not.

Chris Sullivan: No, they have not.

Derek Sach: I have to say I would be very happy to talk to a wider audience than this one if people were interested, and tell them a lot more about what we do because I genuinely believe that we do good overall. If you handle 10,000 customers I acknowledge there are bound to have been some mistakes. I also understand the difficulty that entrepreneurs who fail, or who are close to failing, find themselves in. It is a very traumatic and difficult experience for them. The slightest sign of irritation or not treating them absolutely properly is bound to cause upset, but overall we get quite a lot of letters thanking us for what we have done.

To give you another example, a firm called Independent Slitters in Oldbury, a small firm, made an unfortunate diversification. We worked with them, helped them unravel the unfortunate diversification, lent them more money and 20 jobs were preserved. Again, they are very enthusiastic. They have been in the local press in the West Midlands and they cannot thank us enough for what we did. But, as I say, we have a machine. There are 1,300 people sitting out there today watching this, or will watch this when it is on the internet, who feel very aggrieved by the comments of Tomlinson, that he should impugn their integrity in the way that he did.

John Mann: My comments were quoting from your own internal Clifford Chance report.

Chair: If we were to poll these 10,000 customers with respect to their confidentiality of reply, is it your view that the majority would be expressing gratitude for their contact with GRG?

Derek Sach: We do the same survey that Chris's division of the bank does, asking customers questions about satisfaction. Overall, we are probably about 3% to 5% perhaps behind them. In terms of quality of relationship manager, because our people have a lot more time to spend with the customer and are very thoroughly trained in their restructuring skills, they tend to score a little bit better.

Chair: Is the answer that a majority would be expressing gratitude?

Derek Sach: I would hope so, yes. We do not ask them that question but they are asked if they are satisfied with what we do, are we delivering what we promise, and so on. Then, yes, the majority would.

Chair: When you say that the fees are—I think I was quoting you but correct me if I do not have it quite right—"not ideally as transparent to customers as they should be", that is about as big a euphemism as it is possible produce, is it not? Frankly, opaque to the point of incomprehensibility might be closer to the mark.

Derek Sach: I think that is a little extreme, but certainly they could be clearer, I fully acknowledge that. It is something that we are working on and we have introduced recently a 90-day moratorium on adding default interest to customers who get into difficulty. That is something every bank does so it will be interesting to see if the industry follows suit to give them a period of time to try to sort their affairs out. We have also undertaken to give people 30 days notice of changes in fees because, again, that gives them a chance to discuss if they do not understand.

Chair: Your earlier point a moment ago was that you get involved because—again, I am more or less quoting, I hope—"There is a belief that we [that is RBS] can restructure these businesses for their own good", for their benefit, and therefore the businesses have benefited from your involvement. Whose belief is this? Who forms that judgement?

Derek Sach: I believe we have been a feature of the restructuring scene for quite a long time. I joined RBS at the end of—

Chair: That was not quite the question. I am sorry to interrupt. The question is somebody at the beginning of each of these processes before a firm encounters GRG forms a judgement about whether there are benefits to be had from restructuring. My question to you is who forms that judgment?

Chris Sullivan: It is probably worth me taking that. It is a great question. We would rather that GRG or the restructuring unit was never necessary in the bank. Its primary use is when one of our customers gets into financial difficulty.

Chair: We will be pressed for time today. We do know that. The question I am trying to get at is who is forming this judgment?

Chris Sullivan: It will be formed by a combination of the relationship manager who will see an event, some deterioration in business performance, a particular contract that is lost, excessive use of overdraft, excessive limits, behaviour that is generally—

Chair: At that point they go and consult GRG. Is that correct?

Chris Sullivan: No. At that point they go and talk to our Credit Department and then a group is put together of the relationship management team, the Credit Department and a member of GRG to discuss the case to see whether or not we believe the GRG unit would be beneficial in terms of getting involved.

Chair: In forming that judgment and in offering the advice in that group you have just described, is GRG acting as a cost centre or a profit centre?

Chris Sullivan: GRG is acting as a service to the client.

Chair: I am going to ask the same question again. In forming that judgment is GRG acting as a profit centre or a cost centre?

Chris Sullivan: A cost centre. In the terms you just asked they would be a cost centre.

Chair: Then GRG is not, as is commonly supposed, a profit centre?

Chris Sullivan: It is absolutely not a profit centre.

Chair: In the bank?

Chris Sullivan: In the bank, absolutely not.

Chair: It is inappropriate to describe this activity as has been described?

Chris Sullivan: Totally inappropriate.

Chair: The activities of GRG are a business cost.

Chris Sullivan: They are a business cost, helping customers if they can to get back to normal.

Chair: Having worked in a bank, and there are people around this table who have, the distinction between profit centres and cost centres is well understood and is a crucial one for the internal running of the bank. You are saying this essentially operates entirely as a cost centre.

Chris Sullivan: Absolutely, unequivocally I am saying that this is a cost centre.

Chair: It has always done for the period we have under review?

Chris Sullivan: Correct.

Derek Sach: If I could just add to that, the asset remains with the donor division, because there are many divisions across RBS and we manage their assets. The asset remains with them and any income accrues to the division.

Chair: That is very helpful clarification.

