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Dunfermline Building Society

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The Scottish Affairs Committee

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1 Introduction

1. On 30 March 2009 the Bank of England announced that core parts of the Dunfermline Building Society (DBS) were to be transferred to Nationwide Building Society. This followed a sale process conducted by the Bank of England over the weekend of 28–29 March under the Special Resolution Regime provisions of the Banking Act 2009.[1] This was the first time that the Special Resolution Regime had been used since the Act had been passed in February 2009.

2. The reason for the intervention by the Bank of England, the Financial Services Authority and HM Treasury (known as "the Tripartite Authorities") which was given at the time was that "if the transfer powers had not been exercised, DBS would be unable to satisfy depositors' claims against it." More specifically, they explained that DBS was failing, or was likely to fail, to satisfy the threshold conditions for operating as a deposit taker under the Financial Services and Markets Act 2000; and it was not reasonably likely that action would be taken by or in respect of DBS that would enable it to satisfy the threshold conditions.[2] In essence, whilst DBS had no immediate cash-flow problems, in the judgment of the regulators, its problems related to "future possible solvency under stressed conditions".[3] Jim Faulds, the former Chairman of DBS 2007–2009, publicly disagreed, arguing that the sale was unnecessary and claiming that HM Treasury had "sacrificed" the building society.[4]

3. Since the financial crisis deepened in the autumn of 2008, we have been increasingly concerned at its impact on Scottish financial institutions. As a result, we have taken evidence both on the implications of the crisis on the Scottish economy and on the near collapse of the Royal Bank of Scotland and HBOS.[5] As a continuation of our scrutiny in this area, we decided to take evidence on the circumstances which had led to the failure of the Dunfermline Building Society and the implications of the failure for its customers and workforce alike. On 20 May we heard from the Tripartite Authorities: Mr Jon Pain, Financial Services Authority, Mr Andrew Bailey, Bank of England, and Mr Clive Maxwell, HM Treasury. On 10 June we took evidence from Mr Jim Faulds, former Chairman, Mr Graeme Dalziel, former Chief Executive of Dunfermline Building Society until December 2008, and Mr Jim Willens, former Chief Executive of Dunfermline Building Society from January to March 2009. On 10 June we also took evidence from Ms Liz Kelly, Mr Tony Prestedge and Ms Alison Robb of Nationwide Building Society. We are grateful to all those who gave evidence to us.

1 "Dunfermline Building Society", Bank of England press release, 30 March 2009

2 "Dunfermline Building Society", Bank of England press release, 30 March 2009

3 Letter from Lord Turner to the Chancellor of the Exchequer on the Dunfermline Building Society, 17 April 2009, www.fsa.gov.uk

4 "Dunfermline boss attacks Treasury", *BBC News online*, 29 March 2009, news.bbc.co.uk

5 Oral evidence taken before the Scottish Affairs Committee on 10 December 2008, HC (2008–09) 38-i, oral evidence taken before the Scottish Affairs Committee on 4 March 2009 and 19 March 2009, HC (2008–09) 319-i and 319-ii.

2 Background

Regulation of building societies

4. Building societies are regulated by the Financial Services Authority (FSA) and governed by the Building Societies Acts 1986 and 1997. Building societies are mutual institutions whose members have certain rights to vote and receive information, as well as to attend and speak at meetings. Each member has one vote, regardless of how much money they have invested or borrowed or how many accounts they may have. This means that building societies should be solely focussed on delivering the best services and products to their members. Unlike banks, there is a limit (50%) on the proportion of their funds that building societies can raise from the wholesale money markets. The Building Societies Association states that the average proportion of funds raised by building societies from the wholesale markets is 30%.[6] Building societies are run by their boards of directors who are required to submit certain decisions about the running of the society for the approval of members but who also exercise wide discretion of investment strategies.

5. Building societies are regulated to ensure that their main business is the making of loans which are secured on residential property and funded substantially by the savings of their members.[7] Jon Pain, Managing Director of Retail Markets, FSA, told us that amendments to the legislation had been made to enable building societies to compete "in a modest way" with other financial institutions, for example, with products such as commercial loans, buy-to-let mortgages and housing association loans, without losing their mutual status.[8] As a result of the legislative changes, building societies are now allowed to have up to 25% of their lending secured on non-residential property.[9]

Special Resolution Regime

6. The Banking Act 2009, which received Royal Assent on 12 February 2009, created a Special Resolution Regime (SRR) which provides the Tripartite Authorities with a permanent framework of tools to deal with banks, building societies and credit unions that get into financial difficulties. HM Treasury described it as "a major step forward in the Government's ongoing programme to strengthen stability and confidence in the UK banking system, in the wake of the global instability experienced by financial markets in the last eighteen months."[10] The Act applies to the whole of the UK.

7. The SRR contains five "tools". The first three are known as the "stabilisation options" which are used when a bank or part of a bank is seen to still be a "going concern". They are to:

a) transfer all or part of a bank to a private sector purchaser;

6 "What's the difference between a building society and a bank?", Building Societies Association, www.bsa.org.uk

7 Lord Turner's letter to the Chancellor of the Exchequer, 17 April 2009, p 1

8 Q 85

9 Lord Turner's letter to the Chancellor of the Exchequer, 17 April 2009, p 2

10 "New Banking Act comes into effect", HM Treasury press notice, 23 February 2009

b) transfer all or part of a bank to a bridge bank (a subsidiary of the Bank of England) pending a future sale; and

c) transfer a bank into temporary public sector ownership.

The SRR also gives the Tripartite Authorities the powers to:

d) apply to put a bank into the Bank Insolvency Procedure which is designed to allow for rapid payments to Financial Services Compensation Scheme (FSCS) insured depositors, and

e) apply for the use of the Bank Administration Procedure to deal with a part of a bank that is not transferred and is instead put into administration.

8. There are clearly defined roles for each of the Authorities within the SRR:

- The FSA makes the decision on whether a bank has failed to meet its "threshold conditions" and should thus be put into the SRR. [11]
- The Bank of England decides which of the tools to use (i.e. how to move forward once a bank has been declared "failed").
- HM Treasury decides whether to put a bank into temporary public ownership (it is responsible for any decisions involving public money).

9. There are five key objectives which must be considered in choosing which resolution tools to use. They are to:

- protect and enhance the stability of the financial systems of the UK;
- protect and enhance public confidence in the stability of the banking systems of the UK;
- protect depositors;
- protect public funds, and
- avoid interfering with property rights in contravention of the Human Rights Act 1998.[12]

10. The SRR is triggered only if the FSA decides that a bank or building society is failing or is likely to fail its threshold conditions and has no reasonable prospect of remedying that position. It has been described as a "nuclear option" if all else has failed.[13] The SRR incorporates a wide range of protections for secured creditors, structured finance and netting and set off arrangements. The aim is that no creditor should be worse off than they would have been if the whole bank had been put into administration.[14]

11 Threshold conditions are set out in the *FSA Handbook*, and in detailed rules and guidance throughout the Handbook, particularly in relation to capital and liquidity requirements. www.fsa.gov.uk

12 Banking Act 2009, s 4

13 Treasury Committee, Seventeenth Report of Session 2007–08, *Banking Reform*, HC 1008, Q 231 [Kitty Ussher]

14 Explanatory Notes to the Banking Bill [Bill 6 (2008–09)–EN], para 154

Dunfermline Building Society

11. Dunfermline Building Society (DBS) was established in 1869. In March 2009, it was the largest Scottish building society, with more than 350,000 customers, 550 staff and 34 branches across Scotland.[15] It was the twelfth largest building society in Britain.[16] In 1999 it introduced a telephone banking service for its customers: "Dunfermline Direct".

12. In 2002 DBS created its commercial real-estate lending operation,[17] which expanded significantly in the years 2004–2007 when property prices were rising. The subsequent collapse in commercial property prices was likely to result in a significant loss to the portfolio. By 2008 DBS had ceased its commercial lending. Between 2004 and 2008, the extent of this lending had increased from £112m to £628m.[18]

13. As well as pursuing growth in new business areas, DBS also engaged in an aggressive business acquisition strategy. Between 2004 and 2006, DBS acquired mortgage loans from other lenders, principally of buy-to-let and self-certified mortgage portfolios, just before the global market for such loans collapsed. Of these mortgages, it purchased £410m from GMAC and £57m from Lehmans (by December 2008 the balances had reduced to £165m and £21m respectively).[19] By February 2008, DBS was one of only two UK lenders (the other being Scottish Widows) offering mortgages with a loan to value ratio of more than 100%, after Bradford and Bingley and Mortgage Express ended such deals.[20]

14. In March 2009, it was announced that DBS would make an expected loss of £24m in 2008.[21] It was not alone. In the period between August 2007 and March 2009, as the financial crisis deepened, several societies merged with others in order to avoid difficulties: Scarborough with Skipton; Barnsley with Yorkshire; Catholic with Chelsea; and Cheshire, Derbyshire and Portman with Nationwide.[22]

15. The FSA argued that the problems which led to the failure of DBS were "almost entirely related to its commercial property loans and to the mortgages which it bought from other mortgage originators, including buy-to-let mortgages."[23] On 30 March, the BBC reported that the Prime Minister had stated that the Government had been forced to step in where DBS had failed: "Let's face facts, the Dunfermline Building Society is the author of its own mistakes: mistaken judgments, mistaken investments, mistaken policies".[24]

16. Jon Pain from the FSA told us:

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15 Extract from the *Building Societies Yearbook 2008–09*, p 44, www.bsa.org.uk

16 HC Deb, 30 March 2009, col 659

17 Ev 36

18 Letter from Lord Turner to the Chancellor of the Exchequer, 17 April 2009, p 2

19 Letter from Lord Turner to the Chancellor of the Exchequer, 17 April 2009, p 3

20 "History: Dunfermline Building Society", *BBC News Online*, 29 March 2009, news.bbc.co.uk

21 HC Deb, 30 March 2009, col 659

22 "Skipton and Scarborough building societies to merge", *The Guardian*, 3 November 2008

23 Letter from Adair Turner to the Chancellor of the Exchequer, 17 April 2009, p 1

24 "Brown says Dunfermline 'failed'", *BBC News Online*, 30 March 2009

> [Dunfermline's] previous management had made some poor management decisions that substantially weakened the outlook for the firm in a more difficult market condition environment, but in particular its diversification into commercial property lending, its purchase of non-core lending/mortgage portfolios from third parties and its inability to adequately control its cost base, particularly its IT investment.[25]

3 Downfall of the Dunfermline Building Society

Who was responsible for the failure?

17. Jim Faulds, Chairman of DBS until March 2009, admitted to us that "the responsibility for the plight that Dunfermline found itself in is solely the responsibility of the Board of the society."[26] However, he believed that the Society could have continued as an independent entity if it had not been for the decisions taken by the Tripartite Authorities from October 2008 onwards. [27] He also wanted to put on the record that DBS had "no toxic assets [...] no sub-prime loans [and] no USA loans."[28]

18. When asked why DBS chose to implement the strategy it did between 2004–2008 and diversify away from the traditional building society business of loans secured on residential property into commercial lending, Jim Faulds told the Committee that the Board had felt that DBS had to change its structure, its business and its IT system in order to be competitive:

> Dunfermline's systems and its structure were uncompetitive and out of date [...] we had right on our doorstep giants of retail financial services who were engaged in a price war [...] we had to compete with Northern Rock who were making offers which we could not understand how they could make (and history has shown how they did it).[29]

19. Graeme Dalziel, former Chief Executive of DBS up until December 2008, told us that DBS wanted to be able to provide competitive products, to increase the income for members and to remain independent. He said that the view of the Board at the time had been:

> [...] that in view of the market-place unless we diversified the income to provide the members with those competitive products that they really deserved and wanted, then the only other alternative was to merge with somebody else or be swallowed up by

25 Q 3

26 Q 126

27 Q 127

28 Q 136

29 Q 127

> somebody bigger. It was a view that unless we were dynamic in diversifying there was that risk.[30]

He also pointed out that DBS had also chosen to diversify with lower risk and lower return options through the provision of lending for community regeneration and social housing. One of the purposes of this was to "add some value to the Scottish community".[31]

20. Jim Faulds said that research carried out had informed the Board that members did not want to lose the independence of the building society and did not want DBS to merge with another society.[32] We asked the former management how aware members were of the extent of the DBS commercial portfolio. We were told that details of the extent of DBS's commercial lending were contained in the annual reports and members' reviews of the building society.[33] The strategy of diversifying into commercial lending was also raised at AGMs and at members' panels around the country.[34] However, when asked whether members were aware of the risks involved in engaging in commercial lending in a bid to remain independent, Jim Faulds admitted "the members did not know that at the time. We knew that but we believed that we managed those risks reasonably well."[35]

21. Graeme Dalziel defended DBS's decision to venture into commercial lending by pointing out that by the end of 2007, the commercial lending operation had added a £25m contribution to overall member value. He also added that commercial loans had only amounted to 16.7% of the society's total assets at the end of 2007.[36] The statutory limit under the Building Societies Act 1997 is 25% of a society's total assets—and therefore DBS was well within the limits, which was noted by the FSA in evidence to us.[37] Mr Dalziel also told us that four or five other societies had similar, if not higher, levels of commercial lending.[38]

22. On the subject of the self-certified loans bought from GMAC and Lehmans, Jim Faulds admitted that "In retrospect […] I would rather we had not taken on self-certified loans. As it happened, they were performing but not as well as loans we found ourselves."[39]

23. **While the Board of Dunfermline Building Society believed that it was responding to a desire amongst its members for it to compete effectively in the market, we believe it failed to communicate to them that the moves to diversify into the commercial lending business brought higher risks as well as higher returns.**

30 Q 168

31 Q 128

32 Q 169

33 Q 129

34 Q 129

35 Q 174

36 Q 128

37 Q 21

38 Q 128

39 Q 150

Dunfermline Solutions

24. In 2002 DBS set up a subsidiary called Dunfermline Solutions to "provide software solutions and back office services to deposit takers and mortgage lenders".[40] It was reported that the intention was that DBS would use banking software company Temenos' "Globus" application to develop its own mortgage IT system that would be distributed to other building societies via Dunfermline Solutions.[41] In November 2008, DBS finally went live on the less comprehensive "T24" system which supported DBS's savings and investments but did not support mortgage offerings as had been originally envisaged for "Project Destiny".[42]

25. Graeme Dalziel told us that having initially gone for the "big bang approach" to create an entire new software suite, in 2007 the Board decided to park the mortgage software as 90% of Dunfermline's customers were savings members. He added that there was a business plan to bring the mortgage system into production at a future date.[43]

26. In total, DBS invested £31.4m in Project Destiny—a large sum for a society of its size. However, DBS was forced to write off £9.5m in respect of the IT development.[44] This reduced DBS's operating profits in 2007 from £11.5m to £2m. Problems with Project Destiny did not come as a surprise to the FSA. Lord Turner's letter to the Chancellor of the Exchequer of 17 April 2009 details meetings between the FSA and DBS management in 2006 and 2007 at which Project Destiny was raised as a concern. An ARROW visit in November 2007 looked at the PwC review commissioned by DBS to report on the management and governance of Project Destiny.[45] The PwC report had concluded that weak project management was to blame for the £9.5m loss. Lord Turner described the project as "poorly managed and controlled and subject to significant delays."[46]

27. Jim Faulds told the Committee that the Board started to get concerned in 2004-05 about the project: "We went for a system that we thought would make us extremely competitive. It was too challenging, it took too long, it took too much money and we made a mistake."[47] It is therefore remarkable that in DBS's 2007 "Member Review", the Chairman's statement said:

> We made excellent progress last year in many areas of IT by focussing on those areas that deliver the greatest benefits. Over time the technology market changes and our business priorities and requirements also change which is why we made the decision to suspend the development and implementation in some areas of our

40 "Just why did Dunfermline sink £31m into unproven IT project?", The Herald, 27 March 2009

41 "£30m IT Project Helped Drag Dunfermline Down", *EWeek Europe,* 30 March 2009

42 "Revised Temenos project draws to a close at Dunfermline", *IBS Publishing,* 11 December 2008, www.ibspublishing.com

43 Q 209

44 Letter from Lord Turner to the Chancellor of the Exchequer, 17 April 2009, p 4

45 The FSA's risk assessment process is called ARROW which stands for the Advanced, Risk-Responsive Operating framework. ARROW consists of a high-level reviews aimed at assessing the significance of a particular risk posing a threat to the FSA's statutory objectives. It is not an audit and the FSA is clear that the ultimate responsibility for identifying and assessing risks lies with the Board.

46 Letter from Lord Turner to the Chancellor of the Exchequer, 17 April 2009, p 4

47 Q 212

> investment, particularly those relating to the origination and administration of retail mortgages and in systems integration. This has resulted in a requirement to make an exceptional provision of £9.5m against those areas where work has been suspended. This re-focussing of technology investment towards Savings and Investments, management information systems and the mortgage intermediary market means the Society is in a better position to deliver in 2008 those areas of our investment that are of greatest benefit to our members.[48]

28. **We conclude that it would not be possible for the average member of the Dunfermline Building Society to glean from the Members Review that a serious failing in project management, rather than changes in technology, had led to the £9.5m loss. It is clear to us that, in its management of the Dunfermline Solutions project, the Board of Dunfermline Building Society lost control and allowed spiralling increases in costs which arguably amounted to a breach of the duties owed to the Society's membership. Therefore, we find it disingenuous that the £9.5m loss written off on Project Destiny was described in the Members Review as "excellent progress".**

29. Dunfermline Solutions still exists and the shareholder is the administrator for Dunfermline Building Society. Nationwide has not sought to deploy the Dunfermline IT system into Nationwide branches and the two systems have continued to run independently.[49]

4 Use of the Special Resolution Regime

Events leading up to the transfer to Nationwide

30. The Chairman of the FSA, Lord Turner, wrote to the Chancellor of the Exchequer on 17 April detailing the interaction between the FSA and DBS from 2005 to 2009.

2005–2007

31. The FSA's ARROW Review visit in November 2005 raised commercial lending as an issue and requested the Society to carry out additional risk analysis of its portfolio.[50] The Society appointed an external consultant to do this work in 2006. This resulted in improved controls over the Society's commercial lending, which was later verified by the external auditors in December 2007. In the period between the ARROW Review in November 2005 and August 2007 the FSA met with the Society's management in February and August 2006, and February and July 2007. A major discussion point at these meetings was the IT project which was poorly managed and controlled and subject to significant delays.[51]

48 *Dunfermline Building Society Members Review 2007*, p 1, www.dunfermline.com

49 Q 279

50 The FSA's risk assessment process is called ARROW and consists of a high-level reviews aimed at assessing the significance of a particular risk posing a threat to the FSA's statutory objectives.It is not an audit and the FSA is clear that the ultimate responsibility for identifying and assessing risks lies with the Board.

51 Lord Turner's letter to the Chancellor of the Exchequer, 17 April 2009, p 4

August 2007–September 2008

32. From August 2007, as severe liquidity problems emerged in financial markets in the US and UK, the FSA increased the intensity of supervision of all building societies, with the majority (including DBS) being required to produce additional liquidity data on at least a weekly basis from September 2007 onwards. From this time the FSA was in regular contact with DBS culminating in an ARROW visit in November 2007. In December 2007, as part of the ARROW work, the FSA discussed the Society with its auditors. In early 2008, the FSA told the Society to resubmit its Internal Capital Adequacy Assessment (ICAAP) in early 2008 because the document provided was "poorly prepared and put together (particularly in respect of stress testing)".[52] In May 2008 the supervision team met with Graeme Dalziel to raise concerns about the firm's liquidity position and its resubmitted ICAAP. In light of continuing investigations between June and September 2008, meetings were held with the Society on 2 July and 25 September 2008 to discuss again the revised ICAAP. The FSA expressed concern that DBS's stress tests did not appear to have considered the impact of the economic downturn on DBS's capital resources. The FSA informed the Society that it was considering requiring the Society to hold additional capital above previous regulatory guidance to reflect the higher risks identified. At that time, the Society had sufficient capital to meet this higher capital requirement.[53]

October 2008–March 2009

33. In the light of the sudden intensification of the financial crisis which had followed the collapse of Lehman Brothers, the US investment bank, in mid October 2008 the Government established the Credit Guarantee Scheme. To establish a firm's eligibility to participate in the scheme, the FSA subjected all banks and building societies to a severe stress test, which required the institutions to be able to meet future possible severe losses and still have more than a defined minimum amount of capital. The results of that stress test indicated that Dunfermline did not have sufficient good quality Tier 1 capital to meet the requirements of the Credit Guarantee Scheme. To do this it would have required additional capital of £20m. In Lord Turner's letter of 17 April 2009, he states that at the same time, the FSA was beginning "to have concerns about the ability of the Society's management to cope with the more turbulent conditions which the whole industry was by then facing."[54] The FSA instructed a "skilled person" (KPMG) to carry out an independent review and report on, first, the adequacy of the loss provisions on the commercial property loan book and, second, the viability of the Society's business plan.

34. Given the challenges that were likely to arise in the commercial loan book and the ongoing IT issues, Lord Turner stated in his letter of 17 April 2009 that the FSA "strongly recommended to the Board that a new Chief Executive be appointed".[55] Jim Faulds and Graeme Dalziel strongly denied that the Board acceded to pressure to replace the Chief Executive.[56] However, the FSA stand by this statement and claim that on 27 November it

52 Ev 38

53 Ev 38

54 Letter from Lord Turner to the Chancellor of the Exchequer, 17 April 2009, p 5

55 Letter from Lord Turner to the Chancellor of the Exchequer, 17 April 2009, p 6

56 Q 199 and Ev 36

was considering using powers to replace Graeme Dalziel should the Board not take action on its own account within the next 24 hours.[57] Jim Willens, the new Chief Executive, took up his post on 1 January 2009.

35. In parallel the FSA sought to find a private sector solution which would ensure the financial soundness of the Society which required the additional £20m capital, without the need for public funds. Lord Turner's letter states that:

> the two principal mechanisms considered were either a merger with another building society or the provision of capital from a third party such as a consortium of the largest building societies. This work was co-ordinated with the [Building Societies Association] to ensure that all credible options were assessed. Between January and March 2009 there were merger discussions with three major building societies.[58]

Jon Pain told us that:

> [The FSA] worked excessively hard before the final resolution to find a merger partner and in fact three firms undertook full due diligence on DBS to see whether a merger was possible, but ultimately unfortunately that was not the case. We tried to find a range of market solutions for this particular firm.[59]

By the middle of March 2009, however, it was clear that no other building society was prepared to effect a merger with the whole of Dunfermline.[60]

36. Further stress tests conducted by the FSA to identify the amount of capital required to ensure the long-term future of DBS as an independent entity showed that an injection of £60m would secure the Society's financial position over the next two years. However, it would not be sufficient to secure the Society's long-term independent future.[61]

37. The Building Societies Association (BSA) confirmed, subject to a number of conditions, that it was prepared to invest £30m from a BSA consortium on the basis of £30m matching public investment. In March the FSA also held discussions with representatives of the Scottish Executive about it providing £25m of funding.[62]

38. Clive Maxwell of HM Treasury said that the Government looked at the options for the DBS with three objectives in mind: to protect depositors; to ensure stability and confidence in the UK financial system; and to safeguard the interests of taxpayers. It then looked at the conditions set for the capitalisation scheme which required the Society to be adequately capitalised with funding or have a realistic plan and a sustainable business model to do so:[63]

57 Ev 40

58 Letter from Lord Turner to the Chancellor of the Exchequer , 17 April 2009, p 6

59 Q 56

60 Letter from Lord Turner to the Chancellor of the Exchequer, 17 April 2009, p 6

61 *Ibid*.

62 *Ibid*.

63 Q 5

> All banks and building societies are required by prudential regulations to hold capital above and beyond the assets that they hold; they must have total assets which exceed their liabilities by a certain amount in order to protect their depositors, to protect other people doing business with them, and in the case of Dunfermline there was insufficient capital and that would have needed to be replenished.[64]

39. BSA were then offered the option of injecting the full £60m and declined to do so. On 28 March, having decided not to risk public money, the FSA reached the conclusion that DBS was likely to fail to satisfy threshold conditions and that it was not reasonably likely that action would be taken to rectify the situation.[65] This triggered the Bank of England's Special Resolution Regime process.

Could the Dunfermline have been saved with a capital injection?