Mr Ruffley: Mr Sullivan, on the question of the terms of reference it was quite specific—was it not?—and I am quoting from the terms of reference, "The independent review will be undertaken by Clifford Chance. It will review the most serious allegation made in the Tomlinson Report", namely, that RBS through its GRG division was "culpable of systematic and institutional behaviour in artificially distressing otherwise viable UK SME businesses and through that putting businesses on a journey towards administration, receivership and liquidation". What do you say to those people who believe that is quite a high hurdle? It is very easy to refute the charge. Why was that remit so narrowly drawn?

Chris Sullivan: That was the allegation that was made and it was a very, very serious allegation that needed to be proven to be untrue and was.

Mr Ruffley: There were several allegations, were they not? I am asking you why you chose one particular one.

Chris Sullivan: Because that was by far the most serious.

Mr Ruffley: Let us turn to some of the charges referred to in the Clifford Chance report. I just want to have another go at a question Mr Mann asked. RBS in terms of its internal valuations, and I quote, "Internal valuations were not carried out to the standard of the Red Book". What action are you taking in relation to that deficiency?

Chris Sullivan: That is not really my area. Mr Sach could answer that for you.

Derek Sach: That reference is to valuations that people do within GRG as part of the process of looking at a customer and seeing their state of health. You have to remember that 60% of this particular portfolio is property. They are pure property transactions. They are not businesses that are going on to the next generation or anything. They are often just a one-off property transaction, and 20% is very heavily property-related; hotels, pubs, that sort of thing, nursing homes.

It is often very useful for someone internally to say, "I would estimate that property is worth X". But no significant decision is ever taken on the basis of that sort of valuation. It is an informal part of the internal process. If we want to take action and the customer disagrees, then we would have a formal valuation done by a third party that the customer would instruct in nearly all circumstances. The reason we do it internally sometimes is because it saves the customer money because you need a figure to talk. Particularly in 2009 and 2010 most of this property was unsaleable, so somebody saying, "This is worth £1 million" is a sort of benchmark and to spare the person £5,000 to get a valuation—

Mr Ruffley: I take the point. Can we have another go at this charge about the training manual? You said you had amended the wording of the training manual. What about the underlying business practice of threatening to remove a business overdraft in order to get more leverage in negotiations about equity? I know you have changed the wording of the manual, but what about that practice?

Derek Sach: The reality is not so either.

Mr Ruffley: You just deny that ever took place?

Derek Sach: Yes, and I have found no examples of it. Clifford Chance asked me about that in my interview with them and it would be something that concerned me. I and they can find no evidence of that happening.

Mr Ruffley: No evidence of that. Clifford Chance say in turn that they could not understand the RBS fees in your part of the bank, and I quote, "We found it difficult to understand how the bank calculated the fees it proposed to customers in any particular case and therefore found it difficult to assess allegations of unfairness". Those are Clifford Chance's words. I declare an interest, having formerly worked at Clifford Chance, many years ago. If very clever lawyers at Clifford Chance found it difficult to understand how the bank calculated the fees does that not suggest they are too complicated for customers?

Derek Sach: Yes, and I acknowledge that we have been working on this since 2012 to try to make them simpler. We stopped charging a number of fees to make it clearer for customers during 2013 before any of this occurred and, more recently we are giving people 30 days notice of any change or charge and suspending default interest for 90 days.

Mr Ruffley: You are quite proud of suspending the default interest for 90 days and stating that other banks do. Are you the only major SME lender who now does not charge for the 90 days?

Derek Sach: So far as I am aware.

Mr Ruffley: Has that come as a direct result of this report?

Derek Sach: Yes, in parallel with it.

Mr Ruffley: Clifford Chance found that RBS sought to encourage or incentivise a specific course of action by the customer for its pricing, such as an exit or sale of assets to reduce the customer's debt. It is clear that Clifford Chance did not want to pass any censorious judgment. They merely say, "It is difficult for us to say that it is wrong in principle for the bank to use fees as a lever". Have you amended your practice in that respect, even though Clifford Chance does not wish to pass judgment?

Derek Sach: I think they are observing something that we do and you are probably familiar with and, again, I do not think RBS would be alone. If the customer fundamentally disagrees with, say, the desire to sell a property within a certain timeframe or he is confident he can sell it within six months, you may reach an agreement with him that he can have six months to sell it, but if he has not sold it by the end of six months then, because we feel we are taking additional risk, the interest rate would go up. I do not think that is unfair practice and I think it is a reasonable commercial thing to do with somebody.

Mr Ruffley: I have a final question for Mr Sullivan. There were also allegations in the Tomlinson Report, and you having acknowledged, Mr Sach, this did happen in some cases and was inevitable, given that you have several thousand customers, of rude, insensitive or aggressive behaviour on the part of a minority of your employees. Can I ask, Mr Sullivan, did you ask Clifford Chance to do any detailed report on instances of that kind, and if not, why not?

Chris Sullivan: I did not commission the report so again you should ask Mr Sach. But, quite clearly we would not condone any behaviour that is aggressive or impolite and certainly all our relationship managers are well aware of that.

Mr Ruffley: What active steps have you taken since the Tomlinson Report to ensure that instances like this are kept to a bare minimum?

Derek Sach: If I could make it clear that the Clifford Chance report and the management of all the process was managed by John Kane, who is the head of regulatory affairs in the bank, working closely with the bank's legal department. Like Chris, I would never tolerate aggressive behaviour in any of the team and because of the nature of the work they do they are trained in how to deal with people in what are very difficult circumstances. There were 13 customers that referred to aggressive behaviour. Our internal legal department investigated all of them completely independently of me or anybody in GRG and found that there was absolutely no evidence to substantiate that behaviour.