40. We were told that the typical capital instrument to put funding into a building society (and therefore prevent it being merged or broken up) would be a permanent interest-bearing share on which the provider would expect interest to be paid.[66] FSA stress tests had indicated that the amount of capital necessary for DBS to get through the short term was £60m. In assessing whether to use public money to provide a capital injection, the Tripartite Authorities doubted whether DBS would have been able to service the interest on a loan of that size when previously it had never made more than £6m profits a year.[67] The Chancellor of the Exchequer said "I couldn't be in a situation where we put money into it knowing that they couldn't even service it or pay it back".[68] He also told the BBC: "when you bear in mind the Society has never made more than about £5m or £6m in the recent past, it couldn't even service that sort of loan—let alone repay it."[69] More importantly, the Tripartite Authorities doubted that even £60m would address the issue of the confidence of the depositors.[70]

41. Furthermore, in the opinion of the authorities, DBS was not adequately capitalised and did not have a realistic plan for accessing the capital.[71] This was despite extensive discussions between the FSA and DBS between October 2008 and March 2009 on the best options for a three to five year business plan.[72] Jon Pain of the FSA told us that it was widely known that DBS was going to make a loss in 2008 and the lack of market confidence in the institution would have impacted on its ability to raise wholesale funding.[73] Based on

64 Q 7

65 Letter from Lord Turner to the Chancellor of the Exchequer, 17 April 2009, p 7

66 Q 14

67 Q 14

68 "Dunfermline building society sold after regulator refuses bailout", *The Guardian*, 30 March 2009

69 "Dunfermline boss attacks Treasury", *BBC News Online*,29 March 2009, news.bbc.co.uk

70 Q 8 [Andrew Bailey]

71 Q 9

72 Q 10

73 Q 3

these considerations, the Chancellor of the Exchequer concluded that it would not be in the taxpayers' interests to contribute public funds to the Society.[74]

42. The Tripartite Authorities compared DBS to the bank Bradford and Bingley which they had been unable to save as a whole. This is because there were certain parts that were so unprofitable that it would have been uneconomic to do so.[75]

43. Jim Faulds claimed that DBS had tackled the problems with the IT project, had pulled back from commercial lending, but that the stress test applied by the FSA had come "out of the blue".[76] Graeme Dalziel added that as a Board and an executive team they were confident that they had the adequate capital to survive "a one in 25 year event" and therefore it had come as a "complete shock" when, at the end of October 2008, the FSA told them that they needed to raise £20m worth of capital.[77]

44. The witnesses from DBS told us that in their view, by March 2009, they needed a £30m capital injection, rather than the £60m stated by the Government, and that their business plan would have enabled the Society to pay the interest on that.[78] Contrary to Mr Pain's view, Mr Faulds claimed that, if they'd been given £30m, DBS would have been able to report a small operating profit for 2008, while putting some money aside to resolve issues with its troubled commercial loan book in the coming years.[79] However, Jim Faulds did acknowledge that it would have been "challenging" for DBS to pay the interest on a capital injection if a penal rate of interest had been charged.[80]

45. **There is a clear difference of opinion between witnesses over whether £30m, £60m or more would have been sufficient to secure Dunfermline Building Society's long-term future. This is a question that we are not qualified to answer. This was the first time that the Special Resolution Regime was used. Therefore, the Tripartite Authorities should undertake a review of how the Regime operated, and that review should look at the interaction between the Tripartite Authorities and at the decision making processes.**

Did the FSA take sufficient steps to warn the Dunfermline of the risks it was taking?

46. Jon Pain told us that the FSA had issued "repeated warnings" to both the industry and individual chief executives (through "Dear CEO" letters) of:

> the dangers of actually migrating away from pure mortgage lending and the risks that are inherent in terms of that […] We talked about commercial lending, we talked about diversification into buy-to-let, we talked about the acquisition of non-

74 Q 9

75 Q 19 [Andrew Bailey]

76 Q 127

77 Q 185

78 Qq 204, 205

79 "Dunfermline boss attacks Treasury", *BBC News Online*,29 March 2009, news.bbc.co.uk

80 Q 204

> performing specialist mortgage portfolios from third parties. All those issues were covered.[81]

He also said that the FSA's supervisory process over the past two or three years had brought those issues to the attention of the DBS management and Board: "as part of our ARROW process […] we drew their attention to the controls of their commercial lending and that actually involved them in tightening those controls up."[82] Each ARROW visit took nearly a whole week and involved detailed examination of documentation by the FSA, together with interviews with Senior Executives, some non executive directors, and members of the senior management team.[83]

47. A letter from Lord Turner to the Chancellor of the Exchequer of 17 April 2009 detailed warnings that had been made to the industry:

- March 2003—a supervisory letter was sent to all building societies, warning them of the dangers and risks of commercial property lending.
- May 2004—The then Chief Executive of the FSA gave a speech to the Building Society Association's (BSA) Conference: "However, it is far from clear to us that all societies operating in the commercial, buy-to-let, equity release, sub-prime and self-certified markets have properly assessed the additional risks that inevitably go with the higher margins available."
- May 2006—a supervisory letter was sent to all building societies, warning of the dangers of mortgage book acquisitions.
- October 2007—the FSA requested that building societies cease purchasing non-prime assets.
- May 2008—the current Chief Executive gave a speech to the BSA Conference: "I would like to draw particular attention to three risk areas that we have come across in our supervision of individual societies over the last year: excessive concentration in the buy-to-let market; continued acquisition of mortgage books even when routine funding was becoming problematic, and poor understanding of the extra risk of major exposures to commercial borrowers."[84]

48. The witnesses from DBS did not accept that the Board had been given repeated warnings from the FSA about the Society's commercial lending portfolio, and told us that the Tripartite Authorities' evidence to the Committee had "painted a picture that [the witnesses] did not recognise".[85]

81 Qq 23, 28

82 Q 24

83 Ev 35

84 Letter from Lord Turner to the Chancellor of the Exchequer, 17 April 2009, pp 3–4

85 Q 133

49. Jim Faulds argued that the correspondence following both ARROW visits made to DBS did not raise commercial lending as a key risk facing the industry.[86] In a letter dated 11 April 2008 from FSA, in response to a second ARROW visit in November 2007, Graeme Dalziel was informed that the five key risks facing the society were: treating customers fairly, project management, the IT project, succession planning and fraud.[87] He noted that the FSA did not raise commercial lending, the mortgage books or capital. In addition, Graeme Dalziel quoted from a previous letter from the FSA sent in draft to DBS in December 2005:

> The Society's commercial lending operation has been very successful to date. At the same time it has been well controlled. We are aware of the society's plans to increase its exposure in this area and that you [meaning the society] have recognised that the portfolio has now grown to a large enough size to warrant risk analysis across the portfolio rather than solely at the individual exposure level. We would ask that you keep us informed of your progress in this area.[88]

50. In a follow-up letter to the Committee, Graeme Dalziel confirmed that all "Dear CEO" letters and speeches from the FSA were reviewed internally and discussed at Board level and in the appropriate risk committee of the Dunfermline. However, there had been only one themed letter regarding commercial lending, which was sent to all building societies from the FSA in early 2003.[89] He also argued that there were numerous opportunities for the FSA to comment on, or issue specific warnings to the DBS on the extent of its commercial lending, e.g.:

- annual business plans and updated 5 year strategic plans were submitted annually to the FSA;
- changes to lending policies approved by the Board were sent to the FSA;
- the annual ICAAP (setting out the risk management structure and including capital adequacy forecasts) was submitted in February 2008 to the FSA.[90]

51. Mr Dalziel also pointed out that, whilst the FSA had carried out two themed visits to the DBS on "Treasury Management" and on "Treating Customers Fairly" during his time as Chief Executive, the FSA did not choose to carry out a themed investigation on commercial lending or mortgage acquisitions.[91]

52. The FSA contends that its draft letter dated 20 December 2005, and the final version of the letter dated 18 January 2006,[92] clearly identified the growing size of the commercial lending portfolio as a risk. The FSA also pointed out that the DBS's commercial lending balance at that time was £169m. In the subsequent two and a half years, the Society

86 Q 131

87 Q 132

88 Q 132

89 Ev 35

90 Ev 36

91 Ev 36

92 Ev 40

increased its commercial lending by a further £469m to a total £628m, representing around 20% of its balance sheet.[93] In response to the FSA's letter, DBS appointed an external specialist consultant to conduct a risk analysis. The FSA argues that it maintained its supervision of the Society by monitoring both the risk analysis and also the subsequent verification by the Society's external auditors of the improved controls put in place by the Society on its commercial portfolio.[94]

53. A former employee of the FSA has alleged that the FSA "stood by" as building societies expanded into riskier investment areas. The claims were passed to Liberal Democrat Treasury spokesman, Vince Cable MP, and published in the *Financial Times* in April 2009.[95] The FSA has rejected the claims, but acknowledged that its attention had been less focused on business models leading up to 2007 than it had been since.[96] Jon Pain admitted that the expectation of the role of the FSA had changed since 2007, as had the level and intensity of its supervision of the industry.[97] On 5 June the FSA issued a consultation paper on additional guidance for building societies on the systems and controls that should be included in their business models, particularly for those societies seeking to diversify into new business areas.[98] This guidance will be enshrined in a new "specialist sourcebook" for building societies.[99]

54. **On the evidence we have received, we conclude that the Financial Services Authority failed to give adequate specific warnings to the Dunfermline Building Society to justify the assertion that it was repeatedly warned about the dangers of commercial lending. Warnings need to be specific to the institution being addressed and must be given in terms that savers and investors can understand. The Financial Services Authority should further ensure that the institution communicates these warnings to its members. In all these aspects, the Financial Services Authority failed wholly to discharge its duties to protect the interests of investors and savers. However, this does not excuse the Society from its responsibility to recognise that the higher returns gained from commercial lending came with a higher risk or that it was not responsible for its own downfall. We look forward to the results of the consultation on the Financial Service Authority's additional guidance for building societies which should make explicit the risks involved in moving away from traditional patterns of lending.**

93 Ev 38

94 Ev 38

95 "Eaten alive by investment bankers", *Financial Times*, 16 April 2009, www.ft.com

96 "FSA 'ignored warnings on building societies' risky lending practices', claims former supervisor", *Daily Mail*, 17 April 2009

97 Qq 69, 74

98 Q 70

99 "A Specialist Sourcebook for Building Societies: Enhanced supervisory guidance on financial and credit risk management ", Financial Services Authority, June 2009, para 1.14

Communication between Dunfermline and the Tripartite Authorities

55. At the time of the transfer, Jim Faulds was reported in the press as saying: “we have failed […] because we cannot get the faceless mandarins in London […] to sit around the table and see we have a sustainable future”.[100]

56. The witnesses from Dunfermline Building Society told us that, whilst they had extensive communication with the FSA in the period between October 2008 and March 2009, they felt that they were kept at “arm’s length” from the other two decision makers,[101] kept in the dark and denied information about what it had to achieve in order to stay independent.[102] Jim Faulds felt the Board was “excluded deliberately”.[103] For example, he claimed that the first time they heard publicly that £60m capital was required to secure Dunfermline’s immediate future was from the Chancellor of the Exchequer after the decision had been taken to transfer parts of DBS to Nationwide.[104] The First Minister of the Scottish Executive had previously told Mr Faulds that the Chancellor had told him that the figure was somewhere between £60m and £150m: “We were getting our information second-hand and that is no way to do business.”[105] Graeme Dalziel also claimed that they did not know the level of severity of the stress tests applied to DBS by the Tripartite Authorities.[106] The FSA argued that it had been told by DBS on 25 March 2009 that the Society’s auditors had told the Society’s audit committee that DBS would require a £60m capital injection before the accounts could be signed off. Therefore, the FSA felt that there was no need to tell DBS specifically that the FSA’s stress test had shown that £60m was needed to secure the Society’s future.[107]

57. The witnesses from Dunfermline Building Society felt that a more open dialogue with all three Tripartite Authorities would have enabled the DBS Board to sit down with the Tripartite Authorities to discuss how to produce the necessary capital, rather than have the FSA relay information back and forth between HM Treasury and the Board.[108]

58. However, Jim Willens, chief executive of DBS from January to March 2009, told us that he had very regular contact with the FSA from October 2008 to March 2009 and his impression was that the FSA staff were “working extremely hard but were working under extreme pressure and that they did everything that they could do within their powers to assist during that set of circumstances.”[109] He confirmed that he had no contact with either HM Treasury or the Bank of England apart from one meeting with Lord Myners, Financial Services Secretary, in February 2009.[110]

100 “Dunfermline boss attacks Treasury”, *BBC News online*, 29 March 2009, news.bbc.co.uk

101 Q 185 [Jim Faulds]

102 Qq 185, 189–190

103 Q 200

104 Q 185

105 Q 190 [Jim Faulds]

106 Q 238

107 Ev 39

108 Qq 185, 190 [Jim Willens]

109 Q 185

110 Q 186

59. **Whatever the shortcomings of the Tripartite Authorities' communications with Dunfermline Building Society, it was the Board that had dug the hole in which the Society found itself. We do not intend to adjudicate on these competing claims, but only express our expectation that the Financial Services Authority needs to examine the lessons for the future very critically. For Dunfermline Building Society, it is too late.**

The competitive sale process for the transfer

60. The competitive sale process for DBS's retail and wholesale deposits, branches, head office and originated residential mortgages was conducted by the Bank of England over the weekend of 28–29 March under the Special Resolution Regime provisions of the Banking Act 2009. The Tripartite Authorities told us that they received four bids.[111]

61. It came to light that an error had been made in the transfer order which resulted in some of the commercial property portfolio being transferred to Nationwide Building Society. *The Guardian* reported that this was put down to mistakes being made "in the heat of late-night negotiations."[112] The error was spotted by KPMG and corrected by a statutory instrument.[113]

62. Nationwide admitted that due diligence carried out had not been as comprehensive as might have been the case if the transfer had not taken place over a weekend.[114] However, Nationwide had completed a limited amount of due diligence prior to the weekend in March, and then had a four-week period in which to complete in-depth due diligence. Nationwide then confirmed to HM Treasury that the findings were "satisfactory within the parameters [that Nationwide] had expected."[115] Of the error made in the transfer order, Alison Robb, Divisional Director, Group Strategy and Planning, Nationwide, said:

> It is fair to say that everything was executed so quickly, and we were using legislation for the first time; so certainly, as events unfolded, there was some issue in terms of the transfer order and that has been corrected; but I would say that was an administrative procedure that needed to be completed, as opposed to a substantive issue with the transaction itself.[116]

The result of the transfer

63. The retail and wholesale deposits, branches, head office and residential mortgages were transferred to Nationwide after negotiations over the weekend of 28–29 March. £500m of social housing loans were transferred temporarily into a "bridge bank" owned by the Bank of England. Dunfermline's remaining business, mainly lower quality loans (commercial loans, acquired residential mortgages, subordinated debt and most treasury assets) were

111 Q 51

112 "£600m loans went astray in Dunfermline rescue", *The Guardian*, 3 June 2009

113 The Dunfermline Building Society Compensation Scheme, Resolution Fund and Third Party Compensation Order 2009 (SI 2009/1800)

114 Qq 276–278

115 Q 276 [Alison Robb]

116 Q 278

put into the Building Society Special Administration Process where they were managed by KPMG as the administrator.[117]

Nationwide Building Society

64. Nationwide is the largest building society, the third largest mortgage lender and the second largest retail savings provider in the UK. It employs around 19,000 people, serves 15 million members and has a relationship with one in every four households in the UK.[118]

65. On 30 March the following parts of DBS were transferred to Nationwide:

- £2,353m of retail deposits, representing the accounts of approximately 300,000 DBS members;
- DBS's 34 branches and retail sites, and all related employees, plus DBS's head office at Dunfermline, and
- DBS's £1,022m prime mortgage lending book.[119]

Nationwide made the following announcement:

> [Nationwide] has satisfied itself that the proposed transaction is in the long term interests of its members and will generate value over the medium term. The Board regards it as responsible and commercially beneficial to support the mutual sector in this way and to extend the franchise of Nationwide that already includes two regionally branded building societies.[120]

66. As part of the deal, the Government transferred £1.6 billion of public funds to the Nationwide Building Society, which took £2.35 billion of DBS's deposits in return for absorbing £1 billion of its prime residential mortgages. The transfer was made because the assets Nationwide took on were worth £1.6 billion less than the liabilities. However, the £1.6 billion cost was split between the industry-funded Financial Services Compensation Scheme (FSCS) and the taxpayer. Both HM Treasury and the Financial Services Authority have refused to reveal how much the FSCS Scheme will cover, but insiders had said it was "between £1 billion and £1.5 billion".[121] The Chancellor of the Exchequer said that the taxpayer would be left with "a small residual exposure".[122] The Guardian estimated that this would be about £10m.[123] Andrew Bailey of the Bank of England told us that the Government funding was put there to ensure that the depositors in DBS were "taken very quickly into a safe home."[124]

117 "Dunfermline Building Society", Bank of England press release, 30 March 2009

118 "Acquisition of Dunfermline by Nationwide Building Society", Nationwide Building Society press release, 30 March 2009

119 *Ibid.*

120 *Ibid.*

121 "Dunfermline bill leaves state with £600m exposure", *The Telegraph*, 30 March 2009, www.telegraph.co.uk

122 HC Deb, 30 March 2009, col 661

123 "Dunfermline response leaves a few questions", *The Guardian*, 31 March 2009

124 Q 6

67. At the time of the transfer, Nationwide's press notice stated:

> Nationwide is in a unique position by virtue of its size and financial strength, to provide support to Dunfermline, and we regard it as both responsible and commercially beneficial to undertake this transaction. This transaction excludes high risk assets: commercial loans and some residential loans (including the acquired and equity release portfolios) were not transferred, and the transaction will enhance the overall value to Nationwide's membership over the medium term.[125]

68. When asked about the parts of DBS that it had not taken on, Tony Prestedge of Nationwide told us:

> We were very clear that there were parts of the organisation that we would not bid for under any circumstances. We would never, and did not, bid for the acquired portfolios of residential lending, because Nationwide has never acquired residential lending which we have not originated for ourselves. We did not bid, and never would under any circumstances, for the commercial portfolio, for similar reasons. For the purposes of the business that we did acquire, the billion pounds' worth of primary retail portfolio residential lending as well as the liabilities, i.e. the savings side of the business, the head office and the branch network, we are very happy with what we have acquired.[126]

> We have the parts of the business which, for us, we felt we were able to take on Board without creating risk for our own membership.[127]

Subsequent to our evidence session it was announced that Nationwide had successfully bid for DBS's social housing portfolio.[128] We return to this in paragraphs 71–73 below.

69. The combined business of Nationwide and DBS now has around 900 branches with a geographical spread across the UK. In addition, it was also expected that upon completion of the transfer, Nationwide's market share of retail deposits would increase to around 11%.[129]

70. The Nationwide Building Society not only received the transfer of core parts of DBS, but in the past eighteen months it had also merged with Portman, Derbyshire and Cheshire building societies. In its preliminary results announcement in May 2009, Nationwide's total assets, including the impact of the mergers with the Portman, Derbyshire and the Cheshire building societies and acquisition of certain assets and liabilities of Dunfermline Building Society, increased by 13% to £202.4 billion (4 April 2008: £179.0 billion).[130] However, in May 2009 the Chief Executive of Nationwide, Graham Beale, warned that

125 "Acquisition of Dunfermline by Nationwide Building Society", Nationwide Building Society press release, 30 March 2009

126 Q 257

127 Q 258

128 Ev 35

129 "Acquisition of Dunfermline by Nationwide Building Society", Nationwide Building Society press release, 30 March 2009

130 "Nationwide preliminary results announcement for the year ended 4 April 2009", www.nationwide.co.uk/aboutnationwide

Nationwide should not be considered the automatic saviour of building societies that found themselves in difficulties. He is reported as saying "[Nationwide] will continue to act in a responsible manner and support the mutual sector. However, we will not be a lender of last resort and will consider transactions that will enhance and not destroy value to our members."[131]

Social housing portfolio

71. When announcing the transfer of parts of DBS to Nationwide in March, the Chancellor said:

> When we looked at what the Nationwide was proposing, we felt that on balance the better value for money would be to see whether there was another way of dealing with the housing loans. They are important. The Dunfermline provided a lot of money for social housing in Scotland and it is important that whatever we do we provide the best value for money.

72. On 17 June the Bank of England announced that it had selected Nationwide Building Society as the preferred bidder for the social housing loans and related deposits from housing associations held by the Bank of England's wholly-owned subsidiary, DBS Bridge Bank Limited. This followed a competitive auction process conducted by the Bank of England, in accordance with the Code of Practice issued by HM Treasury under the Banking Act 2009.[132]

73. In follow-up evidence to us, Nationwide stated that it had "a strong record of lending to the social housing sector across the UK, including in Scotland."[133] It would continue to employ Dunfermline's existing Social Housing team at Dunfermline's Head Office "for the foreseeable future".[134] The team had managed the portfolio whilst it was owned by the Bridge Bank.

5 Were the Tripartite Authorities right to invoke the SRR?

74. Jim Faulds argued that there "were some difficulties" with DBS's commercial book, but it was performing and customers were paying interest on those loans.[135] Graeme Dalziel told the Committee that there were only three cases of arrears in the commercial loan portfolio.[136] We were told that DBS had appointed teams with experience in commercial

131 "Compensation scheme knocks £241m off Nationwide profits", *The Guardian*, 27 May 2009

132 "Dunfermline Resolution: Announcement of the Preferred Bidder for the Social Housing Lending Business", Bank of England press release, 17 June 2009

133 Ev 37

134 Ev 37

135 Q 138

136 Q 238

lending and a commercial property expert. The commercial lending strategy was reviewed by the Board annually and submitted to the FSA.[137] Graeme Dalziel did not accept that the losses on the commercial book would be more than £32m as the Government had stated.[138]

75. However Jim Faulds told us that he "passionately" believed that the society should have been given a fair chance to remain independent.[139] This view was not shared by our other witnesses.[140] However, Jim Faulds acknowledged that the next best option would be to merge with a stronger partner and he was "delighted" that Nationwide was that partner.[141]

76. Graeme Dalziel, in follow-up correspondence, questioned why FSA had chosen to implement the SRR in the case of DBS, but subsequently allowed West Bromwich Building Society to maintain its independence through a loss absorbing capital instrument developed by the FSA with HM Treasury.[142] On 12 June, West Bromwich Building Society announced that it had "reached agreement with holders of the Society's subordinated debt to effect the exchange of the full outstanding principal amount of the Society's subordinated debt, totalling £182.5m, for a new instrument, Profit Participating Deferred Shares (PPDS), which will qualify as Core Tier 1 capital".[143] The FSA statement on the same day announced that building societies had been affected by the adverse economic and financial market conditions in different ways but suggested that other building societies should consider whether PPDS could be useful for their own capital management.[144]

77. The *Guardian* questioned whether the capital instrument used by West Bromwich would solve the society's long-term problems and quoted banking sources as saying "This deal buys West Bromwich time, but it's a sticking plaster. The fundamentals haven't changed. The society remains relatively weak and could be picked off by a stronger rival some time down the line."[145]

78. When asked whether he thought the Tripartite Authorities made the right decision in refusing to provide a capital injection of £30m, Tony Prestedge of Nationwide said that in their view, DBS "would have struggled to create sufficient value in order to fully service that level of injection of capital debt." Nationwide also questioned whether £30m would have been enough, based on the limited due diligence that it had been able to undertake.[146]

79. **Based on the evidence from the Tripartite Authorities and Nationwide, it is obvious to us that it was not possible for Dunfermline Building Society to remain independent. However, whilst there may be differences in the circumstances leading to the difficulties in which the West Bromwich and Dunfermline Building Societies found themselves in,**

137 Q 139 [Graeme Dalziel]

138 Q 235

139 Q 208

140 Qq 5, 18, 248

141 Q 208

142 Ev 37

143 "Regulatory News Announcement", West Bromwich Building Society news release, 12 June 2009

144 "FSA statement of profit sharing deferred shares", FSA press release, 12 June 2009

145 "FSA deal gives West Bromwich building society breathing space", *The Guardian*, 11 June 2009

146 Q 248

when preparing a review of the lessons learned from the first use of the Special Resolution Regime, the Tripartite Authorities should confirm whether a solution such as the capital instrument used in West Bromwich's case was considered as a viable option for saving the Dunfermline Building Society.

6 What will happen to Dunfermline Building Society in the future?

Introduction

80. On 30 March, when the Bank of England announced the transfer of core parts of DBS to Nationwide, it emphasised that as far as customers were concerned, it was "business as usual":

> Dunfermline's deposit business will continue to operate normally. Branches and telephone banking will continue to open during their normal hours and customers can deposit and withdraw their money in the usual ways. Savers can be assured that their money is safe. Loan and mortgage customers can continue to contact Dunfermline in the usual way and should continue to make repayments as normal.[147]

81. Andrew Bailey of the Bank of England told us that it was most important to take the depositors in DBS to a safe home very quickly to ensure confidence in the society.[148] Nationwide told us that DBS would be operated as a separate trading franchise of Nationwide within its regional brands business, also including the Derbyshire and Cheshire brands. The regional brands businesses have a common management team and front and back office.[149]

The Dunfermline Building Society "brand"

82. The Nationwide told us that the Dunfermline Building Society "brand" was one that was valued by its customers,[150] and in the short term it was committed to preserving the brand as it believed there was value in local community-based societies, representative of the communities they serve.[151] The Nationwide press notice issued on 30 March recognised "the goodwill attached to a historic and important Scottish brand."[152] However, Nationwide warned that the business would need to be viable and its members would need

147 "Dunfermline Building Society", Bank of England press release, 30 March 2009

148 Q 6

149 Q 269

150 Q 252

151 Q 268

152 "Acquisition of Dunfermline by Nationwide Building Society", Nationwide Building Society press release, 30 March 2009

to commit to DBS to ensure that it continued to perform well.[153] Tony Prestedge, Group Development Director of Nationwide, told us that there were not significant cultural differences between Nationwide and DBS: both had a strong heritage of mutuality and both had a strong service ethic.[154]

83. In the recent preliminary results for 2009, Nationwide's Chief Executive stated that the recent mergers and transfer had provided an opportunity for Nationwide to "deepen its national franchise at a local level. Derbyshire, Cheshire and Dunfermline will all retain their regional identities and operate as three new trading brands for Nationwide".[155]

The Dunfermline workforce

84. Clive Maxwell of HM Treasury told the Committee that part of the deal with Nationwide was that the 500 or so DBS staff in branches would transfer to Nationwide on 30 March and there would be no compulsory redundancies in the branch network for a minimum of three years.[156] He also said that eligible employees would be offered membership of the Nationwide personal pension plan.[157] Tony Prestedge confirmed that the Dunfermline final pension scheme closed at the date of the transfer and is with the Administrator. Members of that final scheme have been invited to join the Dunfermline defined contribution scheme which has continued unaffected.[158]

85. But unlike the branch network, a Nationwide press notice issued on 30 March stated that Nationwide's existing head office in Swindon would remain the head office for the combined Society, and it was likely that some back office and central group functions of DBS would no longer be required.[159] Tony Prestedge told us that Nationwide was undertaking a review of operations within the head office of Dunfermline to assess which roles would still be needed. This review was expected to be completed towards the end of 2009.[160]

86. The Committee was impressed with the professionalism and expertise that the management of Nationwide Building Society has brought to the Dunfermline Building Society business. We would encourage Nationwide to recognise the quality of the loyal and dedicated workforce of the Dunfermline Building Society and to engage fully with the relevant trade union organisations in discussions on the workforce's future.