Also—can I make it clear?—the 135 cases that Clifford Chance looked at were very much an adverse selection to try to find if the, I think appalling, allegation that was made of systematically distressing companies had happened, then we would want to find it because even if there was one, that is one too many. So they were targeted at the very worst 135 in the portfolio and the 13 are out of that 135. I would hate the Committee to say that is 10% are going to say that, because I think they were a particularly distressed and feeling hard-done-by group of customers.

Mr Ruffley: That is very helpful, thank you.

Chair: Can we just go back to this question of whether you are a profit centre or a cost centre? I did not have to hand the Large review, although I have had several conversations with Sir Andrew about this. I am just reading from the review on page 52, "GRG is run as an internal profit centre". He then explains that this leads to conflicts of interest for GRG for RBS's treatment of customers. For the avoidance of doubt, he then explains what a profit centre is, "with its profit and loss account based on the incremental income that it generates for the bank, less its operating costs". Why did Andrew Large get it so wrong? I presume you are sticking by your evidence.

Derek Sach: Yes, I am and he will have seen a piece of paper that records for GRG the costs and the income. But what it does not record are the impairments and the internal costs allocations. The thing we are judged on is very much our costs. We submitted a note to this Committee when we were going to come here in March that explained we are not a cost centre and we also—

Chair: Not a profit centre.

Derek Sach: Sorry.

Chair: That is all right. It might have been a Freudian slip or not. Do carry on.

Derek Sach: That we are not a profit centre and a copy of that was sent to Sir Andrew.

Chair: So he just got it wrong?

Derek Sach: I believe so, yes.

Chair: Therefore the whole of that part of Sir Andrew's report is, to put it mildly, misconceived because on the basis of this point he carries on to explain the governance process for the critical decision of whether a business has reached the point of non-viability. It is therefore opaque both to the relationship management part of RBS and to the SME itself, that may be unaware of or unprepared for the consequences of changes because, and I am paraphrasing now, it is unclear whether GRG is taking its decisions on the basis of what is in the interests of the firm or in the interests of the bank.

Derek Sach: There is another piece that I think you would find he is linking that to.

Chair: I have paraphrased that to avoid reading out a whole paragraph.

Derek Sach: I appreciate that. Just the one important point that he picks up on somewhere around there is that GRG has the right to insist on the transfer of a case. That is designed very much for the larger customers, things that belong to the investment bank—

Chair: When he says, "GRG retains the ultimate authority over which customer relationships are transferred", he was also pretty much wrong there. He was misleading us. That only refers to large customers. Is that correct?

Derek Sach: Yes, and I am not sure he would have even known that because he would have seen some part of our policy and procedures that does make that statement. But it is only ever used for the large companies where investment bankers tend to want to hang onto their customers rather more than perhaps the people who manage SMEs. We have checked and that right has never, ever been used in the whole period on an SME. But, as Chris described earlier—

Chair: It is a bit depressing that your chairman called in arguably one of the best men around in this field with huge experience both of commercial banking and central banking and he has written a report and drawn conclusions that are fundamentally misconceived.

Derek Sach: I think he has misunderstood the nature of how those two things would link together because we have never, ever used that right on an SME. If you have not done that then that rather weakens his first argument.

Chair: It is very helpful that we have clarification at this point.

Steve Baker: Mr Sach, you mentioned that you are overall judged on your costs. Could you just explain how you measure the performance of the individuals in your team and how you therefore incentivise them?

Derek Sach: They will have a balance scorecard in the sense that they will be expected to restore customers back to the good bank. They will be expected to restructure customers. They will not be expected to receive complaints or if they do receive complaints there should not be very many. There will be a lot of subjective judgment on how well they handle things, their capacity for work and their ability to come up with answers to difficult problems. A whole range of things and yes, for each grouping of people there will be a cost base that is primarily salaries they will have to keep control of.

Steve Baker: Presumably there is a bonus pool. How does that scorecard feed into the calculation around who is getting what?

Derek Sach: The whole of GRG's bonus system is discretionary, including mine, and there is no formulaic bonus system whatsoever. I have always fought—I do not have to fight because I can insist—that bonuses are going to be discretionary. People often say, "If I restructure 10 companies I surely should get more than someone who does five" or whatever. But the difficulty has to be taken into account and sometimes five difficult problems in a depressed area of the country is a much greater achievement than maybe restructuring a very large corporate where you have a lot of other professionals all around. So, it is all discretionary and let me say that people who handle these SMEs get relatively small bonuses in relation to their salaries.

Steve Baker: Could you give us an indication of what sort of levels and quantum those bonuses and salaries are?

Derek Sach: As a percentage, most of them would be in the 20% to 40% bracket.

Steve Baker: Of a salary of on average what sort of level?

Derek Sach: Their salaries would probably range from £30,000 to £50,000, £60,000.

Jesse Norman: Mr Sach, I am going to go back to this issue of profits and profit centres. Just to be clear, Andrew Large, banker for 20 years, chairman of the Securities Investment Board, member of the management board of the Swiss Bank Corporation, deputy chairman of Barclays Bank, Bank of England Monetary Policy Committee member; you would expect him to know what a profit centre and a cost centre of a bank was, right?

Derek Sach: Yes.

Jesse Norman: It is evidence of catastrophic misjudgment or misunderstanding or misinformation if he has failed to understand the nature of your business.

Derek Sach: I think that is a rather extreme statement of what he has said. He has linked two facts together in a way that to me is not logical, particularly because the second one just is not exercised and is not there, so far as these customers are concerned.

Jesse Norman: You entirely discount the possibility that he might understand the true function of business better than you are prepared to admit?

Derek Sach: Yes. I am not trying to cover anything up.

Jesse Norman: You said that people's bonuses are calculated on the basis of costs. It is very easy to run costs, right? You keep your salaries low, you try to avoid impairments and if businesses fold, they fold. Why is that not an effective way of managing costs if you are a member of GRG?

Derek Sach: I am sorry, I am not sure I follow exactly what you mean.

Jesse Norman: I am saying if you are entirely cost-focused it sounds like your bonus system is not giving any credit to people who extract businesses that avoid costs and in fact, potentially generate upside for the bank.

Derek Sach: They get credit for restructuring businesses. That is the thing they are really about; something like 850 a year.

Jesse Norman: I understand the advertisement. Let us pause there for a second. A cost avoided is an upside for you, is it not?

Derek Sach: A loss avoided, yes.

Jesse Norman: A loss avoided.

Derek Sach: Yes, and that is always is going to be a much bigger number than any fees you can earn. As I said to you, we lost on this segment of the bank £2.1 billion over the five-year period of 2008 until 2013.

Jesse Norman: Is the bonus conversation you described affected by losses incurred or not incurred on the portfolio you are responsible for?

Derek Sach: In the thing that Andrew Large refers to as a profit and loss, the losses and any recoveries are not part of the equation. That is why it just is not a profit and loss. It is a record of income and costs. It is not a profit and loss account.

Jesse Norman: But the point I think that we are trying to get to is the question of whether or not there is upside for the bank and whether or not the job of GRG is to gain upside and what kind these upsides are. One of our concerns, and one of Andrew Large's concerns appears to be that one of the things that GRG was doing was seeking to make profits for the bank at the expense of the wellbeing of some of the companies involved. That is why he potentially sees it as a profit centre.

Derek Sach: It cannot be a profit centre because we are making a loss on this particular segment that we are looking after, but you can minimise the losses and, yes, you are right there are occasions when upsides are earned. Again, they are rarely of any significant amount of money in this sector but if you take larger companies, something like Samsonite, where we took the risk of putting up some more money when the banks had to convert their debt to equity, we managed to recover 500 million by putting up 20 million at a moment of difficulty.

Jesse Norman: When there is a conflict between the bank and its customers, is your policy to put the customer first or the bank first?

Derek Sach: The customer always.

Jesse Norman: So why is it that one GRG employee has been quoted as saying, during the crisis, they were called in and told, "Save companies if you can but first and foremost get our money back and save the bank"?

Derek Sach: I do not know where that is coming from.

Jesse Norman: We can supply the information if you want. I think it comes from the Channel 4 video report that they did on this.

Derek Sach: Oh well, the Channel 4 video report is one of these whistleblowers.

Jesse Norman: It is certainly a former employee.

Derek Sach: So they say, but I honestly do not know.

Jesse Norman: So you would discount that?

Derek Sach: I am not sure I do discount it because I do not believe anyone would have said it and I am not sure—yes, I know which was the Channel 4 one, I spoke to the director of that programme and told them the subject of the programme, both the husband and wife had been disqualified as directors for seven and five years respectively. I was told by the director that was not really relevant.

Jesse Norman: I cannot comment on that but the same report quoted whistleblowers saying, "It was an immoral survivalist tactic the bank used, which had a huge amount of losses on their balance sheet to try to survive something. They have managed to destroy a number of businesses that did not need destroying."

Chris Sullivan: There was no upside, absolutely no upside in this bank or any bank in destroying a perfectly viable customer. Viable customers are sources of income generated for the organisation. If they become non-viable then we damage the organisation as a whole.

Derek Sach: We would never get any advantage from destroying a customer. Insolvency is always the last resort.

Jesse Norman: Are there any rules or regulations that prevent you from charging whatever you like to customers?

Derek Sach: Not that I can immediately think of other than just—

Jesse Norman: You can charge whatever you like?

Chris Sullivan: There are codes of conduct.

Jesse Norman: Codes of conduct, okay.

Derek Sach: But we wouldn't, we are always reasonable—

Jesse Norman: It sounds like Mr Sach is disagreeing with you, Mr Sullivan.

Derek Sach: I am not disagreeing at all, but I cannot think of a regulation that says you cannot charge more than X. But internal pressures—Mr Sullivan and others sit on what we call the Executive

Committee of GRG so there is considerable oversight of what we do within the bank.

Jesse Norman: Is it true that RBS staff were pressured to raise the amount of fees charged to GRG customers?

Derek Sach: No.

Jesse Norman: Why could Clifford Chance not understand your fees? I just do not understand that. Why was it not possible for them to understand? It sounds like they could not understand any single case of your fees, in any particular case.

Derek Sach: I do not know even which cases they looked at.

Jesse Norman: I think that is very—

Derek Sach: So I cannot comment. Yes, fees historically have—

Jesse Norman: Presumably they raised these fees with you? They said, "Could you explain it to us?" Were you able to explain these fees?

Derek Sach: Yes, all the cases are different. The complexity varies,

Jesse Norman: But it does sound as though your institution could not retrospectively explain the fees to Clifford Chance in any particular case; that is what it sounds like from their report.