153 Q 268

154 Q 269

155 "Nationwide preliminary results announcement for the year ended 4 April 2009", www.nationwide.co.uk/aboutnationwide

156 Q 109

157 Q 110

158 Q 266

159 "Acquisition of Dunfermline by Nationwide Building Society", Nationwide Building Society press release, 30 March 2009

160 Qq 264–265

7 Conclusion

87. **In the words of the former Chairman of Dunfermline Building Society, the ultimate responsibility for the plight that Dunfermline found itself in lay with the Board of the Society. The poor project management of Dunfermline Solutions made a significant contribution to the failure of the Society.**

88. **Whilst the nature of the Special Resolution Regime will be that the Tripartite Authorities have to move quickly and confidentially to preserve market confidence, it is regrettable that, in the first instance it was used, the banking institution at the heart of the negotiations felt that it was kept in the dark about the very standards and criteria it was having to meet to guarantee its future independence. If any bank or building society is unfortunate enough to suffer the same fate as the Dunfermline Building Society, the Tripartite Authorities must consider whether it is necessary to hold the banking institution at arm's length, or whether a more beneficial outcome might be achieved if all parties are fully aware of the standards expected to be met.**

89. **In the years running up to the transfer, the Financial Services Authority failed to provide the necessary level of supervision over the Dunfermline Building Society and to issue clear and specific warnings. As a consequence, savers and investors were left unaware of the true position of the Dunfermline Building Society and of its possible implications. It appears that at no time did the Society's commercial lending portfolio feature as a real concern, and the Board was confident that it had the necessary capital provision to see it through a once in 25 years type recession. It is hard to see how the Society could have improved its position once the global financial crisis intensified in October 2008. Whilst Dunfermline Building Society chose the path of riskier lending, it cannot be said that it was given more than a general warning by the FSA. We look forward to the results of the FSA's consultation on a new code of practice which was issue in June, and which is hoped will provide clear guidance to building societies of the risks involved in straying outside their traditional remit. Only time will tell whether the level of capital provision demanded by the Financial Services Authority was justified, or whether the commercial lending portfolio of the Society would have made back the money given time.**

90. **From the information provided in the Annual Report and Members Review for 2007–08, it would not be clear to the Dunfermline Building Society's members that the higher returns for commercial lending would be accompanied by a higher risk. It was also not clear that the loss of £9.5m on a major IT project was due to a serious failure of management. There can be no doubt that the decisions taken by the management of the Society led it into difficulties.**

91. **The fact remains that a heavy price has been paid as a consequence of the Board of Dunfermline Building Society taking the risk of diversifying into areas that were traditionally outside a building society's core business. Whether or not Dunfermline Building Society's long-term future could have been saved with a capital injection part-funded by the Government, Dunfermline Building Society's actions necessitated**

intervention from the Tripartite Authorities at a cost to the taxpayer that might have been avoided by a more cautious approach. With the transfer of Dunfermline Building Society's core assets to Nationwide, the international reputation of the Scottish banking sector was dealt another blow as 150 years of independence as a mutual society was brought to an end.

Conclusions and recommendations

1. While the Board of Dunfermline Building Society believed that it was responding to a desire amongst its members for it to compete effectively in the market, we believe it failed to communicate to them that the moves to diversify into the commercial lending business brought higher risks as well as higher returns. (Paragraph 23)

2. We conclude that it would not be possible for the average member of the Dunfermline Building Society to glean from the Members Review that a serious failing in project management, rather than changes in technology, had led to the £9.5m loss. It is clear to us that, in its management of the Dunfermline Solutions project, the Board of Dunfermline Building Society lost control and allowed spiralling increases in costs which arguably amounted to a breach of the duties owed to the Society's membership. Therefore, we find it disingenuous that the £9.5m loss written off on Project Destiny was described in the Members Review as "excellent progress". (Paragraph 28)

3. There is a clear difference of opinion between witnesses over whether £30m, £60m or more would have been sufficient to secure Dunfermline Building Society's long-term future. This is a question that we are not qualified to answer. This was the first time that the Special Resolution Regime was used. Therefore, the Tripartite Authorities should undertake a review of how the Regime operated, and that review should look at the interaction between the Tripartite Authorities and at the decision making processes. (Paragraph 45)

4. On the evidence we have received, we conclude that the Financial Services Authority failed to give adequate specific warnings to the Dunfermline Building Society to justify the assertion that it was repeatedly warned about the dangers of commercial lending. Warnings need to be specific to the institution being addressed and must be given in terms that savers and investors can understand. The Financial Services Authority should further ensure that the institution communicates these warnings to its members. In all these aspects, the Financial Services Authority failed wholly to discharge its duties to protect the interests of investors and savers. However, this does not excuse the Society from its responsibility to recognise that the higher returns gained from commercial lending came with a higher risk or that it was not responsible for its own downfall. We look forward to the results of the consultation on the Financial Service Authority's additional guidance for building societies which should make explicit the risks involved in moving away from traditional patterns of lending. (Paragraph 54)

5. Whatever the shortcomings of the Tripartite Authorities' communications with Dunfermline Building Society, it was the Board that had dug the hole in which the Society found itself. We do not intend to adjudicate on these competing claims, but only express our expectation that the Financial Services Authority needs to examine the lessons for the future very critically. For Dunfermline Building Society, it is too late. (Paragraph 59)

6. Based on the evidence from the Tripartite Authorities and Nationwide, it is obvious to us that it was not possible for Dunfermline Building Society to remain independent. However, whilst there may be differences in the circumstances leading to the difficulties in which the West Bromwich and Dunfermline Building Societies found themselves in, when preparing a review of the lessons learned from the first use of the Special Resolution Regime, the Tripartite Authorities should confirm whether a solution such as the capital instrument used in West Bromwich's case was considered as a viable option for saving the Dunfermline Building Society. (Paragraph 79)

7. In the words of the former Chairman of Dunfermline Building Society, the ultimate responsibility for the plight that Dunfermline found itself in lay with the Board of the Society. The poor project management of Dunfermline Solutions made a significant contribution to the failure of the Society. (Paragraph 87)

8. Whilst the nature of the Special Resolution Regime will be that the Tripartite Authorities have to move quickly and confidentially to preserve market confidence, it is regrettable that, in the first instance it was used, the banking institution at the heart of the negotiations felt that it was kept in the dark about the very standards and criteria it was having to meet to guarantee its future independence. If any bank or building society is unfortunate enough to suffer the same fate as the Dunfermline Building Society, the Tripartite Authorities must consider whether it is necessary to hold the banking institution at arm's length, or whether a more beneficial outcome might be achieved if all parties are fully aware of the standards expected to be met. (Paragraph 88)

9. In the years running up to the transfer, the Financial Services Authority failed to provide the necessary level of supervision over the Dunfermline Building Society and to issue clear and specific warnings. As a consequence, savers and investors were left unaware of the true position of the Dunfermline Building Society and of its possible implications. It appears that at no time did the Society's commercial lending portfolio feature as a real concern, and the Board was confident that it had the necessary capital provision to see it through a once in 25 years type recession. It is hard to see how the Society could have improved its position once the global financial crisis intensified in October 2008. Whilst Dunfermline Building Society chose the path of riskier lending, it cannot be said that it was given more than a general warning by the FSA. We look forward to the results of the FSA's consultation on a new code of practice which was issue in June, and which is hoped will provide clear guidance to building societies of the risks involved in straying outside their traditional remit. Only time will tell whether the level of capital provision demanded by the Financial Services Authority was justified, or whether the commercial lending portfolio of the Society would have made back the money given time. (Paragraph 89)

10. From the information provided in the Annual Report and Members Review for 2007–08, it would not be clear to the Dunfermline Building Society's members that the higher returns for commercial lending would be accompanied by a higher risk. It was also not clear that the loss of £9.5m on a major IT project was due to a serious failure of management. There can be no doubt that the decisions taken by the management of the Society led it into difficulties. (Paragraph 90)

11. The fact remains that a heavy price has been paid as a consequence of the Board of Dunfermline Building Society taking the risk of diversifying into areas that were traditionally outside a building society's core business. Whether or not Dunfermline Building Society's long-term future could have been saved with a capital injection part-funded by the Government, Dunfermline Building Society's actions necessitated intervention from the Tripartite Authorities at a cost to the taxpayer that might have been avoided by a more cautious approach. With the transfer of Dunfermline Building Society's core assets to Nationwide, the international reputation of the Scottish banking sector was dealt another blow as 150 years of independence as a mutual society was brought to an end (Paragraph 91)

Formal Minutes

Wednesday 15 July 2009

Members present:

Mr Mohammad Sarwar, in the Chair

Mr Alistair Carmichael	Mr Jim McGovern
Ms Katy Clark	David Mundell
Mr Ian Davidson	Lindsey Roy
Mr Jim Devine	Pete Wishart

Draft Report (Dunfermline Building Society), proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 91 read and agreed to.

Resolved, That the Report be the Fifth Report of the Committee to the House.

Ordered, That the Chairman make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Written evidence was ordered to be reported to the House for printing with the Report.

Written evidence was ordered to be reported to the House for placing in the Library and Parliamentary Archives.

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[Adjourned till Wednesday 14 October at 2 p.m.

Witnesses

List of written evidence

List of unprinted evidence

The following memoranda have been reported to the House, but to save printing costs they have not been printed and copies have been placed in the House of Commons Library, where they may be inspected by Members. Other copies are in the Parliamentary Archives, and are available to the public for inspection. Requests for inspection should be addressed to The Parliamentary Archives, Houses of Parliament, London SW1A 0PW (tel. 020 7219 3074). Opening hours are from 9.30 am to 5.00 pm on Mondays to Fridays.

Email from a customer of Dunfermline Building Society to the Clerk of the Committee.

Oral evidence

Taken before the Scottish Affairs Committee

on Wednesday 20 May 2009

Members present

Mr Mohammad Sarwar, in the Chair

Mr Alastair Carmichael	Mr Jim McGovern
Mr Ian Davidson	Lindsay Roy
Mr Jim Devine	Pete Wishart

Witnesses: **Mr Jon Pain,** Managing Director of Retail Markets, Financial Services Authority, **Mr Andrew Bailey,** Executive Director Banking and Chief Cashier, Bank of England, and **Mr Clive Maxwell,** Director, Financial Stability, HM Treasury, gave evidence.

Q1 Chairman: Good afternoon, I would like to welcome our witnesses to the session. Perhaps you could introduce yourselves for the record.
Mr Bailey: Andrew Bailey from the Bank of England; I am the Executive Director responsible for banking at the Bank of England and I am also responsible for any Special Resolution activities that the Bank of England has to do which therefore includes Dunfermline Building Society.
Mr Maxwell: I am Clive Maxwell, I am the Director at the Treasury responsible for financial stability.
Mr Pain: I am Jon Pain, Managing Director of Retail Markets, Financial Services Authority.

Q2 Chairman: I know that one of our witnesses, Mr Pain from the FSA, has to leave at 3.30 so we will try to finish our business before 3.30 but at the beginning we will probably focus questions relating to Mr Pain. Before we start on detailed questions would you like to make any opening remarks?
Mr Bailey: No.
Mr Maxwell: No.

Q3 Could you tell us why did Dunfermline fail and who was responsible for the DBS failure?
Mr Pain: I wonder if I could lead with a few comments in that regard. I suppose there were a number of factors that ultimately led to the firm's failure. Its previous management had made some poor management decisions that substantially weakened the outlook for the firm in a more difficult market conditions environment, but in particular its diversification into commercial property lending, its purchase of non-core lending/mortgage portfolios from third parties and its inability to adequately control its cost base, particularly its IT investment. Finally, and probably importantly as well, in terms of the overall market confidence there was a heightened awareness of its difficulties. It was widely known that it was going to be substantially loss-making in 2008 and this reflected in its poor credit rating which would have impacted on its ability to raise wholesale funding. Against this and in the absence of any new capital that was required the firm's own management and board concluded that it did not have a viable future.

Q4 Chairman: It has been reported that DBS lost £9 million on its IT system and perhaps you could tell us to what extent was their own IT system failure responsible for their overall failure?
Mr Pain: It certainly played a part, Chairman; I would not take out of context the degree of the part it played but as you rightly say the firm had to write off nearly £10 million. It was a substantial investment, in the order of £30 million, which is large for a firm of this size, particularly against its cost base—it actually had a cost base in terms of its cost to income ratio (how we measured its cost efficiency) as being one of the highest in the sector, so it definitely contributed, it did not help in respect of having that drain on its resources.

Q5 Chairman: An argument has been given that in order to stay afloat, Dunfermline had to expand to riskier lending business to counter the banks' "cut-throat" mortgage practices. Those practices of the banks brought the system down, but the banks were rescued, leaving Dunfermline with the risky debts. How do you respond to the argument that it is unfair that the banks, which orchestrated this crisis, were rescued by the Government with the injection of billions of pounds and on the other hand they sacrificed this small business?
Mr Pain: Chairman, that might be a question more for Clive Maxwell to answer.
Mr Maxwell: Maybe I can answer that. The first part of your question is about the decisions that the business itself made about the ways in which it wanted to make profits, and they were clearly decisions for that business itself. Different organisations, different building societies have chosen to handle things in different ways. When the society was in difficulty the Government looked at it, like it looked at other situations, with three objectives in mind: firstly the need to protect depositors, secondly to ensure stability and confidence in the financial system and thirdly to safeguard the interests of taxpayers. In taking the decision that the Government was involved in, which was whether or not to provide any support to the society, it took all three of those issues into account and then looked at the conditions it had set for its recapitalisation scheme, which really requires

the organisations receiving the capital to be adequately capitalised with funding or have realistic plans to be so and to have sustainable business models. It took the decision that those conditions were not met in the case of this building society.

Q6 Chairman: Nationwide was given almost £1 billion by the Treasury and the critics say that a fraction of that money was not given to DBS to leave it as an independent organisation which has been established over the last two centuries.
Mr Maxwell: The funding provided to Nationwide has been part of that transaction, transferring a set of assets and liabilities to Nationwide. Andrew can perhaps explain the nature of that transaction more fully but it should not be regarded as an absolute cost to the taxpayer but as being in the form of funding. The costs of this resolution will firstly be borne by whatever remaining reserves there were from Dunfermline as part of the administration process and, secondly, by the Financial Services Compensation Scheme.
Mr Bailey: It is very important to draw a distinction between what you might call the capital shortfall that was within Dunfermline and the number that you quoted which is the amount of funding. The amount of funding has been put there as a means of ensuring that the depositors in Dunfermline were taken very quickly into a safe home, and from the point of view of the Bank of England's responsibility as the resolution authority, that is the thing that is most important, that the depositors in Dunfermline at the end of this process, which has to be a very fast process given the confidence issue around deposits and banking, were taken to a safe home very quickly. There is a clear distinction, therefore, between the funding which will be recovered, will come back in time, and the capital shortfall. The capital shortfall was of course nothing like the figure that you have for funding.

Q7 Pete Wishart: It is reported that all the Dunfermline Building Society required was a £60-£100 million loan in order to continue to thrive; was that properly considered and why was that totally rejected by the Treasury?
Mr Maxwell: The options were very fully considered. I should say that it was not a £60 million loan that was considered, it was a form of capital injection that would have been required to meet the shortfall in the balance sheet of the society. All banks and building societies are required by prudential regulations to hold capital above and beyond the assets that they hold; they must have total assets which exceed their liabilities by a certain amount in order to protect their depositors, to protect other people doing business with them, and in the case of Dunfermline there was insufficient capital and that would have needed to be replenished.

Q8 Pete Wishart: What would have been the figure required in order to allow Dunfermline to continue trading?
Mr Maxwell: The figure that has been quoted in a number of public documents has looked at how much would be needed immediately to allow it to do business and that is £60 million, but I should stress that that was in order for it to get through the short term. There are also questions here about the longer term ability of the business to carry on.
Mr Bailey: If I could perhaps just add one point there, Clive is right that in a sense you might say what is the immediate need, but in a banking problem where the issue is confidence—again this is the dominant feature of why are banks different from other companies, it is the issue of confidence, the confidence of depositors—I do not think we were at all confident that a solution which did not address the problem for the foreseeable horizon—and the foreseeable horizon is longer than that covered by the £60 million issue in my view and therefore it is considerably bigger—would have created the sort of confidence that would have put Dunfermline back onto a stable path. There was a real risk around that, that if we did inject £60 million we would have immediately got extensive commentary and extensive coverage saying this has not done it, this is a temporary fix, a band aid type solution, and we would have very quickly been back to the drawing board again.

Q9 Lindsay Roy: Good afternoon, gentlemen. As an extension to that it is my understanding that not only was there a one-off loan from Her Majesty's Treasury rejected as an option but so also was a reported offer from the Scottish Executive. Why were these options not taken up or seen as desirable?
Mr Maxwell: The first thing, as Andrew said, is that it was the judgment that even with the injection of £60 million the Society would be very unlikely to have an independent long term future and that would have led to worries about its sustainability. As I stressed, what was needed was a capital injection, it was not a loan which would be repaid, it would be a simple transfer of assets in the form of capital that the society needed. The Treasury looked at the situation; it looked at the conditions set out for its recapitalisation scheme which had been announced towards the end of 2008. Those conditions are firstly that any firm seeking to access a capital injection from the Government should be either adequately capitalised and funded or have a realistic plan for accessing adequate capital and funding and to have a sustainable business model, and the assessment made was that Dunfermline was not adequately capitalised and it did not have a realistic plan for accessing that adequate capital. Taking all of these things into consideration the Chancellor concluded that it would not be in taxpayers' interests to contribute public funds to the Dunfermline.

Q10 Lindsay Roy: To what extent was there any exploration about a sustainable business model? What level of discussion was there with DBS representatives?
Mr Pain: I will answer that if I can, Mr Roy. There were extensive discussions with the firm over a number of months in respect of trying to understand

its options and its viability in terms of its business model. We had plans presented to us to try and understand what those were over the three and five year horizon, so there was extensive discussion in terms of those issues.

Q11 Lindsay Roy: In terms of the discussions did you or your colleagues point out where you felt there were deficiencies and ask for these to be addressed?
Mr Pain: Indeed, Mr Roy. It comes back to the point made earlier, of course, that the fundamental deficiency is one of capital, but notwithstanding that these are very difficult circumstances in terms of economic circumstances for firms like Dunfermline, so the whole viability of its ability to generate profits going forward and sustaining its current position, those were all factors that were taken into account as part of that discussion.

Q12 Mr Devine: Basically the three of you are saying that this building society was not saveable or its business model was not saveable.
Mr Bailey: As a whole.

Q13 Mr Devine: As a whole, and £60 million, £100 million, £500 million, a billion pounds, was not going to change that.
Mr Bailey: There is some value which would change that, yes.

Q14 Mr Devine: That is what I am asking, what would have been enough? £60 million was not enough, £100 million was not enough, the extra £25 million from the Scottish Government was not enough; what would have been? What sort of figure are we looking at that would have maybe turned this around? I am not asking about taxpayers' value, I am just asking in your experience what would have turned it around?
Mr Maxwell: I should mention one other element in that judgment about the sustainability, and that is if you are putting more capital into a firm such as this the provider of that capital expects to get a particular rate of return on it and the Society involved has to be able to make the payments. The typical capital instrument to put money into a building society would be a permanent interest-bearing share and the provider of the capital would expect to have an interest repaid on that. This society had made losses according to its last accounts of—
Mr Pain: North of £24 million.
Mr Maxwell: The likelihood therefore of it having sufficient profits to be able to pay the sorts of interest required on those sorts of instruments did not seem realistic.
Mr Bailey: That is right. It had never made much more than £6 million profits a year, in a single year, so again picking up on the point that Clive has made, if there comes a certain size of capital that you put in and it cannot service that capital from its income stream—moreover if it uses all its income stream to service that capital it is not building its capital for the future—I am afraid that then tells you a pretty clear story about where this institution is. There is a number that would fill the gap; the problem as Clive has pointed out is that it could not actually pay the rate to service that number.

Q15 Mr McGovern: Could I just ask about something you said earlier, Mr Bailey, in answer to a question from Mr Devine when you said that Dunfermline was not saveable as a whole; so I am clear in my mind do you mean parts of it were saveable and parts of it were not saveable but as a whole it was not saveable?
Mr Bailey: The point we were making, and it goes back to the point I just made, is that there was not a solution that we could see which kept the whole thing together as an independent entity, recapitalised, able to service that capital through the income that it earned. That is my point.

Q16 Mr McGovern: You will have to excuse me, I am not an economist or a banker or whatever but when you say it was not saveable as a whole, what exactly do you mean?
Mr Bailey: What I am saying then is that anybody who had acquired—

Q17 Mr McGovern: Saveable in parts.
Mr Bailey: Parts, yes, because as we will no doubt come on to, as you can see, we were able to do that but it was not the whole of the institution, that is the point. There were parts of the institution—going back to the point that Jon made right at the beginning in terms of describing the problems that the institution had—where the problems were concentrated, so what we were able to do then was to separate those parts out from the good part frankly and deal with the good part, save and sell the good part.

Q18 Mr McGovern: But as a whole it was not saveable and you are happy to be quoted saying that.
Mr Bailey: Yes.

Q19 Pete Wishart: How does it compare with other banks that were saved, just to try and get a perspective between the problems that Dunfermline had and the Royal Bank of Scotland or Bank of Scotland, were they not saveable but saved, whereas Dunfermline was also not saveable but not saved.
Mr Bailey: We can all answer this question because we have all had a lot of experience, sadly, over the last two years now. I would compare it, frankly, with Bradford and Bingley which was a bank which we could not save and, again, we could not save it because there were parts of it which had losses in them which were sufficiently large that there was not a solution that was economic, that was affordable for the institution and would have kept it whole and independent.
Mr Maxwell: The objective of saving parts of the business, in particular the deposit book, was to allow the retail savers in that institution to carry on going about their normal business and transacting if it had been saved.

20 May 2009 Mr Jon Pain, Mr Andrew Bailey and Mr Clive Maxwell

Q20 Mr Davidson: Can I pick up the question of how these huge losses actually came about? We have moved on a bit now and we are talking about should any of the passengers have been revived as it were but I am more interested in who drove the car into the wall. Can you just clarify a bit for me what a mutual was doing involving itself in commercial property lending? My idea of a mutual is that it is safe, it is secure, it is somewhere people put their money in order that collectively they can lend and borrow and so on and so forth. What were they doing diversifying into commercial property lending, which has always struck me as a little short of gambling? Surely somebody amongst yourselves must have had responsibility to say, "Look, this is just far, far too risky, you are being irresponsible, stop it."
Mr Pain: If I can attempt to answer your question, Mr Davidson, firstly there is an important point to be made in respect of how the activities are actually regulated and allowed in respect of individual building societies. The Building Societies Act sets out what those activities can be and actually sets a parameter that is laid down in the legislation in respect of the proportion of its activities that can actually, in effect, be non-core activities in terms of lending, so what Dunfermline was doing at that time was completely within those boundaries—the boundary is 25% of its total assets can actually be in non-core activities.

Q21 Mr Davidson: How close to the limit were they?
Mr Pain: I have not got the figures in my head or to hand, Mr Davidson, but they were well within those limits.

Q22 Mr Davidson: Is well within that they were only doing 5% or well within that they had gone over 21%? I am just anxious that a mutual that I consider ought to have been something that was safe and secure got into basically gambling. Were they pushing the limit or were they just a little bit away from it? I am just trying to get a feel for these people that drove the car into the wall.
Mr Pain: My understanding would be that they would be well within those limits, they were not on the boundary fences as you describe it.

Q23 Mr Davidson: Nobody saw this as being potentially a difficulty amongst the regulators, it was just considered entirely appropriate, was it, that they were getting not right up to the limit but moving in that direction?
Mr Pain: That was the framework in terms of what they were permitted to do under the Building Societies Act and then in conjunction with that, in terms of building societies extending away from their core activities, we issued repeated warnings both to the industry collectively and to individual CEOs of the dangers of actually migrating away from pure mortgage lending and the risks that are inherent in terms of that. In the letter sent out from Adair Turner to the Chancellor you will see that there is a pattern of consistent reminders from the FSA about what those risks are to make sure the management were alive to those issues.