Derek Sach: I was never asked about any particular case and if I were to see a particular case I would have an explanation as to why the fee is what it is.

Jesse Norman: But you would accept that if it is the case that others down the chain—you are after all the boss—could not even in retrospect, with thoroughly intelligent people on the other side, justify or explain those fees it is not clear that there is any accountability behind it at all. It sounds like they are charging whatever they like. Whatever the market will pay. There is not a structure to it.

Derek Sach: I do not think that is the case. The fees are for different purposes.

Jesse Norman: But you have not given any evidence as to why not. All we know is that Clifford Chance have said these could not be justified in any particular case. They have discussed it with RBS and there has been no justification. Now you are saying, "Well, I do not think that is the case" but that is not evidence; that is a psychological first-person report of your view. You are in charge; you would be expected to have that view.

Chris Sullivan: I do not think we said there is no justification. There is absolutely justification. What Mr Sach is saying to you is that every single case is different. There are different levels of risk, different levels of stress within the organisation, different facilities for each customer. On the basis of the mix of all of those things the relationship manager will take a decision that would relate to the amount of risk the bank was were taking and an appropriate reward for that risk. The appropriate reward element comes from market practice and internal checks that are made both by the managers of the bank and then the internal audit department above them.

Jesse Norman: But you would agree not having a decision procedure that allows some kind of basic structure for the charging of fees across different clients is a very strange thing, do you not think?

Chris Sullivan: That is not true, we have one.

Derek Sach: No, but there are—

Jesse Norman: You have one so you could give that to Clifford Chance; they could have understood that; they could have seen how it worked in each case?

Derek Sach: There are guidelines for different levels of risk.

Jesse Norman: Why did Clifford Chance not explain this or mention it? Why were they not able to understand why these fees are being charged? Did you give them to Clifford Chance?

Derek Sach: I imagine they saw them—they saw 1,200 documents—but I do not specifically know whether they saw that. Over the period we have become more and more focused on being able to explain things and being transparent. In the early days of 2008, 2009 you were looking at an organisation in terms of GRG that multiplied 10-fold over nine months as the bank was obviously in a very difficult circumstance. But the fees are charged for different purposes. There are fees for the time spent—which I think as lawyers they would find hard; we do not keep timesheets; there is an estimate—but any fees that are charged are always approved by somebody else so it is not just the relationship manager.

Jesse Norman: Thank you. Final question. I do not think it is appropriate to talk about the early days. As I understand it you joined RBS in 1992 to set up a specialised—

Derek Sach: I did.

Jesse Norman: —lending service that became GRG. So by 2008 this institution had been running essentially under your guidance for 16 years. You cannot suggest it is somehow a new thing. I do not know how long you have been charging inexplicable fees.

Derek Sach: No, the quantum was just phenomenal. Any business that multiplies 10-fold in nine months is going to have stresses and strains. But one of the things I did when I first joined RBS was to take them from top of the league—appointing more administrators or receivers as it then was than any other bank in the UK and RBS was very small then—within a year to being bottom and appointing fewer. The mission was to try to do something constructive for these customers and that has always been the ethos, and it still is, of what GRG does. It is about restructuring. I was very much a founder member of the London approach and the Bank of England's initiatives in the 1990s, which led in London to a complete world-leading position on restructuring. That has persisted right the way through.

Jesse Norman: Final question just on this, Clifford Chance stated that it found it difficult to assess allegations of unfairness regarding fees and so the question is this: is a fee that cannot be explained a fair fee?

Derek Sach: I would say it is not a transparent fee if it is not well explained to the customer.

Chair: Is an untransparent fee an unfair fee?

Derek Sach: You are bandying words—"untransparent".

Chair: I think it is fairly reasonable.

Derek Sach: If fee is not a transparent—

Chair: In other words, were the fees fair?

Derek Sach: Generally banks need to be much more transparent and we are trying much harder.

Chair: All right, unless you want to carry on with that line of questioning I think we have arrived at a pretty clear conclusion on that.

Jesse Norman: I think if Mr Sach were on the other side of a non-transparent fee he might be inclined to call it unfair, Mr Chairman.

Chair: We will think about that as a group privately.

You said that the bank was in very difficult circumstances, I think that is undeniable. Was there no pressure within the bank to rebuild the balance sheet in the short term as fast as possible?

Derek Sach: There was a need to, yes, rebuild the balance sheet and improve capital but so far—

Chair: Therefore was there not a time problem, time horizon differential, between the interests that you might have perceived on behalf of a customer and what would be best for the ban? That is, when you said earlier destroying a customer would never be in the interests of the bank, if you had a shorter time horizon it might well be in the interests of the bank if it could strengthen the balance sheet.

Derek Sach: That is absolutely right and, as you will know, the Asset Protection Agency came into being in 2010 and they were always pushing us to go for more foreclosure for exactly that reason, which is something I robustly resisted throughout the period. There is quite a bit of correspondence between me and them of threats and counter threats and not being prepared to do that.

Chair: So those who have made that general allegation are barking up the wrong tree?

Derek Sach: Yes, and one other explanation for that as well is in the totality of the GRG portfolio, which peaked at £80 billion, the portfolio we are looking at here, the UK SMEs, were only six. So in particular as we move through 2010 and 2011 we were focused on capital targets to reduce the risk-weighted assets because at one time we had about a third of the group's capital under our management. One was not frankly going to spend a lot of time squeezing some poor entrepreneur in Bromsgrove to realise his £1 million when we had huge exposures of £1 billion or more where the risk-weighted assets could be £2 billion or £3 billion. So that is where all the focus of capital reduction went. It was never applied to these people.

Chair: It is helpful that we have that repudiation of the frequently made allegation with respect to RBS. You said earlier, with respect to this profit centre, this vexed question of profit centre versus cost centre issue, that you clearly were not a profit centre because your costs exceeded your profits. Was that what I heard you to say?

Derek Sach: We have never made a profit because we have costs. We do have income and we have big losses, which are the impairments of those customers, and a cost that we have never even tried to identify is the cost that divisions like Chris' has to pay for all the centralised computers, offices and all the infrastructure.

Chair: The fact you never made a profit has no bearing on whether you are a profit centre; it is whether you are seeking to generate income with a view to minimising your losses.

Derek Sach: Yes.

Chair: So that amounts to a profit centre by another name?

Derek Sach: I do not think it is a profit centre as such, but, yes, we are earning income that is offset against the losses.

Chair: You checked the Clifford Chance report for errors of fact. Did the Large report go to your bank in draft?

Chris Sullivan: Yes.

Chair: Why in that case was this glaring error, which was central to a large chunk of these recommendations, not flagged up?

Chris Sullivan: I can only surmise that the view was taken that that was a misinterpretation of a profit and loss. You asked a question, is this a profit centre? Quite clearly it is not operated as a profit centre and the description was overlooked.

Chair: But he put this before you in draft you have just told us, and you allowed him to go ahead with page 52, which is a key part of his report, which you are flatly repudiating today, line by line. Why were you not repudiating it flatly when he showed it to you in draft?

Chris Sullivan: Because it was not put to us in the manner in which you put it and the connection that Mr Sach quite clearly said to you was not an appropriate connection. So the comments that did, I think, emanate from that particular part of the report, which said we must ensure that the GRG behaviour is completely aligned with the customer and with the rest of the core bank was the element that we were looking at and was the element we took action on.

Chair: That is a very confused reply, if I may say so, to a simple question, which is, why did you not just say to Andrew Large, "You have it wrong"?

Chris Sullivan: Because we were not looking at every individual single sentence within it to—

Chair: But this is not an individual single sentence—

Chris Sullivan: We were looking at the underlying.

Chair: —this is a main conclusion on the basis of which he makes recommendations. He says that RBS governance structures do not do enough to address potential conflicts of interest, and he then cites GRG as needing—

Chris Sullivan: That was the element we took action on.

Chair: So it is true? There were conflicts of interest. He was right.

Chris Sullivan: We took action to ensure there were not.

Chair: So was GRG a profit centre at the time that he made his report?

Chris Sullivan: No, it was clearly not a profit centre as you alluded to it. It had a statement of its income and its costs in isolation from all the other economic elements of that customer's relationship with RBS.

Chair: Sir Andrew will have an opportunity to respond to the slightly bizarre story that seems to be developing.

Mr Love: In an earlier answer to a question on valuations, Mr Sach, you drew a distinction between formal external valuations and the internal valuations that your group carries out. What do you use the internal valuations for? What purpose are they?

Derek Sach: We try to do things with customers in a consensual—believe it or not—and as cheap and effective manner as we can. As I said, in the very difficult period of 2009 to 2010 selling properties was a fairly academic pastime because there was not a market. So to use an internal valuation in our discussions with customers, if they were broadly in agreement, was quite an effective way of progressing and saying, "All right, from a security point of view we have a property that is worth, say, £1 million". If ever we were doing anything to rearrange their affairs or doing something legal then they would want a proper valuation. That would be done through the Red Book using a formal valuer externally to the bank.

Mr Love: The Clifford Chance report comments about the use of the assumption of a short marketing period being used consistently for internal valuations. Did that mean that with internal valuations the price was suppressed from what you would get for the formal external?

Derek Sach: Everyone would understand the basis on which it was done but the object of the exercise would be to get a fairly realistic valuation, which, as you say, is probably going to be a shorter time for marketing than if you go for the Red Book; 12 months, willing buyer, willing seller.

Mr Love: Let me turn to West Register. According to your reports, it purchased and held many properties sold by distressed SMEs on your patch. Did West Register intend to turn a profit on those properties?

Derek Sach: No, and again it is an area of loss mitigation. West Register was set up 20 years ago and it has waxed and waned since. It probably peaked in the late 1990s with a portfolio of about £1 billion and reduced again to no more than about £10 million in 2007. You are right that since then it has bought a lot of properties rather than dump them on the market and get absolute fire-sale prices for them. During the period in question we bought 160 properties from SMEs for a cost of about £450 million. The actual loans we would have made on those properties are more like £900 million to £1 billion. So, even if we were to sell them in a year or two’s time and make a book profit on the price we bought it in at, overall, we have still lost a lot of money.

Mr Love: Explain to me what the role of West Register was. If it was not intended to turn a profit are you in fact saying, “We were buying these properties out of the goodness of our heart in order to sustain the business”? If it was not a profit centre what was it?

Derek Sach: Most of the properties that West Register has bought in this cycle have been from pure property positions, as opposed to a trading company. Its origins were doing things like, say, in the leasebacks for trading companies where you could provide some cash for the company and relieve them of perhaps a big burden of overhead. This time round a lot of them would have been incomplete developments that needed to be completed. Often the entrepreneur did not have the ability to do that. In every case where we have bought one it is always marketed on the open market. If any other purchaser bids more than West Register they can buy it and West Register is never allowed to bid again. So, to keep it absolutely fair and without anyone feeling they are being dispossessed of their property unfairly, if someone bids more than West Register they get it.