Q24 Mr Davidson: Can I just clarify, the Dunfermline Building Society would have had repeated warnings from yourselves about doing the things that they were doing.
Mr Pain: Absolutely. The collective industry were advised of that through various means; some of those were what I would call Dear CEO letters, they are written to all the CEOs of the sector, some of those are actually in direct speeches to the Building Societies' Association. That is one level of warnings of those inherent risks in terms of thinking about those risks before you proceed with that diversification. In addition to that and as part of our supervisory process, throughout the last two or three years, we have increased the intensity of those issues, bringing those to the attention of the DBS management team and board, and by way of illustration you will see again set out in the letter that Adair Turner wrote to the Chancellor that actually we made, as part of our ARROW process, which is our review of the risks inherent in any particular firm, we drew their attention to the controls of their commercial lending and that involved them in tightening those controls up. In 2007 they came to us to talk about acquiring another portfolio and after dialogue with us they actually then retreated from that deal and did not proceed with that deal.

Q25 Mr Davidson: They would have gone even further if you had not stopped them, is that fair?
Mr Pain: That would obviously be a question for management.

Q26 Mr Davidson: They were considering investing, they approached you about it, you warned them against it and they backed off, the implication being that if they had had their own way they would have gone even further and taken even more irresponsible decisions.
Mr Pain: On the basis I suppose that they approached us wishing to do that deal, that would be the conclusion I would draw, Mr Davidson, yes.

Q27 Mr Davidson: It would be fair to say in all of this that the people who were running the Dunfermline cannot say that they did not know because they were warned often enough about the sort of behaviour that they were undertaking and the risks they were running, is that fair?
Mr Pain: It is fair to conclude that there were plenty of warnings in the forms that we have set out.

Q28 Mr Davidson: I touched at the beginning there on the commercial property lending; this question of warnings, did that apply only to the commercial property lending or does it also apply to the purchasing of the high risk self-certified mortgages from the American firms? Were the warnings covering both of those or did they need another set of warnings for the self-certified mortgages?

Mr Pain: The warnings covered the scope of what you are referring to, Mr Davidson. We talked about commercial lending, we talked about diversification into buy-to-let, we talked about the acquisition of non-performing specialist mortgage portfolios from third parties. All those issues were covered.

Q29 Mr Davidson: So they were repeatedly warned about both things that caused them the most difficulty eventually.
Mr Pain: In the context of how I have described how those warnings were communicated, yes.

Q30 Mr Davidson: The other thing that seems to have gone wrong is the IT system, and again the Government is not necessarily in the best position to lecture other people about IT systems. Presumably they were just left to get on with that; that is not something that anybody supervises, is it?
Mr Pain: Actually it is something we take a close interest in because it actually refers to the effective systems and controls of a firm, so again one of our ARROW processes actually brought out the fact that that was a project that as an investment was poorly managed, they had issues with it and those were part of our intensive dialogue with the firm at that time, over many months, so it was not just a one-off occasion.

Q31 Mr Davidson: It was the IT project that you warned them was badly managed or the whole society.
Mr Pain: No, I was referring then to your particular question.
Mr Davidson: Fine, thank you.

Q32 Mr Carmichael: If I can just pick up on Mr Davidson's point because I am having difficulty just following your logic in its entirety. You are saying that the warning signals were not there because they were within their limits, they were not riding too many horses. You are sending them a series of what I think you are describing as effectively round robin letters, Dear CEO letters, yes?
Mr Pain: We are doing both. The earlier point was, if I can use your expression, that there were round robin generic letters—and those are fairly specific—written to individual CEOs across the sector as a whole. There were repeated issues raised to the BSA and then, in particular, with this particular firm as part of our ongoing supervision process in 2005 and 2007 we raised particular issues about the controls of its particular portfolio.

Q33 Mr Carmichael: That was 2005 and 2007. What were the terms of these specific issues?
Mr Pain: They were part of the supervisory risk review process and one of the issues that was raised in the ARROW report and is highlighted in terms of the letter that is highlighted here was this question in November 2005 of the control issues in respect of the commercial portfolio.

Q34 Mr Carmichael: You have got a letter in 2005, you have got another one in 2007 and you have a train wreck in 2009.
Mr Pain: I obviously did not complete that whole story when I was answering Mr Davidson's question, but subsequent to that in 2008 there was a specialist KPMG report in terms of the overall position of the commercial book as well. There was a series of interventions and dialogue about the state of the commercial book and other related portfolios.

Q35 Mr Carmichael: How alarmed were you as a regulator in 2005 and 2007?
Mr Pain: Concerned enough obviously in 2005 that that then resulted in acquiring some external expertise to come in.

Q36 Mr Carmichael: Did it not concern you that you could have concerns but a business could still apparently be within its limits? You see where the logical inconsistencies come in here. Did that maybe not raise a few doubts in your mind that maybe the limits could have needed a wee look at again.
Mr Pain: In fairness the limits are, as I have already indicated, enshrined as part of the legislative framework, so it would be a matter for Parliament to decide whether those limits were appropriate.

Q37 Mr Carmichael: Were those representations that you were making to the Treasury at the time as a body?
Mr Pain: I am not aware in terms of that.

Q38 Mr Carmichael: Maybe Mr Maxwell can tell us; were you getting frantic phone calls from the FSA saying these companies are going to hell in a handcart but we cannot do anything about it because you have given us the wrong limits?
Mr Maxwell: I would have to check but I am not aware of any such correspondence.[1]

Q39 Mr Carmichael: It is the sort of thing you would maybe remember.
Mr Maxwell: I would just make one point—and Jon could provide more on this—which is that when the FSA has to make judgments about the way in which firms are behaving there is the legislation but there is also the sense that the firm has to be operating in a particular way, it needs to have the ability and the skills and the experience of the individuals involved. There are a whole series of qualitative judgments that have to be made around these issues as well as hard and fast numbers on capital and the like.

Q40 Chairman: What you are telling us is that the FSA and the Bank of England were spot-on and it was just the failure of and incompetence of the management, the boards of directors of these financial institutions, that was responsible for the downfall of these banks and building societies? I find that hard to believe.

[1] *Note from witness:* We have no knowledge of correspondence from the FSA citing limits on their authority to act.

Mr Maxwell: The primary responsibility for running a bank or a building society lies with its board of directors and its management team.

Q41 Chairman: The responsibility for checks and balances lies with the Bank of England and the FSA.
Mr Bailey: Can I just qualify that? It is not the Bank of England's responsibility to regulate banks, that is of course with the FSA.

Q42 Chairman: If the FSA thinks that financial institutions are not taking their advice seriously then of course the FSA will report it to the Bank of England.
Mr Bailey: No, the remedial measures lie with the FSA. The Bank of England actually only comes into it—and I should say this is very recent because in fact the legislation that was used to resolve Dunfermline was only passed in February of this year, so it was actually only a month after it came in—at that very late point in the whole story. We are not part of the continuous story and we certainly do not have remedial powers of our own, those are with the FSA.

Q43 Mr Carmichael: Could I maybe just finish this? It seems to me that there may well be some substance in what you are saying about the conduct of the DBS as a whole but just within the confines of these four walls, in retrospect do you not think that there is more that you could have done as regulators to highlight what was coming down the tracks? Do you think you served the public interest well in the way that you dealt with Dunfermline Building Society?
Mr Pain: If I look across the spectrum of those years, Mr Carmichael, against the expectations of the mandate the FSA was working to at that time, the levels of warnings we gave to the industry collectively and then to this firm in specific terms, and then how we tried to deal with the resolution of the firm towards its end, then we did. I accept, however, that the expectations of the role of the FSA have changed over that period of time.
Mr Carmichael: Let me get this right: it is not the fault of the Bank of England because it is not your job; it is not the fault of the FSA because you were set up with an inappropriate mandate and it is not the fault of Treasury because you have set up an arms' length regulator, is that what you are telling us?
Chairman: Who is to blame?
Mr Davidson: I would have thought it was Dunfermline Building Society should have a certain share.

Q44 Mr Carmichael: If we have regulators there to regulate, why was the regulation not happening? If the Dunfermline Building Society has been so culpably reckless—and I am not challenging that assertion—why is it that nobody seems to pick it up in a meaningful and active way before the train wreck happens? Is that not what you are there for?
Mr Pain: Sure. As our Chairman set out in the letter that he wrote to the Chancellor he tried to describe, over that period of time, the expectations of us and how we developed against those expectations a more intrusive and challenging aspect of regulation. It is clear to say that over almost a five-year time period the expectation of the role of the regulator has changed, but I do repeat what Clive has already said: ultimately the activities of the management have a significant bearing in terms of then what happens to a particular firm.

Q45 Lindsay Roy: Gentlemen, I am sure you appreciate that we receive briefings prior to this meeting and I just want to check the validity of something I have in writing here about the number of warnings that were issued from 2003 onwards. The briefing then says, "However, DBS was allowed to increase its commercial property book five-fold to £628 million between 2004 and 2008 and buy mortgage books worth £467 million from Lehman Brothers and GMAC." The FSA did intervene in October 2007 to prevent another £160 million book from Credit Suisse." Is that accurate, is that true?
Mr Pain: Mr Roy, in terms of the building of the commercial portfolio from 2004 of about £112 million through to £600 million odd in 2008 that is an accurate description but there are a couple of things that are important to bear in mind. One is that the actual drawdown of the most significant increase in terms of that growth between 2007 and 2008 was already commitments that were made to borrowers, so all they were doing was drawing down on already agreed facilities. There was then an appreciable slowing down of the activities and Dunfermline actually ceased any commercial activities in terms of lending in 2008.

Q46 Lindsay Roy: Who made the decision then not to invest taxpayers' money in DBS?
Mr Maxwell: Not to invest taxpayers' money?

Q47 Lindsay Roy: Who eventually made the decision?
Mr Maxwell: That decision was the Chancellor of the Exchequer's.

Q48 Pete Wishart: It was reported that Mr Faulds, a former chairman of Dunfermline Building Society, went to the press and said that one of the reasons why the Government were not interested in helping Dunfermline Building Society was because of the involvement of the Scottish Government because they had been approached. Can you categorically deny that that is the case, that that had nothing whatsoever to do with the Government not getting involved in helping save Dunfermline Building Society?
Mr Maxwell: As I said, the decision was taken based on value-for-money assessments in the way in which I described.

Q49 Pete Wishart: Why did Mr Faulds think that that may have been the case?

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Mr Maxwell: I do not know.

Q50 Pete Wishart: There was nothing said, nothing hinted, nothing coming out of the Treasury at all to say because the Scottish Government are getting involved we have nothing whatsoever to do with this?
Mr Maxwell: I do not know.

Q51 Chairman: In terms of the tender for Dunfermline, how many organisations were involved in this tender and was there any possibility of a takeover by any other bank or building society?
Mr Bailey: The simplest thing I can do is say to you that we received four bids. I hope you will understand that I am not going to comment on individual institutions that bid for it because that is covered by commercial confidentiality, but there were four bids received and out of that we determined, as Clive has said, the best one that fitted the objectives that the Act and the regime give us, which are the three things that Clive mentioned earlier.
Chairman: Thank you. Can we move on now please?

Q52 Pete Wishart: Just to go back to the role of the FSA in all this, you vigorously contested the suggestion that you stood idly by while the building societies were going to the wall when it was published in the *Financial Times* but it seems to me that sending these letters around and maybe getting in touch with CEOs on a regular basis was all you did. What else have you done in order to alert the building societies to the difficulties they were getting themselves into?
Mr Pain: As I have already tried to explain, Mr Wishart, it varies for the individual firms in terms of their own individual circumstances so we do tailor our approach in terms of individual firms and our supervision of those individual firms to their unique position in terms of what activities they are undertaking and what risks they are taking on board. That is very much our tailored approach in terms of particularly the larger firms across the marketplace as a whole. Without repeating all that I have said I am confident that we did give very clear signals in respect of the issues and risks of diversifying away from those mainstream activities.

Q53 Pete Wishart: What is the current position of other building societies, are there any other building societies in the position that Dunfermline found itself, are there any others that are about to go to the wall?
Mr Pain: As you will appreciate, Mr Wishart, we do not comment on individual firms and obviously with our primary focus on financial stability you would not expect me to talk about individual firms today.

Q54 Mr Davidson: Can I just follow that up without asking you to comment on individual firms? Could it be said that the collapse of the Dunfermline was predictable? Looking at the figures, looking at the direction of travel, the car speeding along, could you see the wall that they were heading towards or did it come as a complete surprise to you as it did to the driver?
Mr Pain: You cannot divorce those issues, Mr Davidson, away from the economic market conditions as well so what happens in the external marketplace in respect of commercial lending or any other form of lending has a bearing in terms of the risk that any institution might endure, so all those factors are part of that. It is clear and very noticeable that obviously the prevailing economic conditions over that period of time for commercial property were difficult.

Q55 Mr Davidson: Are there any other mutuals that also hit the wall?
Mr Pain: There are, as a matter of record, a number of other building societies over the course of the last 12 months who have actually merged to a stronger partner in that respect.

Q56 Mr Davidson: They have obviously been more attractive and more saveable, have they not, otherwise they would not have merged with somebody else? What I am just trying to clarify is that this is a uniquely bad situation, is it not, because even though the others got into difficulty they were in overall terms saveable and were indeed saved? This was just so appalling that nothing could be done except picking through the wreckage and taking the bits that could be utilised elsewhere. Is that fair?
Mr Pain: It is probably fair for the Committee also to realise that we worked excessively hard before the final resolution to find a merger partner and in fact three firms undertook full due diligence on DBS to see whether a merger was possible, but ultimately unfortunately that was not the case. We tried to find a range of market solutions for this particular firm.

Q57 Mr Davidson: Were the firms, the potential suitors, offered appropriate dowries to take the wreckage at all? Would that have been a cheaper way of doing it?
Mr Pain: We looked at all aspects in terms of what the possibilities might be for a market solution, if I could use that expression, Mr Davidson, but ultimately they did not come forward with a solution that was viable.

Q58 Mr Davidson: Thank you. One of the other issues is that if I could quote from Robert Peston, who is the obligatory source on all these matters, he said that Dunfermline's 2007 annual accounts did not show the extent of its exposure to commercial property and its auditors appeared not to realise the exposure. Is there a problem with the system of annual audit that does not allow for an exposure big enough to send an institution under to be visible?
Mr Pain: The audit requirements for any institution in terms of a building society, including Dunfermline, are laid out in regulations in terms of the Building Societies Act and their published accounts were entirely consistent with those requirements. It is fair to say and maybe fair to

clarify in terms of the point you are asking that actually at the point of making those accounts final the auditors are looking at the balance sheet and the known impairments in terms of the portfolio, they are not forecasting the future potential losses, that is not the purpose of the audited accounts.

Q59 Mr Davidson: Robert Peston said, if I may quote directly, "For me perhaps the most shocking element . . . is what it has revealed about the uselessness of the 2007 annual accounts. It's impossible to identify in these the size or nature of its exposure to commercial property." You would say that that was not correct there, you would say that the accounts did give an accurate representation of their exposure.
Mr Pain: I am saying that in terms of the requirements of those regulations to report they were entirely consistent and signed off by the auditors as being entirely consistent with those requirements. There is not a requirement to give further disclosures maybe as Mr Peston is referring to; their accounts were entirely consistent with those regulations.

Q60 Mr Carmichael: Presumably there was a fault in the regulations then.
Mr Pain: Not that I would perceive, Mr Carmichael; Mr Peston might have a different view.

Q61 Mr Carmichael: If you have got accounts that do not identify the single biggest problem that is facing the building society, what is the point? What is the point in having accounts if they do not show the true picture? How can people be expected to make informed investment decisions on them?
Mr Pain: As I say the accounts fully reflected the requirements of the regulations.

Q62 Mr Carmichael: The requirements of the regulations but they did not reflect the true position that the building society was in.
Mr Pain: I would stress that those are not FSA regulations, those are enshrined in the Building Societies Act as an Act of Parliament in respect of that, they are not a requirement for the FSA in that respect.

Q63 Mr Carmichael: You have told us that you were issuing warnings, specific warnings, to Dunfermline. You have told us also that you knew what the true position was, you could see the accounts that did not show the true position and you are not seeing a problem with this systemically.
Mr Pain: One of the things that I tried to helpfully explain to Mr Davidson is that the report and accounts show the level of impairment on the balance sheet at the time the report and accounts are struck. The whole purpose of the report and accounts is not to give a forward-looking view but many of the issues that you are referring to in terms of our assessment of this institution are forward-looking in terms of what it was exposed to.

Q64 Mr Carmichael: Surely though the point of this is that somebody who is familiar with this part of the financial services sector would be able to look at the accounts and, if they were meaningful, to make informed judgments on what was likely to happen. That is surely the point of having a balance sheet.
Mr Pain: Sure, but as I say the balance sheet purpose is to show the level of impairment at that time. Do not forget that we are talking about 2007 here and many of the issues that we are talking about in terms of eventual loss are at the end of the year 2008 and then forward-looking in terms of the potential risks that were in front of the society.

Q65 Mr Devine: If I am a shareholder and I am a saver and you are sending letters of warning for four years, should that not be flagged up to me in the interests of transparency?
Mr Pain: All the Dear CEO letters and the speeches we made to the BSA and the warnings in that respect, apart from the private warning to a firm which obviously is not public information, are publicly available in that sense.

Q66 So I would know from 2005 that you were sending out warnings.
Mr Pain: I cannot honestly recall—because I was not at the FSA at the time—whether those particular letters were published. It is not our usual practice not to make those public in that sense. Letters to individual firms about individuals, given the confidentiality of those matters, are not matters of public record.

Q67 Mr Devine: From 2005 you know there is a major problem and you are sending letters of warning but there are three or possibly four annual reports saying everything is okay. Three anyway.
Mr Pain: Just for the sake of clarity in terms of what we talked about over that period of time, at 2005 if we go back to the earlier point in terms of where the building society was at that stage the portfolio was at a particular point. Many of the issues that we have talked about were issues that came later in terms of the final issues that brought this institution down. The issues that we raised in terms of 2005 as part of our risk review process of that firm were private to the particular firm itself. The issues that we made over the period from 2004 in terms of Dear CEO letters and warnings to the industry at large were a matter of public record. The report and accounts would reflect the level of impairment and losses on the portfolio at that moment in time but would not have been forward-looking to 2007/2008.

Q68 Mr Devine: Mr Pain, we have got the FSA wrong, have we not? You are the unacceptable face of capitalism in 2009 are you not?
Mr Pain: Sorry, I am not sure I understand your question.

Q69 Mr Devine: Here we have an FSA that is light touch on regulation and we have seen a crash of the banking system right across Britain, and what is being said is that you were aware of those problems years before and nothing was done.
Mr Pain: I have described the actions we take. I do not think nothing was done, we did take action over that period of time and we also, as a matter of public record and reflected in our Chairman's letter to the Chancellor, show that the nature and the intensity of the supervision of the FSA has changed significantly over that period of time but particularly since 2007. I am not trying to rewrite history in that respect; we have acknowledged the fact that that is the case.

Q70 Mr Devine: Lord Turner has said that the FSA plan to issue a new code of conduct.
Mr Pain: As part of our ongoing and increasing intensity across the whole sector, but particularly in terms of the building societies you are referring to, it is our intention that we will be issuing a code of practice later this year that refers to the expectations of systems and controls if building societies wish to diversify their business, tightening up those yet still further.

Q71 Mr Devine: The code of conduct at present and the guidance at present is wrong.
Mr Pain: With guidance you can always improve and reinforce those points and that is what we see the code doing later this year.

Q72 Mr Devine: Will that mean a change in the law?
Mr Pain: No, this is guidance that we will be giving in our handbook, the handbook rules to building societies. It is not going back to the point in terms of the framework of what the building societies are operating, it is not our role to rewrite the Building Societies Act.

Q73 Mr Carmichael: If when you have effected all these changes you find yourself with a building society today that presented the same set of facts and circumstances as that which was presented by the Dunfermline in 2005, what would happen differently?
Mr Pain: It is a difficult question to answer in terms of the conjecture as to what might happen.

Q74 Mr Carmichael: Let me tell you my concerns and tell me if they are addressed.
Mr Pain: What I draw you back to, Mr Carmichael, by way of indication is if you look at the intensity in terms of our activities with this particular firm, which is spelled out in that letter over 2007 and 2008, that shows the level of intensity, so it shows that in fact we would effectively make more interventions in bringing external skilled parties in to review the portfolio. The level of management changes that we encouraged the board to make in respect of strengthening its management team was part of the engagement of the FSA at the end of 2008 with this particular firm, so those are indications in terms of the increased level of supervision that we have now recognised is part of the role of the FSA.

Q75 Mr Carmichael: The warning letters that went which were first of all the general round robin letters, the Dear CEO letters, would they be different?
Mr Pain: It depends obviously on the circumstances. As I said before our focus in terms of individual firms has to be tailored to those individual firms and their particular risks, but it is very clear and it is a matter of public record in terms of the level of intensity of supervision that we now expect to deliver against individual firms.

Q76 Mr Carmichael: The specific warning letters that you sent to the Dunfermline as I understand it effectively constituted reminders about the importance of them carrying out due diligence in respect of those matters in their balance sheet that concerned you, is that right?
Mr Pain: In part.

Q77 Mr Carmichael: What more did they have in them then?
Mr Pain: It is actually understanding the risks inherent in purchasing loans from another source where you have not originated those loans for yourself.

Q78 Mr Carmichael: That is where due diligence comes in surely.
Mr Pain: Due diligence is part of that and also, as you will see from our intensification in terms of stress testing and asking firms to undergo stress testing in respect of their portfolios, that would be a feature of that type of activity. If you are going to acquire a portfolio you think then about stress testing that portfolio to understand what risks might be inherent in that.

Q79 Mr Carmichael: Because it seems to me that you have sent out warnings, you are saying we want you to do due diligence, but at no point have you ever gone back to say to the Dunfermline "We told you to do due diligence, we presume you have done what you were told, please tell us what the results were." Did that ever happen?
Mr Pain: By way of implication in just 2007, as I have already alluded to, when they wanted to purchase a further portfolio, that deal was cancelled.

Q80 Mr Carmichael: You stopped what was going to be the most toxic acquisition but in terms of sounding warnings, taking early action in respect of the toxicity that they had already acquired, nothing really happened.
Mr Pain: I do not think that is right.

Q81 Mr Carmichael: What did happen then?
Mr Pain: As I have already explained and as spelled out in Lord Turner's letter to the Chancellor, if you look at 2005 through to 2008 there are aspects in terms of the interventions we made in 2005 with the further tightening of the controls of the portfolio, there is the rejection in 2008 of the firm's internal capital assessment, which goes back to the risk and the stress testing of the portfolio, and there is the further stress testing we took for all firms, the

additional liquidity requirements that we required for all firms throughout the end of 2008. There is therefore plenty of evidence to show, to answer your question, the level of intensity of supervision on that basis, both to this individual firm and to firms across the market as a whole.

Q82 Mr Carmichael: But it still all managed to go horribly wrong.
Mr Pain: In a sense the economic conditions, as I have already said in my opening remarks, in terms of what this firm was exposed to—if the market, particularly the commercial market, takes an appreciable turn for the worst, those assets are already on their balance sheet.

Q83 Mr Carmichael: As the regulator did you allow yourself to think the good times were going to last forever?
Mr Pain: No, what we have talked about in terms of stress testing is an indication that obviously we expect firms to think about what would happen if economic conditions changed.
Chairman: Can we please move on as Mr Pain has to leave at 3.30?

Q84 Mr Davidson: Can I just ask one point about this? In all of this with hindsight do you think you were under-powered?
Mr Pain: In what sense Mr Davidson?

Q85 Mr Davidson: You mentioned earlier on to me about the limits that were there of 25% of gambling as it were that you allowed. Would you not, with hindsight, have wanted to have had more powers so that instead of just sending out circular letters you would have wanted to be able to step in and say, "Look, stop doing that?" What we are trying to do is just identify what could have been done earlier to stop this disaster. I recognise that the main responsibility for the crash lies with the drivers, I understand that, but what I am just trying to clarify is whether or not you should have been able to have taken action, warned them, done something else. Are there particular powers that, had you had them, you would have been able to utilise to stop this disaster happening or was it inevitable? I am working on the basis in all of this that the collapse of the Dunfermline Building Society was not an act of God and therefore there were decisions made by people that led to that collapse. What I am seeking to clarify is whether or not you feel at any stage with additional powers you would have been able to stop it, or was it in some way always inevitable?
Mr Pain: The point I would make would be that obviously the Building Societies Act enshrined the activities and 25% of those activities could be in non-core lending. That is enshrined in the Building Societies Act and it would obviously be a matter for Parliament to decide. It must be remembered that the context of that at that time was to allow building societies in a modest way to compete as financial institutions across the marketplace as a whole and the balance of that was in terms of 25% of lending. There are other firms that have undertaken that, without endangering their whole enterprise.

Q86 Mr Davidson: That is a very good point; other firms have involved themselves in diversification without endangering the whole enterprise so clearly the rule itself as it is just now is not sufficient, there will have to be presumably some opportunity for someone to intervene within that 25% and say "Look, this is not appropriate." That presumably is an indication that you do not have sufficient powers to intervene, is it not?
Mr Pain: I believe that with our intensifying level of supervision in terms of what we have already set out since 2008 and post Northern Rock gives us a framework to actually do that. As we have already referred to, in 2009 the code of practice we intend to enshrine in the handbook for building societies will further solidify those controls.

Q87 Mr Davidson: We will not make the same mistakes again.
Mr Pain: Obviously, ultimately, one would not wish to see any firm go the way of Dunfermline, but equally at the same time it is probably impractical to believe that any regulatory environment could avoid any firm, of whatever size, getting into difficulties.

Q88 Mr Davidson: I wonder if we could move on then, Dunfermline was the first to go into the Special Resolution Regime. How well did that work?
Mr Bailey: As I said earlier one of the principal objectives of the resolution regime when we have to apply it—and I can assure you that we all go out of our way to not apply this regime because of the difficult situation that results—is that the depositors in the institution are put into a safe home and have the confidence that that solution protects them and that it can go on as business as usual. As you know, that involved a transfer to the Nationwide Building Society of the deposits and also of the prime mortgages, and there is often in these institutions quite a strong overlap between the prime mortgage borrowers and the depositors so that they in a sense quite naturally sit together sometimes. I can say that so far that objective has been achieved, the whole atmosphere is much calmer around Dunfermline, we obviously look very carefully at the movement of deposits, the outflows and the inflows—there has not been an outflow since then—the press speculation and coverage has died down, which is obviously an important issue for the confidence of depositors, so in that sense we can say, yes, we have achieved the objective.

Q89 Mr Davidson: The other two of you are both happy with all of that and the three parties are working well together and everybody is agreed about the courses of action that were followed.
Mr Pain: We would share Andrew's view that the resolution process worked effectively to protect particularly depositors, both retail and wholesale depositors, which is quite important.
Mr Davidson: Fine, thank you.

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Q90 Lindsay Roy: How well is the bridge bank operating?
Mr Bailey: I should have perhaps said at the outset—I am sorry, Chairman, I did not give my full list of titles—I am also currently the Chairman and Chief Executive of the Dunfermline Building Society bridge bank. Perhaps I should start by explaining why the bridge bank. When we looked at the Dunfermline it was evident that it had a very large, disproportionate to its size, presence in the social housing lending market in Scotland—it is, I believe, the second largest social housing lender in Scotland after the Royal Bank. That was obviously an important consideration in terms of the objectives and making sure that we could stabilise the building society and stabilise the activities that it undertakes. That was a particular reason for creating the bridge bank, which only has the social housing lending in it.[2] We are of course looking to sell it, obviously we are trying to find a buyer for it, and we are—I should stress this—running the bridge bank as business as usual, and I have made this point to the Scottish Executive, to the Scottish housing regulator and to the Scottish Federation of Housing Associations, that we have not come in to change the nature of what it is doing, we are running it as business as usual. We obviously want to put good controls around it and, to give you a figure if you like, since the bridge bank was created on 30 March and as it is a wholly owned subsidiary of the Bank of England at the moment, we have advanced, as of last night anyway, £10.2 million of lending to registered social landlords in Scotland, which is all part of the undrawn but committed lines that Dunfermline had. Finally, the bridge bank is advancing the pipeline of new social housing projects that it had on its books coming through at the point when we took it over. Frankly, I and my colleagues are doing all that we can to make sure this is business as usual as we get it ready to be sold.

Q91 Chairman: Are you happy with having the social housing loans in the bridge bank?
Mr Bailey: Let me be clear, as the Bank of England I am not in the market to acquire activities and banking books, but I am happy to have it in the sense that, as I said, it is clearly an important function in Scotland, and that was very evident. It is clearly something that ought to be kept whole and continuous in that sense, so in that sense, yes I am because it was a sensible use of a tool that has been created in legislation that only came into being in February of this year.

Q92 Chairman: Did the Treasury request that inclusion?
Mr Bailey: Given the process that exists to decide upon the resolution, I have to consult both the Treasury and the FSA on what I call the choice of tools. In this case we used several of the tools because there was a transfer to Nationwide and there was a bridge bank, so yes we did consult and yes they were involved.

Q93 Chairman: How do you see the future of social housing lending?
Mr Bailey: I have to say I do not take a long term view on social housing lending because it is a bridge bank and the word "bridge" is important. I have talked to officials from the Scottish Executive and that was very interesting because they gave me a very clear account of the way in which social housing lending operates in Scotland and the intention as towards future social housing lending in the immediate future, so that was very helpful to us. As I said, we are doing all that we can, frankly, to support that in terms of keeping the second largest social housing lender going in a business as usual fashion.

Q94 Mr Carmichael: Can I just ask as well on the point of the bridge bank the information I have is that there are issues about the staffing and the resourcing. You have a very small number of staff who are struggling to service it and to sell it off at the same time. Are you satisfied that you have got the staffing that you need?
Mr Bailey: I was there on Friday—and it is a staff of four essentially. I understand and I am very sympathetic to them that obviously we have placed a large burden upon them because, as we say, we want to run the business as usual. They have all the contacts and the knowledge—we have people there, but they have the knowledge quite clearly—and at the same time we want to get this to a future home which will set it off on a permanent footing. To do that we have got to do all the due diligence process, we have had to set up a whole mechanism for prospective purchasers to do due diligence and, as part of that of course, one of the things that any purchaser wants to do is to talk to the people who know about the business, take their time up and find out. I am very conscious—and it was something that I talked to them about when I saw them on Friday—that we are putting them under strain but trying to do it in a reasonable course of time rather than spin it out is sensible, because the other point that I am very conscious of is that as individuals they want to know what their future is, and this is very important too. They all have, as you will know, long experience in this business and long experience actually with Dunfermline. They are a very experienced team, they have built up a business, clearly, as the second largest lender; they want to know where it goes in the future and I would like to be able to say to them this is Dunfermline's solution and this is your part in it. It is a strain, you are absolutely right.

Q95 Mr Carmichael: You have identified staffing as an issue then, because I have to suggest to you that there is a public interest issue here given the fact that we are dealing with social housing that that bridge bank be managed in a way which is effective. There

[2] *Note from witness:* The bridge bank only contains social housing business. The bridge bank contains social housing loans and associated deposits.

must be concerns surely that if the staff are struggling to do everything that is required of them they are not going to be doing it effectively?
Mr Bailey: There is a concern and I am concerned about that because I am trying to balance a number of objectives here, and you are absolutely right to make the point that in doing that there is a strain that obviously falls on the staff, so I am trying to balance the objective of continuing to support social housing lending and the objective of finding a permanent home for the bridge bank and, as I said, finding a permanent home for the staff to know what their future is.

Q96 Mr Carmichael: Probably what I am coming to ask you is you have identified the problem; is that something they are just going to have to live with or are you going to do something to make their life a bit easier? In fact, these are not the people who are responsible for the situation in which they find themselves, are they?
Mr Bailey: No, they are not. I said to them last Friday when I was there, "Look, we have put resources in but I do not have resources who are experts in social housing lending in Scotland, I will be absolutely honest with you on that." One thing I said to them, to be very clear, was: "You can get in touch with me personally if we are causing you an unnecessary burden. I will be honest with you, we are putting some more controls around the whole operation, I will be quite clear with you on that; if we are doing things that you think are unnecessary, tell me."

Q97 Mr Carmichael: And their concerns about their pension future and the rest of it, the final salary scheme, that is clearly something which is a legitimate and substantial concern for them.
Mr Bailey: Exactly.

Q98 Mr Carmichael: Are you able to offer them any reassurance?
Mr Bailey: I can offer them the reassurance that we will endeavour to find the best future for this operation and for them that we can. They are all very committed, they all want to be part of this future and that is a great credit to them by the way.

Q99 Mr McGovern: The Government has been, perhaps understandably but in my view disappointingly, reluctant to give us exact details of the potential losses to the taxpayer from the use of the special resolution regime. Are you in a position to tell us now what exposure the taxpayer now has in this regard?
Mr Maxwell: I can talk through how the exposure arises and the nature of that exposure. As we discussed earlier, the Treasury provided roughly £1.6 billion to fund the transfer of the retail deposit book to Nationwide; consequently, that makes the Treasury a creditor in the administration process and one would expect there to be a very significant recovery from the winding-up of the estate as part of that process. The other thing is that the losses through this process will firstly be borne by whatever reserves are that remain in Dunfermline's business and, secondly, by the Financial Services Compensation Scheme. Under the Banking Act, to which Andrew referred earlier, the FSCS is liable to contribute to the cost of this resolution up to the level of the costs that it would have accrued if there had been a straight liquidation or administration of the society, so it is liable up to those costs. The Treasury is liable for certain types of costs over and above that.

Q100 Mr McGovern: I do not know if your microphone is not working but I can barely hear you, I do not know if everyone else is in the same situation.
Mr Maxwell: Shall I go through it again?

Q101 Mr McGovern: No, just continue.
Mr Maxwell: That is it; that is the process by which the costs and the liabilities will be dealt with.

Q102 Mr Davidson: I had difficulty hearing that and it would be valuable if you would just tell me again. How much has this actually cost the Government because at the beginning of our briefing, part of the note suggests that some had argued that the Government could have saved Dunfermline with £100 million and the Scottish Executive—unfortunately Mr Wishart has now left and he would be able to tell us a better figure—it was suggested would be able to find £25 million that would solve the problem in some way. Can you just tell us exactly how much the Government has put into this?
Mr Maxwell: The Government has provided about £1.6 billion in funding.

Q103 Mr Davidson: Sorry, can you say that again?
Mr Maxwell: £1.6 billion of funding.

Q104 Mr Davidson: That is quite a lot more than the amount that the Scottish Executive were able to find.
Mr Maxwell: But that is funding. We will not know the costs to the taxpayer until the end of that administration process and, as I say, the first part of any losses will be borne by the capital that was in the Society, the second part of any losses will be borne by the Financial Services Compensation Scheme up to the amount that they would have borne if the society had simply gone into administration or liquidation and then the Treasury would be on the hook for certain costs beyond that.

Q105 Mr Davidson: And we have no idea how much those sums cumulatively could conceivably be. What is the worst cost of all options in terms of liability to the Government?
Mr Maxwell: I do not think this is something we can speculate about; we need to wait to see how that administration process works. There is a large buffer there in the form of the Financial Services Compensation Scheme.

Q106 Mr Davidson: How could grown-ups suggest that £100 million would actually have saved all this? What I do not quite understand is the juxtaposition

between these huge figures that you are mentioning that it has actually cost and the suggestion that we were hearing earlier on at the time of the crash that for what sounds like loose change the whole thing could be saved? Are we comparing apples and apples?
Mr Bailey: This is not a comparison, this is an apples and oranges thing. I mentioned earlier that the key thing about the resolution was to put the depositors into a safe place. In order to do that there has to be substitute funding to match the assets that are being left behind, and that is the number that Clive has quoted which is around about £1.6 billion, but that is not the same as the numbers that have been quoted of £60 million, £100 million, more than that, all sorts of numbers, which relate to what you think the eventual losses would be once this whole story has unfolded. That is quite a different number, so in other words the replacement of the funding to allow the depositors to be put into a safe home, you would expect to get that money back because there is not that big a hole in the balance sheet. What we do not know and we cannot know until, as Clive has said, the process of completing the winding-up of the administration is done, is exactly what the final loss will be. One of the reasons we do not know that is because of course it will depend on how the economy and economic circumstances unfold during the time in which this administration process is undertaken, and it will also therefore depend upon decisions that the administrator will have to take—that is KPMG—in consultation with the Creditors' Committee, in which process the Government and the FSCS will be parties, and on just how quickly therefore they do propose to wind this thing up. They can obviously take decisions about the scheme and that will influence the eventual outturn.

Q107 Mr Davidson: I just want to be absolutely clear about this because none of us are trained bankers or anything, but those who were saying that this could all be saved, all be sorted, for £60-£100 million, effectively that was nonsense then, was it not, because you would have to have somebody behind that with enormously deep pockets in order to provide the sorts of guarantees that you are indicating were necessary.
Mr Bailey: Again, it comes back to this problem of apples and oranges. The question of could it be saved for £60 million, could it be saved for £100 million, could it be saved for something more depends critically on what level of capital provision to support future losses would have created the confidence that the problem was taken care of under a sensible set of outcomes as to where the economy will go and where the value of the assets in the Dunfermline Building Society will go. All those things are the critical determinants of where this thing eventually runs out, but as I said earlier to give confidence—and confidence is the critical thing here—it would have taken a number in terms of the provision of capital which gave the message clearly to the depositors, frankly gave the message clearly to all of you and to the press, this problem is taken care of, we do not need to worry about this one any more.

Q108 Chairman: Mr Pain, we will probably finish the whole thing in the next ten minutes but if you want to leave now you can leave with our thanks.
Mr Pain: Thank you, Chairman; if it is ten minutes I am more than happy to stay and help the Committee.

Q109 Chairman: I am sure we will finish everything in ten minutes. Can you tell us what impact is there going to be on jobs? Will head office staff be retained?
Mr Maxwell: Firstly, as part of the transaction agreed with Nationwide the 500 or so DBS staff in branches transferred to Nationwide on 30 March and as part of that deal Nationwide has agreed that there will be no compulsory redundancies in the branch network for a minimum of three years—that is quite a useful reassurance about the stability of the situation for those members of staff.

Q110 Mr Carmichael: Can I just follow up on that and come back to the question I asked Mr Bailey about the pension fund which is in administration. Of course, that goes well beyond the bridge bank across the staff as a whole; what is the position for the wider staffing *vis-à-vis* the pension fund?
Mr Maxwell: All existing Dunfermline employees were transferred to the Nationwide. Eligible employees are going to be offered membership of the Nationwide personal pension arrangements.

Q111 Mr Carmichael: What constitutes eligible employees, is that the ones that have transferred under TUPE or what?
Mr Maxwell: I would have to check the details of that I am afraid.

Q112 Mr Carmichael: You do not know what constitutes eligibility in this context.
Mr Maxwell: Not the precise details of that.
Mr Carmichael: It would be helpful for the community and indeed for the staff themselves if that sort of point could be clarified.[3]

Q113 Mr Davidson: Could I just clarify, in terms of the numbers what is the balance between eligible and non-eligible? Is it 50% in each category or 90% in one and 10% in the other?
Mr Bailey: The substantial majority are eligible but the safest thing is that we write to you about that.[4]

Q114 Chairman: There is a criticism by some that the Government saved the big banks and the big institutions and on the other hand in respect of building societies of a smaller size the Government failed to act. What is your assessment of this as there are widespread concerns on this issue?
Mr Maxwell: The Government has approached all of these issues in relation to different institutions through those three criteria that I referred to earlier about protecting financial stability, protecting depositors and protecting the taxpayer, and it has looked at all of the situations through those three criteria in coming to its decisions about how to act.

[3] Ev 35
[4] Ev 35

In respect of particular schemes like the recapitalisation scheme they have again particular criteria that have been used to assess the eligibility of individual institutions.

Q115 Chairman: Are you sure that the size of the Dunfermline Building Society did not have any bearing on the Government not rescuing it?
Mr Maxwell: Clearly one of the big issues here was about the sustainability of its business model going forward and the significance of the losses it was making as a proportion of its balance sheet, for example, so in that sense the size of the losses relative to the size of the institution was a factor in those sorts of decisions.

Q116 Mr Davidson: Can I just clarify that? Compared to HBOS or compared to the Royal Bank of Scotland the size of Dunfermline's losses as compared to its overall size were greater, is that what you are saying?
Mr Maxwell: What matters is the fact that the size of the extra capital that was required made it, according to the assessments we have just discussed, unrealistic to expect it to remunerate any extra capital that was put into the business to fill a gap that size.

Q117 Mr Davidson: Was that different from the Royal Bank of Scotland then?
Mr Maxwell: Yes, the Government was taking different forms of ownership stakes and returns from those institutions.

Q118 Mr Davidson: I just want to be clear. Notwithstanding the point that there are different forms of ownership stakes I am just trying to clarify whether or not the Dunfermline Building Society was in an even worse state than the Royal Bank of Scotland or whether or not it got less advantageous treatment either because it was Scottish or because it was small. If you can tell me that in words of one syllable it would be helpful.
Mr Bailey: Maybe I could answer that first of all. Clive has made the point that we had to take a judgment on whether the Dunfermline was going to generate sufficient future income over a period of time to support any injection.

Q119 Mr Davidson: I understand that, that was one of the few things I did understand. What I do not understand is whether or not it was worse in terms of its financial position than the Royal Bank of Scotland. That seems to me to be a pretty straightforward question to which you should be able to give me a yes or a no.
Mr Bailey: The answer to that is that the Royal Bank of Scotland is in a position where there is a reasonable expectation that it can earn sufficient income in the foreseeable future that it can service the provision—

Q120 Mr Davidson: That is a yes then, it was worse.
Mr Bailey: That is a yes.

Q121 Mr Davidson: Fine, thank you.
Mr Bailey: Let me also make one other point because a point about size was made. Bradford and Bingley was an institution that was, to my memory, more than ten times bigger than the Dunfermline so it is not a question of very small institutions go one way and everybody else goes another way.

Q122 Mr Davidson: And Bradford and Bingley was worse than the Royal Bank of Scotland as well was it?
Mr Bailey: Yes.
Mr Davidson: Thank you.

Q123 Mr Carmichael: Can I clarify that the clarification I am seeking in respect of the pension fund is the final salary pension scheme.
Mr Maxwell: I will check that.[5] My colleague just passed me a note to explain that the Government ministers have already written during the statutory instrument debate explaining the pensions of DBS and have placed a copy of that letter in the library of the House, but I will make sure that this Committee gets a copy as well and I hope that will answer your question.

Q124 Chairman: Can I thank the witnesses for their attendance. Before I declare the meeting closed would you like to say anything in conclusion perhaps on areas which have not been covered during our questions?
Mr Maxwell: No thank you, Chairman.
Chairman: Thank you very much once again.

[5] Ev 35

Wednesday 10 June 2009

Members present

Mr Mohammad Sarwar, in the Chair

Mr Alistair Carmichael
Mr Ian Davidson
Lindsay Roy
Pete Wishart

Witnesses: **Mr Graeme Dalziel**, former Chief Executive, **Mr Jim Faulds**, former Chairman, and **Mr Jim Willens**, former Chief Executive, Dunfermline Building Society, gave evidence.

Q125 Chairman: Good afternoon, I would like to welcome our witnesses to today's evidence session. Perhaps you could introduce yourselves for the record.
Mr Faulds: Thank you, Chairman. My name is Jim Faulds and I was Chairman of the Dunfermline Building Society from April 2007 until the end of March 2009. On my right is Graham Dalziel, who was appointed Chief Executive of the Society in 2001 and retired in December 2008. On my left is Jim Willens, who joined us in October last year as Chief Operating Officer and took over the post of Chief Executive on 1 January 2009. May I make an opening statement?
Chairman: Just give me one second, Lindsay has to say something.
Lindsay Roy: Chairman, I am not sure if this is a proper declaration but I think it is important that I acknowledge that I have known Graeme for ten years as the Chief Executive of Dunfermline Building Society. I worked with him on the executive of Lauder College Board of Management and I worked very closely with him as a school head in terms of sponsorship and work experience.

Q126 Chairman: Before we start detailed questions would you like to say anything in opening remarks?
Mr Faulds: Yes I would, thank you, Chairman. I would like to say first of all thank you for giving us this opportunity of providing evidence for the Committee's work. We have provided in advance written evidence too and any and all written evidence will be made available to you should you wish it. I would also like to make clear right from the start that I consider, and the Board of Dunfermline Building Society considers that the responsibility for the plight that Dunfermline found itself in is solely the responsibility of the Board of the society. I would also like to add that in all the decisions we took we had at the front of our minds and for the best intentions the benefit of our members, our staff and the communities we work in. Thank you.

Q127 Chairman: Dunfermline Building Society was the largest Scottish building society and 12th largest in the United Kingdom. Can you perhaps help us: why did Dunfermline Building Society fail and who was responsible for this?
Mr Faulds: Well, I believe that we were responsible up until October last year for the position we found ourselves in. Thereafter it is a different story so there are two stories here really, Chairman. Why these events came around, if I may take you back to the beginning of this century, Dunfermline's systems and its structure were uncompetitive and out-of-date. At the same time, we had right on our doorstep giants of retail financial services who were engaged in a price war. We had to compete with them and we had to compete with Northern Rock who were making offers which we could not understand how they could make (and history has shown how they did it). More than that Dunfermline was in danger of being uncompetitive, so we had to the change the system, we had to change the IT, we had to change the structure of the Society, and we had to improve profitability. One way of cutting the costs, which were too high, was to improve the systems and the IT. There is no doubt about it, that took longer and cost us more than we had planned, but we did change the structure. We also had to find other streams of income and we did that too. Then we found ourselves just before the credit crunch, as it is called, came along and we had some issues to tackle. We tackled the IT issue. We saw the crunch coming and we pulled back from commercial lending and we were setting about managing the issues that we faced. And then out of the blue the FSA applied the stress test to us which they required us to pass for us to qualify for access to the special lending schemes. They told us that we needed £20 million extra capital as a result of this stress test, which we were not engaged in by the way, and then we set about looking for that capital. Those are the reasons we got to where we were. What happened after October is a different story.

Q128 Chairman: You mentioned commercial property lending and one of the factors in the failure of DBS was probably commercial lending. Why did you decide to diversify into commercial lending?
Mr Faulds: By the way we were not alone, Chairman, it was perfectly legitimate and legal for societies to do that, in fact there is a 25% nature limit placed on us by the FSA and we could take it up to that. However, we had to find other sources of income because our core business, savings and mortgages, were being squeezed by the retail competition in the private sector. Would you like to add to that?
Mr Dalziel: It was essentially to grow value for our members and, as the Chairman said, because of the competition in the market-place we saw a need to diversify, and commercial lending was one of the things that we did, but essentially it was to grow value for members, enhancing income so that we could then provide our members with competitive

products in the retail market. The other angle that we had in setting it up is that we saw opportunities in the market-place for lending in some areas where it was allied to the mutual status that we had, to do with community regeneration or lending attached to housing associations for example, which became a major part of our business as well. So it was to enhance income for our members, to provide a return in excess of that which we could earn in residential lending, but also to add some value to the Scottish community at the same time. I should also say that in the years up to the end of 2007 that commercial lending operation added about £25 million in terms of contribution to overall member value during that period of over £100 million. As a percentage of assets, you asked the question at the last hearing two weeks ago about the percentage. At the end of 2007 it was 16% against a nature limit of 25%. That figure was disclosed in the accounts as part of the annual business statement that is produced by every single building society and it is clear in the accounts that it is there to be seen in terms of the lending limit. In comparison with other societies at the end of 2007 that just over 16% compares to another four or five societies with ratios around about the same level; one was higher at nearer 19%, and the rest were all round about 15 or 16%.

Q129 Chairman: What steps did you take to ensure that members of the society were aware of your dramatic change to commercial lending?
Mr Faulds: We came to the last session when the Tripartite gave evidence and we noticed that there was a short debate on whether these facts were in our annual report and I think the FSA said they were not. They are in our annual report. Each year we detailed non-retail loans and mortgages.
Mr Dalziel: The other area too that we tackled in our annual members' review that goes out to all members, and the Chairman at the time highlighted this, I think it is either at the end of 2005 or 2006 review, is the successes that we had had in the commercial lending market and he actually identified one or two of the loans that we had actually lent during the year. At the AGM each year we also did our best to bring our members up-to-date with the strategy as it unfolded, and I had on average each year about eight member panels around the country in which I engaged with members about strategy and what we were doing and asked them their views on what we were doing and took their views into account in coming back to report to the board.

Q130 Chairman: When we took evidence from the Financial Services Authority, Jon Pain told us that repeated warnings were given to you in your building society and this is what he said: "Its previous management had made some poor management decisions that substantially weakened the outlook for the firm in a more difficult market condition environment, but in particular its diversification into commercial property lending, its purchase of non-core lending/mortgage portfolios from third parties and its inability to adequately control its cost base, particularly its IT investment." Do you agree with that assessment?
Mr Faulds: Not at all and I am delighted to get the opportunity to refute that. Certainly they did these round-robin letters to chief executives and the board of the society saw them all and certainly we read and were given copies of speeches they made where they touched on commercial lending. In the two ARROW visits while I was Chairman, commercial lending came up in the first one and that was about the process controls where they suggested some areas of improvement, which we implemented and they said they were happy with. In the second ARROW visit, and we have letters from the FSA to us following both visits, and we would like to submit them after the meeting.[1]

Q131 Chairman: That would be very helpful if you could do that.
Mr Faulds: And in the meeting at the end of 2007, November 2007 I think it was, they listed five areas that they felt were the key risks facing the society, and commercial lending was not mentioned. Do you want to read them out?
Mr Dalziel: Basically if I could go back, you mentioned the words "repeated warnings". That is not the case. If I can tell you that in 2005 when we had the ARROW risk assessment, this risk assessment that the FSA carry out is looking at risks to their statutory objectives under the Financial Services and Markets Act, and what they actually said in 2005 in the letter was that our commercial lending operation was well controlled. It also identified in the letter.

Q132 Chairman: You have copies of those letters?
Mr Dalziel: I could read the actual section out to you. I have got the actual letter here from the FSA: "The Society's commercial lending operation has been very successful to date. At the same time it has been well controlled. We are aware of the society's plans to increase its exposure in this area and that you [meaning the society] have recognised that the portfolio has now grown to a large enough size to warrant risk analysis across the portfolio rather than solely at the individual exposure level. We would ask that you keep us informed of your progress in this area", which we did through correspondence and a commercial director meeting with the FSA at Canary Wharf in 2006. The ARROW visit in 2005 demonstrates that there was only one themed letter that we got about commercial lending and that was in the first quarter of 2003. Themed letters from the FSA to the chief executives are not part of formal guidance but are there to give us tips and hints. I think this demonstrates that we did take cognisance of what they said in 2003 and also in John Tiner's speech in 2004. As the Chairman said, going on to 2007, two years later, at this similar visit, the ARROW visit in 2007 finished on 29 November 2007 but it was not until 28 March 2008 that I received a letter from the FSA with the outcome of

[1] Ev 38, copies of letters provided by FSA

that risk assessment. That is 12 weeks later. On 28 March 2008 the FSA in response to the ARROW visit told me that they have five key risks facing the society in terms of their regulatory authority responsibilities, in order of significance: treating customers fairly, project management, the IT project, succession planning and fraud. At no time did they mention anywhere in the letter anything to do with commercial risks, anything to do with mortgage books, or anything to do with capital. Bear in mind that this is 12 months exactly before the society was told by somebody in the Treasury, or by somebody, that we needed to raise £60 million-worth of capital.
Mr Faulds: Can I add we were very disappointed with Jon Pain's evidence. However I do not want this to sound like we are blaming the FSA for what happened.