Mr Love: You will be aware of the controversial nature of West Register and the accusations made about under-valuation of customers’ assets. You did not ask Clifford Chance to test the accuracy of the valuation methodology. Why not?

Derek Sach: I did not instruct Clifford Chance, so I honestly cannot comment on why we did or did not ask them to do any specific thing. But they do comment that there is no evidence that West Register tried to buy things at under-price, because these assets are marketed and if somebody else bids more they will get it. That to me is a market price.

Mr Love: That may well be the case but, Mr Sullivan, perhaps you can shed some light on why Clifford Chance, were not asked to look at this. This was obviously an area of great controversy, the valuations that were made of assets and the consistent complaint that they were under-valued. It would have been simple to ask Clifford Chance to look carefully at this to see whether there was any merit in the criticism. Why was it not done?

Chris Sullivan: I did not instruct Clifford Chance either but, nonetheless, I would have been very comfortable to do so. It is worth understanding where West Register was used. Generally West Register would buy a property or such like from a customer that had failed. So the business could not meet any of its debts and was not then trading. Therefore, this asset had to be realised. Bids were put out and taken from the external world. If we believed that the market was not valuing those highly enough then West Register would put a bid in at a higher level, thus reducing the loss that the bank made and holding that for some time to realise at perhaps a better point of the cycle. So this was not taking properties off people and profiting from them, it was mitigating the loss the bank already had.

Mr Love: Surely the first test in all of this is to check for manipulation of valuations and to see whether there was a systematic bias. Surely that could have been done fairly simply.

Chris Sullivan: But as Derek says—

Mr Love: That would have answered the criticisms that have been made about valuations.

Derek Sach: I am sure Clifford Chance did address this. They addressed the main accusation of deliberately distressing companies. Alongside it, or as you go through the first three or four pages, there are about eight separate sub-headings of things that Clifford Chance addressed, one of which is West Register and buying at the right valuation. I am sure it is there in some way.

Mr Love: Let me reverse this. Probably you do not know the answer to this but perhaps you can find out for us. Did Clifford Chance ever suggest that this would be a sensible thing for them to do in order to address this criticism that was being made? Presumably, if you were not involved in the report, you cannot tell us whether that is the case.

Chairman, I think it would be helpful if we could have more information on exactly what Clifford Chance were or were not asked to do in this regard, because it would seem sensible for them to have looked at this systematic bias issue and they clearly have not done so.

If I can come on finally to this issue of threatening the removal of overdrafts. You indicated earlier—and you mentioned also the unfortunate drafting of the manual—that you were not aware that anyone had taken this seriously. Mr Sach, do you deny that there was any behaviour of this sort that went on in your particular division?

Derek Sach: Yes, we would not treat someone in that fashion. We would say to them, "If you are not prepared to make changes you are going to reach your overdraft limit and we will not be renewing it" or "we will not extend it" but we would not threaten to do what I think is suggested there, just threaten to take it away on a capricious basis to force someone to do something.

Mr Love: Do you think that someone saying, "If you do not play ball with us we will not renew your overdraft" is a threat?

Derek Sach: I think that is the commercial way that banks have to operate because we have to have a regard to our shareholders to protect our money.

Mr Love: I fully understand that. What I think we are trying to get to the bottom of is this criticism that was made that it was the threats that were issued against your small business customers that made them feel that you were not on their side; that this was a regular occurrence reported by a number of small businesses that they were told that overdraft facilities would be cancelled. You only need to give a day's notice to withdraw overdraft facilities. This was used regularly in order to—if I can put it colloquially—soften up the customer.

Derek Sach: Yes. I mean I can only say that is not done. Invariably we extend people's overdraft and the forbearance, which we are quite famous for and again got into conflict with the APA over, is we frequently allow customers to go over their overdrafts. In addition to that, over the last three years we have formally advanced £100 million of new money—more than £100 million, £120 million—to these SMEs to help them with their problems. We just do not do that. We have been examined as well by other independent people with a different perspective. The APA commissioned McKinsey to look at us in 2010, and they concluded that we were a good comparator with other organisations they had seen in Europe and the United States. The FSA did a visit to GRG with a team of about half a dozen people in 2011. They produced a report whereby they said we were fit for purpose. So again these things would have been looked at by both of those.

Stewart Hosie: Mr Sach, you said a bit about the salaries of your staff. You said they were in the £30,000 to £60,000 range. These seem very modest for people who the bank would put in to restructure businesses that would have substantial liabilities if they get it wrong, not just to the bank but at the moment to the taxpayer.

Derek Sach: These are the sort of range of salaries of the typical person who is dealing with an SME. We are looking at a very discrete part of the overall portfolio, the 10,000 SMEs. But let me just check with Chris. I would not like to mislead you.

Chris Sullivan: We are talking about the relationship managers who would be dealing with small to medium-sized enterprises. We are not talking about relationship managers who would deal with very, very large restructurings, so I think the £30,000 to £60,000 range that Mr Sach described is appropriate.

Stewart Hosie: It did strike a number of us as very low salary figures for staff—

Chris Sullivan: It is not often we get accused of that.

Stewart Hosie: I am sure your staff will be pleased to hear that. It has been said earlier that GRG can insist on a transfer of a business into GRG, but it has never been used for any SME. This is for larger businesses. Can I confirm, Mr Sach, that what you said at the beginning would still apply, that the assets and income from the business being transfer would still remain with the donor division?

Derek Sach: Yes.

Stewart Hosie: So, even though you insist on it and handle it completely, the assets and income still remain with the donor division?

Derek Sach: Yes. What transfers is the management.

Stewart Hosie: All right. If I can also go back again to where you spoke about how you deal with businesses in relation to valuations in a cheap and effective manner. You will be aware—and we are all certainly aware—that businesses have come to us complaining bitterly about multiple valuations at your insistence but at their cost. That does not really chime with the cheap and effective manner argument that you made earlier.

Derek Sach: We would never charge for the internal valuation but, yes, on occasions the documents will require, or the situation they are in will require, that a formal valuation is undertaken and, yes, regrettably they do have to pay for that.

Stewart Hosie: Again the criticism is that these are multiple valuations. It is not just once, it is every six months or every year. You will be familiar with these arguments, I am sure.

Derek Sach: I am not familiar with people having to have multiple valuations at our request. Sometimes a customer will want to have his own. Usually we try to agree with them who is going to do the valuation. We have a panel of valuers who we use and we will offer them four or five and say, "Is there one of these that you would like to use?"

Stewart Hosie: I was going to ask about that because, again, it has been put to me that the bank have insisted on a particular firm, whereas the business would prefer a different firm who have much more understanding of that portfolio. Why would the bank insist on one from their panel rather than a professional valuer who knows the portfolio better?

Derek Sach: Like all hypothetical examples you need to see the particular to be sure, but I would surmise that, for some reason or another, the bank would not be confident that the valuer the customer wanted was going to provide the right valuation. I would have to look at the particular situation.

Stewart Hosie: Of course, but presumably it would be the correct valuation rather than the right valuation?

Derek Sach: Well, valuation is an art as well as a science so I am—

Stewart Hosie: Let's talk about valuations then. You made the point earlier, quite understandably, that over a number of years recently properties in particular may be unsellable. But there are instances where the bank may deem that to be the case but the business will say, "I understand why the valuation may fall but it is fully tenanted. There is an income stream in terms of the loan I had. Affordability was not an issue". Do you understand why sometimes businesses—particularly in property—thought some of the decisions taken by the bank were slightly irrational?

Derek Sach: Businessmen will often have that view and I appreciate that they can be in a difficult position. But the example you describe where they were able to service their loan we would more or less never ever foreclose on that. That again has been the subject of criticism by people like the APA. I have always taken the view—and this the team would agree with—that if a property customer like that can service their loan, as you say it is fully tenanted, then it must make sense to carry on with that business.

Stewart Hosie: You said that the bank would not foreclose in those circumstances. I appreciate that. But the bank may decide to reduce facilities, to reduce exposure, indeed to suggest that a business re-bank, and they may well do that on the back of a business review, again, which the business pays for.

Derek Sach: Again, in GRG I do not believe we would be very likely to say, "We are going to reduce your facility" like that. We would say to a customer, "We disagree with what you want to do, therefore we think it would be a good idea if you were to re-bank within the next six months" or something like that. I think that is a good, open and honest conversation to have with customers. They are always upset the day you have it but, assuming they are successful in re-banking, they are quite pleased because they have gone somewhere that wants them as opposed to somewhere that doesn't rate their future.

Stewart Hosie: But in terms of requesting or suggesting that a business re-banks, if that is done on the back of a business review, which the company pays for, there have again been allegations that the businesses themselves do not get sight of the reviews that they pay for, which the bank request. Is that correct?

Derek Sach: I do not believe that ever happens because the customer is paying for it and, whether it is a surveyor's report or one of the infamous independent business reviews—which I have to say I am not a proponent of—the customer always gets sight of it.

Stewart Hosie: Always?

Derek Sach: I cannot think of a circumstance where he wouldn't. In 10,000, yes, I would accept that you could find an exception of everything somewhere but the policy and philosophy is the customer has to agree it. It is not worth an awful lot if he just says, "It's not right".

Stewart Hosie: One final question. You said in relation to West Register that even if the properties in the portfolio now were sold marked up from the book price, the price at which you bought them, the bank would still lose money. That of course is not necessarily true, is it, if the price increases over the next few years from the book price?

Derek Sach: Let me take you rapidly through the whole process: we lend a man £1 million to buy a property for £1 million in 2007 at the height of the boom. West Register buys it in in 2011 for, let's say, £500,000—so we have lost £500,000—and with good fortune we sell it next year for £550,000. End to end we have lost £450,000. I accept West Register shows it has made £50,000, but end to end the West Register UK property companies have lost something like £120 million over this period. I will confirm the figure for you. So even over the book values they have lost money. Admittedly, most of them are large properties. They are not SME properties.

Stewart Hosie: That is helpful. Thank you.

Chair: Thank you very much for coming to give evidence this morning, now afternoon. It has gone on a bit longer than expected but there has been a great deal of concern publicly, widespread concern, about RBS' lending practices over the last few years, so you understand the reason. We all have constituents who have come to us with complaints and we have come to the conclusion that there is unlikely to be all this smoke without some fire somewhere, which has been borne out by a number of the reviews.

It has been an uncomfortable hearing perhaps at one or two points but you have given very direct replies, if ones that have surprised the Committee from time to time. Thank you very much for coming in to see us.