Q133 Chairman: They had a responsibility and you had too.
Mr Faulds: They have as a regulator and it is entirely your responsibility to judge them on that, but we were running the business and whatever happened in the business up to October was our fault, not the FSA's, but why we are disappointed in the evidence is that it painted a picture that we did not recognise whatsoever.

Q134 Mr Carmichael: I am glad you said that, Mr Faulds, you have obviously read the evidence if you did not actually see it at the time—
Mr Faulds: I was here, yes.

Q135 Mr Carmichael: And you will have perhaps gleaned from that that I was less than impressed by the evidence that was given by the FSA, but the analogy, at the risk of being pejorative—and I apologise if you think it is—it is a bit like people who blame the police for rising crime because it is not the police who are committing the crime, it is the criminals. I am not saying that what you did here was criminal but I want to just focus on how you got to the point where you did in 2008. I have a lot of sympathy for the position that you describe at the turn of the century. I think you said that it was an uncompetitive business and it was in danger of getting out-of-date. You saw opportunities and you wanted to enhance income and add value. I think probably in retrospect we would have to say that you were not ultimately successful in that.
Mr Faulds: Clearly we were not successful. I would argue that, given a fair chance, that strategy—and we had to change our strategy because, as any business knows, you have to change your strategy according to the environment and the circumstances in which you find yourself and the circumstances in 2008 were entirely different from 2000, would have succeeded, I believe.

Q136 Mr Carmichael: We can come back to that because I think those are different issues and for the purposes of the Committee in actually drilling down into the history of this they need to be dealt with separately. You say the circumstances were different. I do not actually know that they were. I think what was different was the perception of the circumstances, and I think there was perhaps a more realistic perception of the circumstances in 2008 than there was in 2000. We can come back to that. It is how we get to the point in 2008. The information that I have heard, and we have heard as a Committee alluded to perhaps without having direct evidence on it (but you are the people who can give us the direct evidence) is that the procedures of due diligence were effectively overridden in making some of the decisions on what we now regard as being the riskier, more toxic lendings that you took on. Was that the case and was that done with the knowledge and consent of the board?
Mr Faulds: I would quite like Graeme to reply to the process of the loan approvals, but I would like to say here and now, and I know you do not mean it in a pejorative way, I am tired of listening to the media talking about "toxic" assets. We had no toxic assets, we had no sub-prime loans, we had no USA loans. The spin that has been thrown at us has been frankly outrageous. We had our commercial book which at the time—

Q137 Mr Carmichael: Can I just drill down on that a second, was it not in fact the case that you did have self-certified mortgages on your books?
Mr Faulds: Yes we did have.

Q138 Mr Carmichael: That cannot now be regarded as best practice.
Mr Faulds: At the time we were able to analyse those. With retrospect, no, I would give you that. At the time they were looked upon as prime; they were not sub prime. Just last week a journalist I have great admiration for, Alex Brummer, in the main feature column on the City page of the *Daily Mail* talked about us having £900 million of toxic assets in buy-to-let books that we bought. When the society ceased as an independent society that was down to £180 million and it was performing. There were some difficulties in it but it was performing. Going back to the £665 million commercial book, at the time the society was broken up the customers were repaying the interest on those loans. We were perfectly happy with the provision that we had put aside with that book and yet it is all lumped together, including social housing by the way. This business of £1.5 billion of toxic assets that you read about in the press, what they were taking is social housing, which is the safest possible lending you can do in this sector, and they lump that in. The Government will get all its money back on that. They lump in the commercial. The Government should get all its money back on that or they are not doing their job right. They lump in the buy-to-let books which we have taken down from £500 or £600 million to £185 million, and all of this is deemed to be toxic assets. One of the other figures you hear today, probably, because I am fed up hearing it in the papers, is a £150 million provision needed to be put against the commercial book. Where did that come from? I will tell you where that came from: a society who wanted to merge with us and clearly wanted the assets

discounted so that it would get a bargain. If you hear £150 million again, give me a ring and I will tell you exactly where it came from.

Q139 Mr Carmichael: So you do not like toxic assets. What about due diligence?
Mr Dalziel: In terms of commercial lending, we did a number of things. We appointed a team of people from different banks with different experiences in the commercial lending area. We recruited in 2002 two different teams, a group of people who could go out and develop relationships in the market-place and a team of underwriting specialists who had experience in that sector. We also appointed to the board a commercial property expert.
Mr Faulds: Who is here today by the way.
Mr Dalziel: We also in terms of the process made sure before we lent that there were proper controls in place and the policy was reviewed by the board annually. That policy also went to the FSA. The diligence that was done in terms of each loan was deemed to be best practice.

Q140 Mr Carmichael: By whom?
Mr Dalziel: We had external auditors over the years both Ernst & Young and Deloitte's. We had quality assurance reviews from KPMG and then when we put it out to tender that changed to PricewaterhouseCoopers.

Q141 Mr Carmichael: Did your due diligence process change over the years?
Mr Dalziel: We made improvements as the years went on, of course.

Q142 Mr Carmichael: You made improvements?
Mr Dalziel: We made improvements across all areas of the business. That was our whole way of existence; learning from experience.

Q143 Mr Carmichael: When you said you made improvements that is a qualitative rather than a quantitative assessment. You will understand that. Let me put it in this way then: were there loans that were taken under the latter due diligence procedures that would not have been taken under the former ones?
Mr Dalziel: I do not think so. None that I can think of, to be honest.

Q144 Mr Carmichael: The point that I put to you and I have suggested to you was that due diligence procedures were actually overridden. Did that happen?
Mr Dalziel: Not to my knowledge.
Mr Faulds: Could I answer that, Mr Carmichael. I heard Vince Cable saying in Parliament that we had lent to an insolvent company. We cannot comment on individual customers, as you will understand, but can I give you an assurance that we did not lend any money to an insolvent company.

Q145 Mr Carmichael: I do not doubt that. I cannot think of the reference but if you have got an issue with Vince I am sure he will be more than happy and better informed than I am in terms of talking to you about it.
Mr Faulds: I wondered if that was where you were coming from.

Q146 Mr Carmichael: No.
Mr Dalziel: Could I also go back to the acquisition of the books, the point you made about the self-certified loans. That process that we undertook was the mortgage portfolio. We spent a lot of time looking at detailed cases and the particular books that we bought we spent at least a week or so down with the people that we were buying the books from looking at 25% of the cases. We also did retrospective credit scoring analysis, making sure that the quality of the mortgage that we were taking on to our balance sheet was in line with what we wanted to have, so we had a policy of no sub prime. That gave us the opportunity to assess where we came across any cases that we did not want to have because we were worried about affordability or we were worried generally about the quality of the property, so for self-certified loans we did a lot of work to satisfy ourselves that those people could actually afford to repay the loan by looking at other aspects of their credit history, which you could do by modelling.

Q147 Chairman: Did you satisfy yourselves that when they put in the claim, "I earn £50,000 or £100,000", that was legitimate and that was valid? That is the main question.
Mr Dalziel: It was looking at does this look reasonable and actually does that person's credit score reflect what we would expect of that particular person's ability to repay.

Q148 Chairman: I think the most important thing is that somebody is self-certifying, and I think the industry knew then that the people who were self-certifying their income were not being truthful but building societies and others did not challenge those self-certified assessments.
Mr Dalziel: We challenged it looking at the overall credit score of the applicant concerned.

Q149 Chairman: That was the credit score.
Mr Dalziel: That actually does give a very good handle on that person's ability to repay given previous experience, so we satisfied ourselves there. Those self-certified loans were actually a very small part of the overall books.

Q150 Chairman: If you consider overall, I am not talking about just one building society, if you take all the lending institutions put together, I think that was one of the big factors in the failure of the whole system because people were declaring their income and the financial institutions were granting loans on the basis that whatever they wrote on the paper they accepted.

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Mr Faulds: In retrospect, personally, I cannot speak for my colleagues, I would rather we had not taken on self-certified loans. As it happened they were performing but not as well as loans we found ourselves.

Q151 Mr Davidson: It sounds to me as if you are now saying that you did everything right. It is almost as if the operation was a success but the patient died! Can I just go back to the beginning. One of the local Members did say: "Let's face facts: the Dunfermline Building Society is the author of its own mistakes: mistaken judgments, mistaken investments, mistaken policies." Is that correct; yes or no?
Mr Faulds: No, not entirely.

Q152 Mr Davidson: It is not correct? What part of that is not correct? Three points: are you the author of your own mistakes?
Mr Faulds: Yes we are.

Q153 Mr Davidson: Mistaken judgments?
Mr Faulds: We made bad judgments and we made good judgments, lots of good judgments.

Q154 Mr Davidson: Okay.
Mr Faulds: And could I just add, Mr Davidson, we made a lot of judgments over those years and all of them were taken at the time in the best interests of the members and—

Q155 Mr Davidson: But some of them were mistaken?
Mr Faulds: Of course they were. Have you not made any mistakes in your life, Mr Davidson?

Q156 Chairman: The way this works is that I ask you the questions, you see. Can I just come on then to the mistaken investments, there were mistaken investments as well, were there not?
Mr Faulds: Every financial services organisation—

Q157 Mr Davidson: Is that a "Yes" then?
Mr Dalziel: What is a mistaken investment?
Mr Faulds: Are you trying to cross-examine me and trying to trip me up or do you want an answer to your question?

Q158 Mr Davidson: I just want to be clear—
Mr Faulds: It is not a yes or a no. Chairman, am I allowed to answer in the way I want rather than a yes or no?

Q159 Mr Davidson: Within reason. We are pretty used in this Committee and other committees to people trying to spin their way out of things.
Mr Faulds: I am not spinning. I am here and you can tell I am angry at what happened. I started off, and I am genuine about this, by saying yes, we were to blame for what happened up to October 2008. Yes, we made mistakes and, yes, there are areas that we regret and if, like any business person, we had our time again, we would not do it again. But I am not going to sit here and be cross-examined like some New York courtroom.

Q160 Mr Davidson: We run these sessions the way that we wish. I will just come back to this, you agree that you are the author of your own mistakes, mistaken judgments, mistaken investments, mistaken policies, which I think you pretty well do accept. Can I come to the question of why as a mutual, which is meant to be safe, secure, stable, you felt you had to actually go into these other areas? Would you have been able to just potter on perhaps not as large as you would want to be but just exist without going into commercial lending and buying up commercial mortgage books?
Mr Faulds: We do not believe that we would have. Our net interest margin, basically our gross and net profit, was reducing year-on-year because of the competition that we were facing and we were unable to compete effectively. In order to protect the independence of the society and to protect the branches and the jobs we had, we believed that we had to strengthen the business. That is what business people try and do: strengthen the structure and fabric of the business, and that is why we did that.

Q161 Mr Davidson: But strengthening the business by going into much higher risk? These areas were higher risk than the areas you were already in, were they not, commercial lending is by definition higher risk?
Mr Faulds: Yes they are, higher margin and higher risk, yes.

Q162 Mr Davidson: Then buying up the mortgage book from Lehman Brothers and others was much higher risk as well?
Mr Faulds: Higher risk and higher margin.

Q163 Mr Davidson: So you had no choice you are saying to us but to go down that road?
Mr Faulds: We also went into social housing which was lower risk and lower margin, so we had a balanced portfolio.

Q164 Mr Davidson: Just coming back to this, would you have collapsed had you not gone into commercial lending or acquiring the mortgage books?
Mr Faulds: I do not believe so. I believe this society would still be independent today if post October things had been handled differently.

Q165 Mr Davidson: I am not asking about post October; I am asking initially. What I am not clear about is why you went bust and others did not and then what the alternatives were that were available to you.
Mr Faulds: Excuse me, we did not go bust.

Q166 Mr Davidson: We will come on to that later on.
Mr Faulds: No, I am not having it, we did not go bust. I want that struck from the record.

Q167 Mr Davidson: That is not quite the way the system works.

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Mr Faulds: Right, I thought I was in a courtroom.

Q168 Mr Davidson: That is American courtroom style; we do not do that here! The fact is that you went into commercial lending, high-risk stuff, when you could have done without it; is that correct?
Mr Faulds: You always have choices in business and we took those choices. If we had not taken those choices the society's margin would have continued to go down and it probably would have merged with someone else.
Mr Dalziel: That was the view of the board at the time. The view of the board at the time was that in view of the market-place unless we diversified the income to provide the members with those competitive products that they really deserved and wanted, then the only other alternative was to merge with somebody else or be swallowed up by somebody bigger. It was a view that unless we were dynamic in diversifying there was that risk.

Q169 Mr Davidson: Right. What would have been the downside to your mutual members of being taken over by someone else? Would they have suffered in any way?
Mr Faulds: It is not what they wanted. We know that from the research we did.

Q170 Mr Davidson: The difficulty is that we have had correspondence and contact from some of your members saying that they did not feel they were adequately consulted about the moves that led to the disaster.
Mr Faulds: Yes.

Q171 Mr Davidson: And therefore whether or not they agreed with that is a moot point.
Mr Faulds: That is an entirely different point, if I may say so, a point I have great sympathy with. May I address that because we felt terrible at the time. Because we were in discussion with the FSA and the Tripartite and because we were worried about any leak getting out about the society needing this extra capital which may lead to a run on the bank, if you will, we could not say anything. Also we were told by the FSA that we must not say anything so we could not communicate with our customers and then when the society was broken up we had no power to do so. I know the Nationwide sent out a letter immediately after. I have every sympathy with the members who felt they were cut out of it but we could not do anything other.

Q172 Mr Davidson: But going back to the strategic decision that was taken to move into buying up the mortgage books of people like Lehman Brothers and so on and commercial lending, you did have alternatives at the time. One of the alternatives would have been to accept a merger with somebody larger and more financially viable?
Mr Faulds: Yes, you always have choices.

Q173 Mr Davidson: Can I just clarify why that was rejected?
Mr Faulds: Because it was the view of the board at the time that we wished to remain as a strong and independent society in Scotland and we believed, based on proper research amongst our members, that that was their preference.

Q174 Mr Davidson: Even though the route that you were taking was much riskier?
Mr Faulds: The members did not know that at the time. We knew that but we believed that we managed those risks reasonably well.

Q175 Lindsay Roy: Can I just clarify that up until mid-2008, am I right that you had external validation that your self-evaluation and regulation was robust and rigorous within the society?
Mr Dalziel: I would say so, yes. There were no concerns.

Q176 Lindsay Roy: Fine, and is it the case that before 2007 you do not feel that the FSA could have done any more? From what I have seen, the advice was indirect, non-specific and became specific later in 2008. Would that be accurate as well?
Mr Dalziel: I think that is accurate, yes. Capital for example was not an issue at all. Capital adequacy was not an issue at all with the FSA until the end of September and then definitely in October, so that was certainly the case.
Mr Faulds: I really want to underline the point you made that I never got to come back to, Mr Davidson, we are not blaming the FSA or anyone else. We were responsible for running the business, they are the regulator, and I do not have any beef with them up until October 2008 at all. Can I refer you to Lord Turner's letter to the Chancellor, which I think actually was a rather fair letter, all in all, and in that you will see that they were perfectly relaxed and he makes the point that we did not breach any regulatory rules at any time.
Lindsay Roy: Can I move on then because—
Chairman: Just before you move on.

Q177 Mr Carmichael: Can I finish the boring stuff because even New York courtrooms deal with the boring stuff sometimes. The self-certified mortgages which you acquired—the information we have is that some of them were acquired as full status mortgages which would be the prime product, if you see what I mean. Was there any occasion on which you acquired self-certified mortgages which you only discovered after the acquisition? Did your procedures fail at any point on that?
Mr Dalziel: Not to my knowledge, no, there was nothing that has ever been brought to my attention or identified.

Q178 Mr Carmichael: What scrutiny was carried out by the FSA of your procedures for taking on self-certified mortgages and were they happy with that?
Mr Dalziel: In terms of the acquisition of the mortgage portfolios, bearing in mind, as I have said, the self-certified portion of one particular book, it was only one particular book and it was a small proportion, the vast majority were normal prime

residential loans or buy-to-let loans. The FSA got copies of all our board papers for example and all detailed credit assessments that we did which were put at our credit risk committee, so the FSA had access to that and were given copies of that at the time. We also discussed with the FSA at various points during the period how the book acquisitions were going and what we were planning to do next. The last book that we purchased was at the beginning of 2006 and the Lehmans book that you referred to was from a subsidiary of Lehmans and that was purchased in late 2005 and it was all buy-to-let business. I want to say this again: despite what government ministers have said live on British television, that was no sub prime lending; there was no exposure to the US market at all.

Q179 Mr Carmichael: Full status lending?
Mr Dalziel: Full status lending and it certainly was not any exposure to the Lehman Brothers who then obviously collapsed. These were residential loans in the UK.

Q180 Mr Carmichael: Your evidence then is that there was no concern expressed by the FSA beyond these "Dear CEO" letters?
Mr Dalziel: None at all, none whatsoever.

Q181 Mr Davidson: Can I just ask before we move off that, when you led the company into this much riskier area of work in terms of commercial lending and buying up of loan books, did you yourselves benefit by more than you would have had you not done so in terms of either salary or bonus?
Mr Faulds: Absolutely certainly not, from a non-executive point of view, not from Graeme's point of view either.

Q182 Mr Davidson: So it made no difference to either you personally or to anybody else on the board the fact that you moved into a much riskier area? It is the balance of risk and reward.
Mr Faulds: I assure you that is not the case, absolutely not.

Q183 Mr Davidson: Thank you.
Mr Faulds: And I can give you detailed chapter and verse separately.
Mr Davidson: That would be helpful to have that in writing for the Committee.

Q184 Lindsay Roy: We have had a clear view from you about the position before 2008 and acknowledgement from yourselves about your own roles and responsibilities. Post October 2008 though you are saying that you are far from happy about the way things went and one of the things that is reported in the press was you said: "We failed because we cannot get the faceless mandarins in London to sit round the table and see we have a sustainable future." Can you tell us a bit about why that was, who you were unable to hold discussions with, whose responsibility you felt it was in terms of process to initiate, how many attempts were made to make contact, and so on, the whole regime around that?
Mr Faulds: Of course. Can I do that in the context of the work that you are doing to look forward because what has happened to us has happened, and I know I am bleating on about it because I do feel angry about it but the experience we had may be able to be improved for those who might follow us.

Q185 Lindsay Roy: I think that is one of the purposes of this initiative.
Mr Faulds: Indeed. Our biggest frustration with the FSA, and we could feel their frustration too, is that we felt we were not dealing with the decision maker. We still do not know but we think the decision maker was the Treasury, and therefore I made attempts to meet the Treasury. Jim Murphy facilitated a meeting with Lord Myners who basically gave me tea and sympathy and he told me I had to convince the FSA of our case. We had good reason to believe many times we had convinced the FSA although, as they are perfectly entitled to do, they did change their opinion. You got evidence from the Tripartite and you saw the dynamics: the man from the Treasury Hugh Maxwell (and I would have had more chance of meeting Robert Maxwell than Hugh Maxwell by the way) hardly said anything, Jon Pain did it all, and that was basically what we were dealing with too. It was always the FSA and they could never tell us yes, no or maybe, nothing. I asked for a meeting with Jon Pain and got one. That was the only time I had any involvement with Jon Pain and he promised to get us a meeting with the Treasury, which he did not. You know what it is like in business, if you are not dealing with the decision maker you are in the dark. I think going forward it would help if there were a more open dialogue. We felt, to be perfectly honest, we were treated, sorry to keep the criminal court analogy going, like the accused. We were denied information and we were shut out. If we were being brought in, for instance the big issue about how much capital was required, the first time we heard a figure of £60 million was from the Chancellor of the Exchequer on the Sunday after they broke us up, the day after they broke us up. If they had just sat down and said it is £60 million we could have worked together but we were kept at arm's length, and that for me would be one telling lesson going forward: do not exclude the society, we are not the accused, we are not criminals. We were doing everything with the best of intentions and we were working very hard for our members and our staff.
Mr Dalziel: It is worth also just highlighting—and Mr Willens might want to come in on this too—at the time I handed over the reins on 3 or 4 December, at that particular point in time, we thought we had an offer on the table from the Treasury of £20 million of capital. We had a business plan that not only had been approved by the FSA, it was actively encouraged by the FSA as this was a society that had a business plan to remain independent, providing the people of Scotland with alternative access to financial services. As the Chairman said, up until a

particular point in October when we were advised in a telephone conference call on a Thursday at 1 o'clock that they had done some additional stress tests for the whole sector and in order for us to get into the Government Guarantee Scheme we needed to raise £20 million-worth of capital to cope with the most extreme stress. This is after we had done our own stress testing earlier in the year and submitted it to the FSA. We were happy as a team and as a board and as an executive team that we had the capital to survive what the capital adequacy directives call an "extreme but plausible event" a one-in-25-year event. This came as a complete shock to us at the end of October that we were needing to raise £20 million-worth of capital. We were given until the Tuesday to say how we were going to raise the capital and if we did not raise the capital who did we want to merge with. At that point in time we had already done some business planning as an on-going part of the business, we had been doing that anyway, and the business plan for remaining independent was subsequently approved by the board and the FSA was comfortable with that. It was clear at that time in the market-place—and bear in mind you are looking at a very, very fast-moving environment in September and October, things were changing daily, the financial world was collapsing about our ears—it was becoming apparent, and the Finance Director and I went round the City looking at ways that we could raise the capital, the advice that we got was the only way we could really raise it was if the Treasury was willing to support it in some way. I did actually manage to meet the Treasury and an offer of £20 million was put on the table, subject to some conditions, though. One of the big conditions that subsequently came from the FSA was that they had to be satisfied with the level of provision in the commercial mortgage portfolio. We felt those conditions were met following external work that was done by KPMG in November. The story then unfolds and it is a complete shock to me, having retired at the end of the year, to find in March that the speculation was such, because it was clear that we had a plan approved and capital that appeared to me anyway at that time to be in the bag from the Treasury, that that was put on hold until we were able to explore a building society option. That was important at that time because the building society sector as a whole was looking to avoid, if we could, anybody going to the Treasury for capital because we wanted to be seen to be protecting our own sector, if you like, and that is what then led to the building society route being followed. Thereafter the rest took over.
Mr Faulds: Jim, do you want to add anything to that?
Mr Willens: Just to comment I certainly had very regular contact with the FSA throughout the period October 2008 all the way through to the end of March 2009. My impression is one that the FSA were working extremely hard but were working under extreme pressure and that they did everything that they could do within their powers to assist during that set of circumstances. At no time did I have any contact with the Treasury and at no time did I have any contact with the Bank of England until the weekend 28/29 March 2009. I would concur wholeheartedly with the view put forward that increased dialogue with the decision maker would be enormously helpful to both parties/both sides and would potentially lead to a different solution.

Q186 Mr Carmichael: Why did you not get that dialogue?
Mr Willens: We made efforts to meet with the Treasury and that was done, as Jim Faulds has just described, through a meeting with Jon Pain at the FSA. We subsequently did have a meeting with Lord Myners on February 13 and it was explained very clearly to us at that stage that the gateway to the Tripartite for a building society was via the FSA and that all our communications had to be funnelled through the FSA. That really was spelt out very clearly.

Q187 Mr Davidson: I am slightly confused by that then. If you were being told the people to speak to were the FSA and you had lots of meetings with the FSA and you had a meeting with Lord Myners as well, and he was essentially saying to you to deal with the FSA, I am not quite sure who you did not meet then.
Mr Faulds: The Lord Myners meeting came via Jim Murphy. Subsequently I wanted to meet the people who were day-to-day doing the work, like the chap you met two weeks ago. By the way, there was no great desire to meet the Treasury. We just wanted someone to give us some information and some decisions and some guidance.

Q188 Mr Davidson: Surely you were getting clear guidance. It is this question of not meeting various people. I get people writing to me who have already written to the Queen or they tell me if I do not deal with it they are going to write to the President of the United States and all the rest of it, so people saying that they want to meet somebody else is often because they do not like the answer they have had from the people who they have met.
Mr Faulds: I would not have minded if I had got any answers. When you get no answers, when you are getting stonewalled, then what do you do? Sit on your hands.

Q189 Mr Davidson: Were you not being told by the FSA and Lord Myners what it was necessary for you to achieve?
Mr Faulds: No.

Q190 Mr Davidson: You were left totally in the dark?
Mr Faulds: That is the whole point. We were told at the beginning that we had to raise £20 million which we subsequently did. We felt subsequently, looking at it, that with a bit more headroom we could raise £30 million which we did. They then told us that events had moved on and we needed to raise more money. How much more? No idea. We were told at one point that this mythical £150 million had come in from a competitive bidder and the £60 million popped up when the Chancellor was on. The First

Minister told me that he had spoken to the Chancellor and the Chancellor had said to him that the figure was somewhere between £60 million and £150 million but probably at the lower end. We were getting our information second-hand and that is no way to do business.
Mr Willens: If I could just add to that, the view that was expressed regularly from the FSA in the on-going dialogue which was daily was that the decision maker was not them; it was somebody else (ie the Treasury we think) and therefore they had to refer matters to that party or that body before being able to come back to us. That is where the frustration lay. It was not that we just wanted to see people.

Q191 Chairman: Can you tell us how much was the value of your deposits?
Mr Faulds: Sorry, Chairman, I did not hear that.

Q192 Chairman: How much in deposits did you have and how much more was the lending on commercial property?
Mr Faulds: Retail lending was £1.1 billion.
Mr Dalziel: Total assets of £3 billion.
Mr Faulds: Commercial £650 million, the buy-to-let—

Q193 Chairman: The ratio to your deposits?
Mr Faulds: Sorry, I beg your pardon.
Mr Dalziel: 75% of our funding came from retail deposits.
Mr Willens: It was 70% funding from retail deposits and 30% from wholesale markets. The lending ratio of commercial assets to overall assets was 16.7% at the end of 2007, comparable to other societies, which has already been covered.

Q194 Mr Davidson: Can I pick up the next question that we have got down here. A couple of times you have referred to the fact that the building society sector likes to look after its own, so to speak. The fact that nobody came forward to help you at that stage and the fact that the Building Society Association was not prepared to put up the full £60 million that was said at one stage to be necessary to save you is obviously a cause for concern. Why did other building societies not step in to help you? Was that because you were seen to be—and I know you do not like the term toxic—so toxic that that was not going to be sufficient?
Mr Faulds: Clearly, and we would need to speculate because we have never been told, a couple of things: one, eventually, to be fair to them, they did come up with £30 million but they wanted Treasury to stand beside that with another £30 million, so they did come in to support us. They did have concerns. What we did not know at the time but has subsequently been revealed is that all these societies bar none had their own problems. I will give you one fascinating fact. We were denied access to this special lending scheme. This is what this whole issue is about. If the wholesale markets had not have closed down we would still have been pressing on. A good number of those societies who qualified for that SLS scheme who are in it, if they had to qualify now would not get in it. In a sense timing was against us too.

Q195 Mr Carmichael: Are you telling us then that basically you were small enough to be allowed to fail?
Mr Faulds: I would not say that. I actually think that at the time, the context of the times were pressured, and I do not know what was going through the minds of the FSA and the Tripartite, but here they had a problem: everyone else got in, we did not get in; you want to tidy up the problem and it is gone forever.

Q196 Mr Carmichael: Does anybody else have a different view on that?
Mr Faulds: What then happened is all the other societies faced similar problems to those we faced.

Q197 Mr Carmichael: Does anybody else have a different view on that?
Mr Willens: I think that the authorities were looking at challenges such as they had probably never seen before and they were looking to make sure that they protected the stability of financial markets to the best of their ability, and in doing that it may well be that if hindsight is applied, which is always terribly easy, that it may have been different.
Mr Faulds: I agree.

Q198 Mr Carmichael: If building societies release you, Mr Willens, you could have a wonderful future as a civil servant. That was worthy of Sir Humphrey.
Mr Willens: Thank you.

Q199 Mr Davidson: It was not a compliment!
Mr Dalziel: The other comment I would make is I was not there after December but before December, prior to the Banking Act being implemented, there were several societies that had been rescued already, so we were coming along, if you like, fourth in line as being an issue for the FSA to resolve.
Mr Faulds: And the first one where the Banking Act could be applied.
Mr Dalziel: So in answer to your direct question about were we small enough to be allowed to fail, Lord Turner makes that clear in his letter, that, yes, we were small enough, and that is what is most disappointing for me, and it is so sad that Dunfermline Building Society has provided services for all those years and the fact that the board at the time were not allowed the opportunity to look at what they could do differently to change their plans or whatever to meet the capital requirements that the Tripartite laid down, that is shocking and very sad.
Mr Faulds: On the point of Lord Turner's letter, Chairman, could I just correct one other thing. The FSA said that pressure was put on the board to remove executives. That is categorically 100% not true. No pressure was put on. In fact when I rang a Mr Eric Enstrom at the FSA to tell him that Graeme was moving on and we were going to appoint Jim Willens as Chief Executive, and this was mid December—he had a canary fit when I told him that.

He said, "You cannot appoint someone full time," and I thought, "I can see some writing on the wall here."

Q200 Mr Carmichael: I think the range of questions that we were wanting to drill down was the role of the Tripartite, but I think probably we have already covered that. Can I just distil down what I think you are telling us today, and we will then decide whether we agree with it or not. What you are almost telling us is that there was a conspiracy to exclude you amongst the Tripartite, or at least if not among the Tripartite between the Treasury and the FSA. Is that your honest view?
Mr Faulds: I would not use the word conspiracy. I think we were excluded deliberately.

Q201 Mr Carmichael: So when two people decide together to do something, does that not make it a conspiracy?
Mr Faulds: It sounds a bit sinister.

Q202 Mr Carmichael: A bit New York courtroom?
Mr Faulds: A bit political.
Mr Carmichael: A bit political? Heaven help us.

Q203 Chairman: With profits of £5-£6 million a year would DBS have been able to pay the interest on a capital injection of £60 million?
Mr Faulds: By the way, we did a business plan and the business plan we put in was a much simplified business plan, but to answer your question.

Q204 Chairman: You do not agree then there was a need for a £60 million capital injection?
Mr Faulds: No, we do not agree with that. We believed we needed £30 million. However, our business plans going forward, depending upon what interest rate you charged—I do not know if you know what interest rates they are charging on this government money but it is penal—we had an offer of £30 million from the Scottish Government which was at very favourable interest rates because the offer was conditional. If we could have matched that with the building society club offer that would be £60 million, which we did not really need, so it is too simplistic to say that we could not pay the interest on £60 million. It depends on the interest rate. On the penal rate that would have been challenging.

Q205 Mr Carmichael: You could have afforded it on the SLS payments?
Mr Willens: The business plan was stressed to look at capital injections ranging from initially £20 million, but subsequently increased up to £30 million, up to £60 million. That business plan would have supported a £60 million pound capital injection at the rates that were being charged.

Q206 Mr Carmichael: With a £5-£6 million profit a year?
Mr Willens: But the business plan also included looking at ways to improve the organisation's efficiency by removing cost and simplifying the business over a period of time to take out that additional cost that sat within it, so a combination of factors would have allowed that to have happened.

Q207 Mr Carmichael: And you have the elephant in the room as well which is Dunfermline Solutions.
Mr Willens: I would not quite describe it as that but there was certainly a need to manage through the costs that had been built up by Dunfermline Solutions on the IT system. Again that would have been run over a period of eight to ten years and the business plan again took account of that.

Q208 Chairman: If you put aside the interests of the building society, do you accept that it was not in the public's interest to save DBS?
Mr Faulds: I passionately believe that the society should have been given a fair chance to remain independent. The board examined all options. If it could not the next best solution would be to merge with a stronger partner. I have to say that I am delighted that that partner is Nationwide. It could not have found a better home.

Q209 Mr Davidson: Can I turn to the question of the IT system, why did you decide to build your own IT system rather than seeking to buy something that was already in operation elsewhere?
Mr Dalziel: We did evaluate the market several times in fact and we did actually choose an existing software provider with software that was already being used. The reason we did it was so that we could provide our customers with a flexible range of products and be open for business anytime anywhere. We were alive to the fact that whilst face-to-face service through branches was vitally important to a lot of our members we also recognised that having the systems and technology capable of dealing with things over the internet was important so that is why we went into it. The reason for the £9.5 million exceptional item in the 2007 accounts—and that was explained at the time and we explained to members and we apologised to members for that at the time—was down to the fact that in order to implement it we had decided to try and go for a big bang approach and taking everything out and putting the entire new software suite at the one time. As we got into the project we realised that was not the thing to do and we needed to put it into bite-sized chunks. Putting it into bite-sized chunks at that time in 2007, we took the view that because of the way the market was going we really needed to focus on the members. 80%, or even higher than that, 90% of our members were savings members, investors in the society, and we felt that we needed to get the savings part of the system in before mortgages, and there were other things we wanted to do with mortgages in the meantime, so we parked our mortgage software on the side to leave that for another day to implement. Because we did not have a concrete action plan as to when we wanted to implement that particular mortgage suite, the auditors would not allow us to keep the value of that particular bit of software on the balance sheet, which then led to the £9.5 million. Had we remained going

forward, as Mr Willens has described, the business plan allowed for bringing that mortgage system into production at some time in the future.

Q210 Mr Davidson: How many other building societies of similar size suffered a similar loss through the adoption of a new computer system?
Mr Dalziel: Well, there is one other; Derbyshire aborted their product. There have been a number of aborted attempts. We were all in the same boat. Certainly a number of us were looking for this Holy Grail of better technology to provide a better service for our customers. Ours went live in 2008. In previous years some other societies with different products had aborted their development, so figures of £10 million or £20 million were being written off in one year.

Q211 Mr Davidson: So there is a whole group of you doing pretty much the same thing and all making pretty much the same mistakes? I am trying to make clear whether or not this mess with the computer was unique to yourself.
Mr Dalziel: I have yet to meet anybody in the world of business who has been trying to implement IT who has not experienced some kind of problem, to be honest.

Q212 Mr Davidson: Indeed, absolutely, I sit on the Public Accounts Committee and we get them all the time, but what I am not clear about here is whether or not yours was as bad as or was uniquely bad in the sense of a screw up.
Mr Faulds: We went for a system that we thought would make us extremely competitive. It was too challenging, it took too long, it took too much money and we made a mistake.

Q213 Mr Carmichael: At what point did you start to realise that?
Mr Faulds: Unfortunately with these systems if you have ever been involved in them, it is not black and white, but I would say about the year 2004-05 we started to get concerned. We made changes down the years in the project management, bringing in different suppliers. Eventually we got a team—and this is the irony—where the product that went in worked terrifically well and given time the other part would go in, so we ran out of time.

Q214 Mr Carmichael: What were your front-line staff telling you about this?
Mr Dalziel: The front-line team is one of the things that encouraged us to implement this because they were looking for something different. The staff out in the branches were desperate to get their hands on this new system. We were doing simulation techniques to show them what the system would look like in real life for training purposes.

Q215 Mr Carmichael: I have seen it suggested, particularly in press reports, that some staff were raising concerns and they did it to their own personal detriment in that they were encouraged to leave.
Mr Dalziel: Not to my knowledge.

Q216 Mr Carmichael: So criticism was quite welcome?
Mr Dalziel: At all times in the society anywhere.

Q217 Mr Carmichael: You just did not get it; you only got encouragement?
Mr Dalziel: We had staff opinion surveys where people could identify areas that they were concerned about. We had lots of these mechanisms in place through the period.
Mr Faulds: Jim, you worked with the system when it was in.
Mr Willens: Yes, the system went live in November 2008 and there is no doubt that there was anticipation amongst the employee base for a new system because, not surprisingly, having waited for it for a number of years, they were looking forward to the benefits of it. The system and the management information portal both went live and both went well and it is not an insignificant thing to launch a new core system for savings in a financial institution, so I think that in itself was to everyone's credit. Was the system perfect? No. Were there still things about it that you would look to improve on an on-going basis? Yes, and there was feedback coming in on a regular basis from employees and indeed from customers. Was it ideal against what was originally planned? Then the answer has got to be no. Was it as it was first laid out? Because of the time-frame involved in getting it to implementation quite clearly that was not as it should have been, but the main part of it worked extremely well.

Q218 Mr Carmichael: So where did the failure for the lack of control lie?
Mr Willens: I am not in a position to be able to answer.
Mr Faulds: It lay with the executive and the board.

Q219 Mr Carmichael: The executive?
Mr Faulds: And the board.

Q220 Mr Carmichael: The executive being the executive who was employed by Dunfermline Solutions or—
Mr Faulds: I beg your pardon, the management.

Q221 Lindsay Roy: Was the objective to make it highly customised to give you a market edge and now you have this is there interest from any other building society or bank in terms of what you have done?
Mr Dalziel: In terms of the original intention in terms of market edge, absolutely, yes. That is why it was in Dunfermline Solutions because we saw an opportunity in the market-place based on research. As I said earlier to Mr Davidson, everybody was looking for this Holy Grail and a lot of other building societies were very interested. We had the idea of providing services to other building societies with the technology in place.

Q222 Lindsay Roy: Has anybody picked it up since it has gone live?
Mr Dalziel: No, it is too soon.
Mr Carmichael: Can I ask will we have an opportunity at a later stage as things stand at the moment to take evidence from staff associations and former employees?
Chairman: It is always possible.
Mr Carmichael: Thank you.

Q223 Mr Davidson: One of the suggestions that we have got here is the PricewaterhouseCoopers report which had indicated that pure project management was to blame. You accept that?
Mr Faulds: Yes and I would add that that report was commissioned spontaneously by the board. Not by the FSA as you may have been led to believe.

Q224 Mr Davidson: I understand that. Can I clarify what has happened to Dunfermline Solutions now? Is it freestanding?
Mr Faulds: It is freestanding. The shareholder is the government, I believe?
Mr Willens: It is with the administrators.
Mr Faulds: It is with the administrators and the directors of that company, including myself, are currently in conversation with Nationwide, who wants the rights to use the software, and we are just tidying that up.

Q225 Mr Davidson: Is it a viable operation or is it just a question of picking up the wreckage?
Mr Faulds: It is difficult to say because although we are on the board we are not involved but I believe it is tidying it up.

Q226 Mr Carmichael: So what happened to the people who were responsible?
Mr Faulds: The management of the society and the directors?

Q227 Mr Carmichael: I mean the specific project managers for this.
Mr Faulds: There was a change of project manager in 2007.

Q228 Mr Carmichael: Who was it up to that point?
Mr Dalziel: KPMG project management.
Mr Faulds: And then a chap called Stuart Cooper ran it.
Mr Dalziel: Prior to that.
Chairman: Lindsay, communications with customers.

Q229 Lindsay Roy: There was some disquiet, and I can understand why. Apparently there are issues about communication, that neither from Nationwide nor from DBS was there direct contact with customers when things came to a head. How did that come about? Was it just because of the situation that occurred?
Mr Faulds: I feel terrible about that because it is fundamental to communicate with your customers, but for two weeks we were under pressure with media commenting on speculation but we were under a three-line whip from the FSA, and rightly so, that we could not say anything and we were nervous about running the bank. Then on the Saturday when it all came to a head we were stood down so—

Q230 Chairman: We have received an email from a customer of DBS who was concerned that he had received no official communication to him from either DBS or Nationwide about the transfer: he was forced to rely on press releases for information. Why did DBS not communicate directly with customers about the transfer?
Mr Faulds: We as a board were unable to do so until that Saturday 28 March and thereafter the power to do so was taken out of our hands. I do believe Nationwide did write to customers. I have seen a letter that went to customers but you would need to ask Nationwide about that.

Q231 Chairman: I think there is another issue here. The Committee received an email on 20 May from a customer of DBS who said that when his wife visited an Edinburgh branch of DBS on 14 April and asked why they had not received any information, she was told that the staff had not received any information either. That is quite serious.
Mr Faulds: Well, we were stood down on 28 March and we had no power thereafter to do anything.
Mr Willens: If I could just add, I have been in place (but not with executive accountability) since 28 March and I have seen communications that have gone out from the Nationwide management team to employees, and several of them. I also have had contact with many employees who have been very positive about the communications that they have received since that time, so I have to say I am a little surprised at that particular comment.

Q232 Chairman: So you do not think it is the situation, it is just some report?
Mr Willens: It may well be that there has been either a misinterpretation or some miscommunication there. I have certainly seen many communications from the Nationwide to the employee base.

Q233 Chairman: Jim, you told us that DBS made available for commercial loans about 16% of your assets. Some building societies have up to 25%. Do you accept that under the Building Society Act of 1986 you were only allowed to have commercial loans of 10% and is that the right balance?
Mr Faulds: I think clearly there are lessons to be learned. Graeme and I were discussing this yesterday. We do not think that the 25% is really an issue. There are some things that perhaps more regulation should be applied to, like development finance, like, as we discussed earlier, self-certified loans, but I do not think—and you may like to add to that—that 25% is a problem, but maybe the nature of the lending within that.
Mr Dalziel: I think in the overall concept of learning for the future there are two elements of it. There is a macro element where a large part of the issues that we have got here are to do with capital and the stress testing that was applied. The second part of that is

commercial lending and the limit of 25%. If you close up too much in terms of capital then it does not allow banks and building societies to offer innovation in the market-place and move forward. In terms of the 25% limit, as long as the capital is controlled then that should be fine, but I think there are some areas of lending that, if you look at the history across a number of societies, could be ruled out or restricted.
Mr Faulds: Could I add to that, Chairman. The commercial lending issue could easily be misleading here. Lord Turner's letter says that the decision was taken based on potential future losses on the commercial book, not existing losses. We were all looking at commercial property suffering large cuts in value, and we still are, but there is some evidence that came out recently that it is not going to be as deep as we feared. In fact I saw yesterday one report which says that it has stabilised, so these potential future losses may not occur, so let us not beat up commercial lending as if it is the problem. Commercial lending done properly and managed properly need not be the problem.

Q234 Mr Carmichael: Does this not come though actually just to the very heart of the present situation? If you were to say that, then what is there to stop us finding ourselves in this situation again in ten, 15 or 20 years' time? Do we not actually have to have a much more rigorous and perhaps, yes, much more risk-averse structure for the future because surely it is your responsibility in a position like yours to take account and make provision for potential future losses?
Mr Dalziel: We did, we did.
Mr Faulds: We did. We put aside £32 million and that provision was looked at deal- by-deal loan-by-loan and then the FSA appointed KPMG to stress test that and they suggested that the maximum we should put aside is £40 million. We were putting aside £32 million. We believed that we would bring that book home profitably without that full provision we needed. You are absolutely right, Mr Carmichael, if I am wrong about this, if these potential future losses do occur, then yes.

Q235 Mr Carmichael: You have to make provision.
Mr Dalziel: If what Lord Turner is saying is he had to break down the society because he is scared of these potential future losses—and let us say they do come, you are absolutely right, you could not go on like that, but we do not accept necessarily that those losses would be more than £32 million.

Q236 Chairman: Those potential losses are not going to come; they are already there. I know banks who have lent £10 million on a property and they are lucky if they are recovering 25% of that. Properties in Britain, in Scotland where the banks have loaned £10 million are being sold at 25%, £2.5 million. You think these are not losses?
Mr Faulds: If you sell at the moment, absolutely.

Q237 Chairman: How can you hold on to it?
Mr Faulds: Our customers were paying the interest so why would you sell?

Q238 Chairman: If the banks are selling those assets then the customers have failed to pay that interest.
Mr Dalziel: In our case the customers were paying the interest. We have only had three cases in arrears of interest.
Mr Faulds: Three cases.
Mr Dalziel: We had arrears of interest of £100,000 in the commercial loan portfolio. To go back to the point, the key thing is the stress test. We allowed stress tests in the capital base of a fall in the commercial property market in the UK of between 30 and 40% from peak to trough. We do not know what the Tripartite authorities allowed for in their stress tests. That is a crucial fact. But reading the *Scotsman* newspaper two weeks ago it was claimed that the stress test that they are now using is to allow for a 60% peak to trough fall in the commercial property market. In the last six months the commercial property market has fallen by about 20%, I believe. As somebody was quoted two weeks ago, there is a great risk we all get stress tested out of existence here. There are some countries around the world who are taking a slightly different view. Germany for example are saying let us allow these companies to manage their way out of this issue rather than bolting the door after the horse has bolted, because if you try and get capital stoked up into the system at a time when there is no capital available in the world, then this is what we have been caught out by. We have essentially been caught out by, as Lord Turner has said in the Turner Review, the deepest financial crisis in the history of capitalism that we have been going through in 2008 and 2009. The Chancellor on Monday night on television said that he regrets having made a statement last September about the economy suffering a one-in-a-60-year crisis. He wished he had called it a one-in-a-100-year crisis. I think the real nub of this is the fact that we in Dunfermline did all we could to have breakfast and dinner with the Governor of the Bank of England, the Chancellor, leading economists in the UK to try and guess what was going to happen to the future environment and we were caught out by this huge storm, and had we known this storm was going to be there we might have done things differently.

Q239 Chairman: A final question, if you could reverse the clock tell us three mistakes that you would not repeat?
Mr Faulds: Speaking personally, clearly we would have approached the IT project differently. On commercial lending we might have been tighter on the lending. We were perfectly content with what we did in commercial but clearly with hindsight maybe tighter on that. For me, frankly, we should have moved faster on the strategy we had in place because it was the right strategy; we just were too slow for our own good.

Q240 Chairman: Thank you very much. Can I thank the witnesses for their attendance. Before I declare the meeting closed would you like to say anything in conclusion, perhaps something we have not covered in the questions?

Mr Dalziel: Maybe I could just say that as Chief Executive for eight years and having spent 24 hours a day putting my whole soul into the society trying to grow value for members, I am very saddened by what has happened and disappointed and shocked actually by what has happened.
Mr Willens: Likewise, everything that was done was done with the very best interests in mind for the membership and employees, and it was a very sad outturn for Dunfermline.
Mr Faulds: I would like to say we have talked a lot about members who were always in our minds, but we have fought very, very hard in the last six months to protect our staff and it is them I really feel for.

Q241 Mr Carmichael: A lot of your staff are very bruised and very financially hurt. Is that an apology to them?
Mr Faulds: Absolutely. I am sorry if anyone has suffered for this. That is an absolute unreserved apology. A lot of staff have spoken to us and they were very supportive of the fight that we were putting up.
Chairman: Thank you once again.

Witnesses: **Ms Liz Kelly**, Group Counsel, **Mr Tony Prestedge**, Group Development Director, and **Ms Alison Robb**, Divisional Director, Group Strategy and Planning, Nationwide Building Society, gave evidence.

Q242 Chairman: Good afternoon. I would like to welcome our witnesses to today's evidence session. Perhaps you could introduce yourselves for the record?
Mr Prestedge: Mr Chairman, could I first say that we are pleased to be here on behalf of Nationwide to help you with your business today? My name is Tony Prestedge. I am one of the executive directors for the Nationwide Building Society. With me today is Alison Robb, our Director of Strategy and Planning. Alison is with me because she was heavily involved in the transaction and the discussions with the Bank of England, and indeed the Treasury and the FSA during the process of the acquisition of parts of Dunfermline. Also with me is Liz Kelly, who is our General Counsel, who is with me partly because we were advised in advance that you may have a number of questions around the process of the transaction under the Banking Act, given that it was the first time that such an Act was used.

Q243 Alistair Carmichael: And partly because you thought you were coming to a New York courtroom!
Mr Prestedge: Indeed I am looking forward to the process!

Q244 Chairman: Before we start on the detailed questions, do you have any opening remarks?
Mr Prestedge: Very briefly, Mr Chairman. The one thing I would ask the Committee to remember is that I am conscious that the evidence, both from the previous panel and also from the Tripartite members, was very much about the history of the organisation. Given that Nationwide only acquired a subset of the business on 30 March, I hope you will appreciate that we feel it would be wrong for us to speculate around the process that was adopted by any part of the regulator or indeed the past decisions that were made, and that we can focus part of this evidence on the running of the business, moving forward—albeit we accept that there may be questions that you do want to ask, based on the parts of the business that we have inherited.
Lindsay Roy: Before we proceed any further, it is important that I declare an interest here. Mr Geoffrey Howe, the Chairman of Nationwide Building Society is my cousin.

Q245 Mr Davidson: So you had better answer his questions!
Mr Prestedge: Now that is worse than in a New York courtroom!

Q246 Chairman: Could you tell us why did DBS fail?
Mr Prestedge: I did say that I think it would have been wrong for us to speculate, and we have already heard the evidence—

Q247 Chairman: We are not asking for speculation; we are asking the reason.
Mr Prestedge: In our view there was insufficient capital, or in the view of the Tripartite, who ultimately made the decision, there was insufficient capital for the business to continue to trade independently.

Q248 Chairman: Did the Tripartite authorities make the right decision in refusing to provide DBS with a capital injection of £30 million?
Mr Prestedge: In my view it was the right decision, partly because this is not just about capital; it is also about profitability. To inject capital would have required the Tripartite, or any other member who decided to inject capital, to seek some form of repayment and interest on that. The business within Dunfermline, given the very severe economic recession that we now find ourselves in, in our view would have struggled to create sufficient value in order to fully service that level of injection of capital debt. Also, we would have questions whether or not £30 million would have been sufficient, based on the limited due diligence that we were able to undertake.

Q249 Chairman: So you think £30 million capital injection was not sufficient?
Mr Prestedge: In our view it would have been insufficient, yes.

10 June 2009 Ms Liz Kelly, Mr Tony Prestedge and Ms Alison Robb

Q250 Chairman: What figure would you put on it then?
Mr Prestedge: In fairness, we never completed all of our due diligence on parts of the assets that subsequently never came to us. The acquired portfolio within the residential lending book never came to us; the commercial book, as well as the RSL portfolios; so it would be hard for us to predict. Certainly our view is that the numbers that were quoted earlier, which I believe were attributed to the Chancellor of being between £60 to £150, would be the range; but we never finished full due diligence in order to be more precise.

Q251 Chairman: Would any other building society have been able to take on the transfer from DBS?
Mr Prestedge: It would be wrong for us to talk on behalf of other building societies. In our view, however, given the limited due diligence we would have been able to undertake, we do not believe that there would have been others in the sector in any different position than us in concluding that a normal merger would have been right for their members.

Q252 Chairman: What have you discovered about DBS since the transfer, about the business?
Mr Prestedge: We have discovered a fantastic workforce who, I have to say, I would absolutely commend in terms of their performance and their behaviour, given the very significant uncertainty that they must have lived through. We have discovered a membership through the branch network who clearly value the brand of Dunfermline and they clearly value the franchise upon the high street. We have engaged both in a political sense and in a broader community sense within the Scottish community and have found a community that has welcomed us, in terms of our support for the business that we have purchased.

Q253 Lindsay Roy: According to the information I have, a one-off loan from HMT was rejected as an option, as was a reported offer from the Scottish Executive. In your view, why was it that these options were not seen as desirable or taken up?
Mr Prestedge: In fairness, I do not know the details of those potential offers. It was a discussion between members of the Tripartite and Dunfermline. What I would say is that my understanding of why they were not accepted is that they were not considered to be long-term solutions; *i.e.* they may have provided a solution for a period of time; however, in the very stressed economic environment in which we are finding ourselves, they may not have provided a long-term systemic solution.

Q254 Lindsay Roy: From the information you have, who decided not to invest the taxpayers' money in Dunfermline, and on what basis was that decision made?
Mr Prestedge: I do not know the basis upon which that decision was made. The only information I have is that I heard from the Tripartite within your last hearing, which is that that decision was made by the Treasury and ultimately the Chancellor.

Q255 Lindsay Roy: Nationwide did not feel that they should pursue that and make an enquiry about that?
Mr Prestedge: We do not feel that it is for Nationwide to do so. There was an open-market transaction for a business that went into temporary public ownership. The decision-making was by the authorities and not by any commercial organisation within the sector.

Q256 Lindsay Roy: How competitive was the tender for Dunfermline?
Mr Prestedge: Clearly we do not know that. We indeed found out ourselves that there were four people who supposedly put forward a bid, because we heard that from Mr Bailey from the Bank of England, but we do not know the details of those bids. They were details, I guess, only supplied to the Tripartite itself, and therefore it is difficult for us to comment.

Q257 Lindsay Roy: But you were happy to take on what you were asked to take on?
Mr Prestedge: We were very clear that there were parts of the organisation that we would not bid for under any circumstances. We would never, and did not, bid for the acquired portfolios of residential lending, because Nationwide has never acquired residential lending which we have not originated for ourselves. We did not bid, and never would under any circumstances, for the commercial portfolio, for similar reasons. For the purposes of the business that we did acquire, the billion pounds' worth of primary retail portfolio residential lending as well as the liabilities, *i.e.* the savings side of the business, the head office and the branch network, we are very happy with what we have acquired.

Q258 Lindsay Roy: In effect, you had the *crème de la crème*?
Mr Prestedge: We have the parts of the business which, for us, we felt we were able to take on board without creating risk for our own membership.

Q259 Alistair Carmichael: You have just outlined there a very different corporate history to the one which we heard described by Mr Faulds, when you were sitting in the audience here. He identified a situation where the Dunfermline felt that they had no option but to pursue these acquired loans and that, if they had not done, they would not have grown; they would not have been able to survive independently. From what you are telling me, you took a policy decision as an organisation not to pursue that business.

Mr Prestedge: That is true.

Q260 Alistair Carmichael: Why not?
Mr Prestedge: In fairness, I think it is important to remember there are two very different businesses we are discussing here. Nationwide has a balance sheet at the end of last year of £200 billion; we have 800 branches and 15 million members, and a much more diversified business, including current account banking as well as credit card operations and, at points in the past, a life business and, now, a full regulated sales operation. So it would be wrong to compare apples with pears. What I would say, however, is that the board of Nationwide has had a policy over time that it would not use members' capital to acquire assets that it had not self-originated; *i.e.* it would not pass accountability for the credit decision into a third party, and that we would use the capital within the business to originate assets where we believe we had oversight for the credit quality within our own organisation. That is not to say that there are not very good assets within acquired portfolios within the UK, and that is not to say that I can pass comment upon the quality of the assets within the portfolio within Dunfermline—because I cannot.

Q261 Alistair Carmichael: You would not pass comment, apart from the fact that you did not want to buy them.
Mr Prestedge: On the basis that it is not an asset class that we choose to have on our own balance sheet.

Q262 Mr Davidson: Can I pick up the point about staffing and compulsory redundancies and related matters? As I understand it, you have promised that no branch staff will be made redundant in the first three years.
Mr Prestedge: We have.

Q263 Mr Davidson: What does that mean, though, for staff in the headquarters and any other back office staff?
Mr Prestedge: At this moment in time, if you consider the majority of merger transactions—if we were to take something like the Portman, which was one of our earlier transactions, it took 12 months to complete, and Derbyshire and Cheshire, because it was a different nature of transaction, took 12 weeks to complete, and therefore we had a much longer period of time to assess the operations—with Dunfermline, in reality, the transaction was completed within 48 hours. The reason why we felt able to give 100% guarantee for three years for the branch high street employees is because we were clear that we wanted to commit to the branch network for that period of time, to prove that it had value. What we have said to all of their head office employees—and I have said this personally and I have been with colleagues when they have said it—is that we are now going to go through a process of reviewing what operations within the head office environment within Dunfermline will remain, and how could that site be used, moving forward, in order to mitigate any potential job losses. What we were not prepared to do, and it would have been wrong to do, was to mislead employees at the point of the transaction or even today, when those final decisions have not been made.

Q264 Mr Davidson: Within what sort of timescale do you believe a decision on the plan would be taken about the future of the back office staff in their headquarters?
Mr Prestedge: My expectation is that we would be able to have a clearer picture on the roles that will exist within Scotland and that head office environment over the course of the next three to six months, but no sooner than that. We need to identify what technology platform we decide to deploy for this business, which may or may not be the current existing technology platform. We also need to remember that in many respects, because of the size of Nationwide, we have an opportunity to move work around the country, which is not just about Dunfermline. So we need to consider how we might use that site in Scotland to service a consumer base that may go beyond the Dunfermline consumers themselves. In many respects, I would rather that work to complete in its fullness before giving false hope or promises or guarantees to any employees.

Q265 Mr Davidson: I understand that. It is three to six months, you say. Is that three to six months from now?
Mr Prestedge: I think I said six to nine months. My expectation was that we would be able to be clear around the direction for that site towards the back end of this year, when we have completed the assessment of all that work.

Q266 Mr Davidson: Can I just clarify about pension arrangements for existing Dunfermline staff? Are they just slotting seamlessly into a new pension system? Is the old pension system continuing to run?
Mr Prestedge: There were two pension schemes that operated within Dunfermline. There was a defined benefit final pension salary scheme. That scheme closed at the date of the transaction. It was not part of the acquisition or part of the assets that we as Nationwide purchased, and therefore is with the administration business. There was, secondly, a defined contribution scheme, which is essentially a money purchase scheme. For those employees within the money purchase scheme, their pension scheme has continued unaffected. For those people within the final pension salary scheme, accrual within that scheme ceased at the date of transaction with Nationwide and they have been invited into, and are indeed members of, the defined contribution scheme.

Q267 Mr Davidson: So the final salary scheme has been closed, effectively?
Mr Prestedge: The final salary scheme has been closed and the liability for that scheme resides with the administrator.

Q268 Chairman: What will happen to the Dunfermline Building Society brand in the long term? Will it remain intact? It is a popular brand in Scotland.

Mr Prestedge: We have made clear our intention, not just with the Dunfermline brand but also with Cheshire and Derbyshire building societies, that we identify and believe that there is value in local community-based brands, representative of the communities they serve; therefore we are committed to that brand in the short to medium term. What I would say, however, is that the business does need to be viable; it does need to trade commercially; and that is dependent on the performance of the business and the usage and the purchasing processes adopted by the members themselves. If the members within Dunfermline continue to commit themselves to the business and the business continues to trade commercially, there would be no reason why we would choose to do anything different—which is why we have committed to the brand at this stage. But, again, it would be wrong for me to give any form of indefinite or long-term commitment. Businesses will constantly need to review their business operations over time.

Q269 Chairman: Obviously there are cultural differences within the organisations—DBS and Nationwide. How does DBS exist within Nationwide?

Mr Prestedge: First, I would say there is much less cultural difference than you might imagine. My experience is that both businesses hold their heritage of mutuality very strongly. Both businesses' employees feel very strongly about the service ethic and the right thing to do on behalf of the membership. My personal experience—and I have been to Scotland on numerous occasions now since the merger—is that the culture between the two employee bases are not very different. In terms of the business operation, we operate the Dunfermline within our regional brands business. That includes the Derbyshire, the Cheshire and the Dunfermline operations. There is a common management team; so a common front office management team that runs all of the branch network, the sales and the servicing operation, as well as the back office. Because, as you would expect, it is right for us to identify efficiency opportunities across those three businesses. Where we are attempting to move towards is a business where the front office, the experience that the consumer receives, is no different, and in many respects, we hope, may improve over a period of time. That is not a judgment on their past services or pricing; it is just we would hope that we would be able to bring the benefits of the Nationwide Group to bear; but we would seek to share the back office facilities, processes and capabilities in order that we can run an efficient operation.

Q270 Chairman: What presence did Nationwide have in Scotland before taking over DBS?

Mr Prestedge: Prior to the transaction, we already had just over 40 branches in the Scotland environment. We also have a commercial lending business within Nationwide itself that did trade in Scotland. We did not identify Scotland as a distinct trading operation and, therefore, as far as the commercial organisation is concerned, it is hard to determinately isolate Scottish-related lending, because we do it through relationships that may be both within England, Scotland, Ireland or Wales. Certainly within the retail environment we did have a presence of over 40 sites.

Q271 Chairman: What practical problems are there with taking on the business of DBS?

Mr Prestedge: If I am honest with you, there are always operational challenges when you go through a transaction, about how you manage your cash; how you ensure you reconcile your own balance sheet; how you determine your risk profiles. We have not, however, at this time, experienced any significant difficulties that are giving us any concerns around the merger with Dunfermline that we undertook.

Q272 Chairman: We see this IT system cost DBS a lot of money, a loss of over £9 million. Are the IT systems compatible?

Mr Prestedge: We genuinely have not yet concluded whether or not the IT solution within Dunfermline will continue. What I would say is that, as I am sure you would expect, with an estate that goes across almost 1,000 branches in many respects and four brands—Nationwide, Cheshire, Dunfermline and Derbyshire—we will look at how we find synergy across all of our IT estate. From the IT solutions that I have seen within Dunfermline, what I would say is that they are operating but, as Mr Willens said earlier, there are continuing improvements that would be needed if we were to retain them as an ongoing IT estate for the business.

Q273 Chairman: We have received an email from a customer of DBS who was concerned that he had received no official communication to him from either DBS or Nationwide about the transfer. He was forced to rely on press releases for information. Have you now explained the situation in writing to your customers?

Mr Prestedge: What I would say, Mr Chairman, is that I am very disappointed about that, because we have actually written to all of the different consumers within Dunfermline. There if of course a unique set of circumstances here. Under a normal building society merger, members would receive notification in advance of a merger happening. Of course, during the course of that weekend there was very broad speculation within the media around the processes and the risks that were currently emerging. What we did do on that following Monday was to have two of our principal board directors from within Nationwide, and indeed a Nationwide team, in Scotland, many of whom have remained on an enduring basis and have rolled out a programme of engagement with the employee base through communication, as well as the membership base. What there was on that first day of trading was heavy engagement with the media, because in many respects that was the quickest way for us to engage in terms of messaging the transaction that had gone through. Secondly, we did use the internet and the Dunfermline internet in order to detail the nature of the transaction. I am disappointed, however, if there are individual members who, through their engagement in the branch network believe that staff have not been well briefed, because that is not my understanding and certainly is not our intent. Secondly, I can confirm to you that we have written to every Dunfermline member. Not only that: we have also just written again to every Dunfermline member, because they are now members of the Nationwide and therefore they have the opportunity to vote within our own democratic processes of the AGM. So indeed there will have been two full communications to every Dunfermline member.

Q274 Chairman: When you take on a new business there are always mountains of problems but, from your evidence, it appears that the structure, priorities and culture of the DBS were reasonably functioning well. So what went wrong, for the failure of DBS?
Mr Prestedge: As I said earlier, my observation from the outside looking in is that we are in a very severe economic downturn. The shape of the balance sheet within Dunfermline was skewed towards non self-originated residential lending or commercial. I cannot comment on the quality of that. Clearly the Tripartite decided that as a result there was insufficient capital to continue to trade. What I can comment on are the parts of the business that we acquired. Inevitably, in any organisation—indeed our own organisation—we would always seek to find further efficiencies, and we will seek to do so with Dunfermline. We will always seek to drive further improvements in the service delivery for consumers, as well as the origination and product performance of any organisation. It would be wrong for me to say there are not performance improvements that we would seek, but that is no different in Dunfermline than within our own business. What I would say is that the culture of the employee base that we found is that they have been open-minded; they have been accepting of the change; and they have been embracing of the change. That in itself has made the transition much easier.

Q275 Chairman: Do you believe that it was a wise decision of Nationwide to take over?
Mr Prestedge: I do believe it is a wise decision, for two reasons. First, I think that, in the parts of the business that we were able to acquire through the process, there is a business there that, over time, we will prove there is value in. Secondly, because we believe it was the right thing to do on behalf of the mutual sector. Whilst we could not step in and do a voluntary merger because of the risk it would have posed to our own business, we were clear that, if we were able to do so, we would seek to find a solution to help Dunfermline in the position that it found itself. What I would caveat that with, however, is that we do not view ourselves as the lender of last resort for the sector. Clearly we would only ever conclude any transaction of which Dunfermline was a part if we believed that did not create unnecessary risk or bring unnecessary risk into the business of Nationwide itself.

Q276 Lindsay Roy: Am I right that, given the speed of events, due diligence was not as comprehensive as might otherwise have been the case?
Mr Prestedge: That is very true. However, as part of the transaction that we were able to complete post-announcement on merger due diligence, with the agreement of the Bank—maybe I could ask Ms Robb to comment on that.
Ms Robb: We did complete a limited amount of due diligence prior to the actual execution of the transaction over the weekend, but we then had a four-week period in which to complete our in-depth due diligence, which we did. We confirmed to the Treasury that we had completed that and the findings were satisfactory within the parameters which we had expected.

Q277 Lindsay Roy: Was there anything you found that was surprising?
Ms Robb: No.

Q278 Mr Davidson: So this was a cherry-picking, shotgun wedding. There was nothing that you found that was untoward at all; you are perfectly happy with everything; and the process has all run smoothly since, has it?
Ms Robb: It is fair to say that everything was executed so quickly, and we were using legislation for the first time; so certainly, as events unfolded, there was some issue in terms of the transfer order and that has been corrected; but I would say that was an administrative procedure that needed to be completed, as opposed to a substantive issue with the transaction itself.

Q279 Mr Davidson: I am sorry if this was dealt with while I was out of the room, dealing with a practical issue. The IT systems—can I just ask about that? There is compatibility between the two, is there? Before we get on to Dunfermline Solutions, you were able to operate with the system that Dunfermline has and there is no difficulty about meshing them together, is there?
Mr Prestedge: Perhaps I could answer that. Because we have chosen to continue to run the business independently, the only point of integration that we need is at a balance sheet and an accounting level. We have not sought to deploy Dunfermline systems into Nationwide branches or vice versa. They have continued to run independently, and therefore the points of technology integration are very limited.

Q280 Mr Davidson: What is your view of the technology systems that they are using?
Mr Prestedge: There have clearly been, since deployment last October, a number of ongoing developments that have been required, and there

would need to be on an ongoing basis. It is a solution that, as with any technology solution, will take a period of time to bed down, and has been live for only six months. What I would say is that it is operating; it is fit for purpose for the way in which the organisation is currently operating. Whether or not we retain that, however, in the medium and longer term is a debate that we are as yet still to conclude, because we will do that across the entire Nationwide estate.

Q281 Mr Davidson: Do you think that the system that Dunfermline is operating is worth the money that was spent on it?
Mr Prestedge: I clearly was not part of the choice of that supplier and I am unclear what price you would pay for a similar solution in the marketplace.

Q282 Mr Davidson: That was delightful! You should certainly be in the Civil Service! That told us absolutely nothing at all.
Mr Prestedge: In fairness, I am not trying to be evasive. In many respects I cannot answer the question because, without going out to the market and tendering for a common solution with multiple suppliers to determine the price, without having done that, it is a question that I cannot answer.

Q283 Mr Davidson: You are not in a position where you are aware of the way in which Dunfermline operates and you are saying, "This really is an absolutely super, whizz-bang system and we wish we had that in all our other locations". As far as you can see, it seems to do the job adequately but you are not in a position to judge anything else and to judge its value for money.
Mr Prestedge: I certainly am not able to say the former, partly because it would not be an appropriate solution for the Nationwide Group, because we operate services and products beyond savings and mortgages. Therefore, it is not a current account banking solution and would not be able to service the full suite of product offering that we offer within the Nationwide Group. What I would say is, as with any solution that is deployed and is now only six months old, there is ongoing development work required. The IT function within Dunfermline are working incredibly hard to understand the IT solution they are now operating and, over time, we will evaluate that. In terms of value for money, because I have not had the privilege of going out to the market to determine what else is out there and at what cost, it is not a question I feel able to answer—but I am really not trying to be evasive.

Q284 Mr Davidson: Can I clarify what has happened to Dunfermline Solutions, the IT business? You were not involved with taking that over; that remains with the administrators, does it not?
Ms Robb: Dunfermline Solutions is still a trading company. The shareholder is the administrator and the previous directors remain directors today.

Q285 Mr Davidson: And you took a conscious decision that you did not want to take that over?
Ms Robb: Yes.

Q286 Chairman: Is there a case for restricting commercial loans to 10% of a building society's total assets, as it used to be before the Building Societies Act 1986?
Mr Prestedge: My own personal view would be not. I do not believe that straightforward limits in terms of extent of exposure is an appropriate way to regulate a business. The appropriate way to regulate a business is to determine its competence, its capability and its capital level. If a business has sufficient capital in order to allow it to take risk and not disproportionate risk, and to create sufficient return for that to be the right commercial thing to do, then I believe that businesses should be able to do so.

Q287 Chairman: You think that this is a matter for the judgment of the management board?
Mr Prestedge: I think it is for the judgment of the management board. I do however agree that, with some organisations it is right—and I believe we heard this from the regulator—moving forward, there does need to be some closer supervision to ensure that the business is operating in specific markets; that they have the right skill, they have the right competence and, particularly, they have the right risk management capability to understand and assess the risk they are taking onto their balance sheet, and to ensure that they can manage those responses it originated.

Q288 Chairman: This might be a difficult question for you to answer. What responsibility does the FSA and Government hold for the failure of DBS?
Mr Prestedge: As I was not a director of DBS, I cannot comment on the way in which business was supervised or the way in which the regulator engaged. What I would say, and I think that Mr Pain said this himself, is the regulator has learnt lessons and the way that they are supervising firms is clearly going to change over time; and, given the experience that we have all observed within the marketplace, that clearly is right.

Q289 Chairman: How can you say that the regulator has learnt lessons? The regulator told us repeatedly that warnings were given to DBS about their commercial loans; we have noticed that there is a letter there, appreciating their decisions.
Mr Prestedge: I have not seen either the correspondence from the regulator to Dunfermline, nor indeed Dunfermline's response; so it is not something I feel able to comment upon.

Q290 Lindsay Roy: From your enquiries and investigations since you have taken over DBS, do you have evidence that there was proper external validation and robust internal self-evaluation procedures prior to 2008?
Mr Prestedge: We do not have evidence of that, simply because the parts of the organisation that we did not acquire we have not acquired, and therefore we have no information associated with that. What

I would say is that, for the parts of the organisation that we did acquire, and principally the prime residential book, it is a good-quality book which is performing well and the risk assessments within that book itself would be very comparable to that of our own and one that we are very comfortable to have on our balance sheet. Beyond that, I am afraid I cannot comment.
Ms Robb: Perhaps I could add that, as part of the due diligence process, we sampled a significant number of cases manually and validated the information that we had been provided over the course of the weekend; so the evidence was there.

Q291 Chairman: A final question. In your view, what lessons can be learned by other building societies about the position DBS found itself in?
Mr Prestedge: I think that there would be three things that I would observe, and I believe we heard this earlier from the ex-board members from Dunfermline. The first is that consolidation within the sector, in itself, is not a bad thing, and that if an organisation can be stronger as part of a different organisation, then boards should consider that, and consider that in an open-minded way. The second is that boards of building societies need to understand the risks that are being taken and the capability they require within their own organisations to do so. Finally—and I believe this is the case within Dunfermline—to remember that, within a mutual, the virtue of the business is that generally you are highly retail-funded and highly capitalised, and that in itself, even in a very distressed economic environment, is a very viable business model; and to remain confident during the period that we now find ourselves in.

Q292 Chairman: I would like to thank the witnesses for their attendance. Before I declare the meeting closed, would you like to say anything in conclusion, perhaps on areas that we have not covered in our questions?
Mr Prestedge: Nothing at all, thank you.
Chairman: Thank you very much.

Written evidence

Memorandum from HM Treasury

I am writing to you on behalf of Alistair Darling. Further to your recent meeting on the topic of Dunfermline Building Society, the Chancellor thought it would be helpful to inform you about the latest developments regarding the resolution of Dunfermline, in particular in relation to the social housing loans business that was transferred to a Bank of England owned bridge bank.

I am pleased to inform you that, the Bank of England has today selected Nationwide Building Society as the preferred bidder for the sale (by way of a competitive auction process) of Dunfermline's social housing loans business, in accordance with the Bank of England's powers and duties under the Banking Act 2009 and the Code of Practice.

It is our opinion that this is a positive outcome that meets the shared interests of the Treasury and the Scottish Executive regarding continued lending to Registered Social Landlords in Scotland and the principles of fairness and equality of access to funding by RSLs across the UK.

17 June 2009

Memorandum from Nationwide Building Society

On 30 March 2009, Dunfermline Building Society was placed into Building Society Special Administration. The majority of the Society's mortgage assets and certain other assets were transferred to Nationwide Building Society and the social housing was transferred to Dunfermline Building Society Bridge Bank Limited which was set up by the Bank of England. The remainder of Dunfermline Building Society's operations were left behind to be managed by KPMG, the insolvency administrators appointed to wind up Dunfermline Building Society's affairs.

1. Under employment legislation (TUPE) employees ceased to be employed by Dunfermline Building Society, but automatically became employees of Nationwide. With the exception of their pension provisions, they transferred on their existing terms and conditions of employment.

2. The Dunfermline Building Society 1974 Pension and Life Assurance Scheme was not part of the transfer from Dunfermline to Nationwide, and the service of active members of that arrangement ended on 30 March 2009.

3. No employees were eligible to join Nationwide Building Society arrangements, so on 16 April 2008 all active members of the Dunfermline Building Society Final Salary Pension were offered membership of the existing Dunfermline's Group Personal Pension scheme, operated in conjunction with Standard Life.

4. The Dunfermline now has a single pension arrangement for all employees, this is a defined contribution scheme with an employer contribution rate of 3% and an employer contribution rate of 5%, plus AVC matching up to a further 4%.

5. This is similar to the Group Personal Pension Plan offered to new employees of Nationwide, having closed our defined benefits scheme to new members in 2007.

18 June 2009

Memorandum from Graeme Dalziel

DUNFERMLINE BUILDING SOCIETY-FOLLOW UP TO 10 JUNE ORAL EVIDENCE

During our oral evidence session on 10 June both Jim Faulds and I agreed that we would submit the correspondence from the FSA that I quoted from. This was clearly set out in the transcript. The letters have been sent to you, under separate cover.[1]

It is important for the Committee to understand the context in which I referred to this correspondence at the hearing. The Lord Turner letter in April followed by Jon Pain's evidence on 20 May gives an impression to some observers that we at Dunfermline had ignored some warnings from the FSA about such things as Commercial lending and other activities. As Jim Faulds said in evidence these assertions were totally untrue. All "Dear CEO" letters and speeches were reviewed internally, and discussed at Board and appropriate Risk Committees. There was also only 1 "Dear CEO" letter regarding Commercial lending in early 2003. I was trying to make the point in my oral evidence that the FSA had plenty of opportunities to provide specific regulatory warnings to DBS about DBS activities but it had never done so.

[1] Not printed as also submitted by FSA, see Ev 38.

The correspondence following each ARROW visit reflected the FSA view, at the time, of the risks from DBS to the FSA regulatory principles. These ARROW visits took nearly a whole week and involved the FSA in fairly detailed examination of documentation and interviews with Senior Executives, some non executive directors, and members of the Senior management team.

Apart from the ARROW visits (which took place every two years) the other opportunities for the FSA to make comment or issue specific warnings to DBS included the following:-.

— Annual Business Plans and updated 5 Year Strategic Plans were sent to the ISA annually. Those plans laid Out clearly the intended route of diversification in strategy including planned volumes of lending across each area of the business, and routes to acquisition of business.

— Board approved policy documents were sent to the FSA at least annually. In practice this meant, for example, that Lending Policies (including Commercial Lending) were sent to the FSA following any changes in lending practice or policy.

— Prior to engaging in a new activity there was an obligation to inform the FSA of our intentions. This is something we took seriously by making sure we kept in regular dialogue with the FSA about our strategic thinking, opportunities we were reviewing, and about business progress. This would have included, for example, discussions surrounding acquisitions of mortgage portfolios in 2005 and 2006 and prior to the creation of the Commercial lending operation in 2002.

— With regard to Commercial lending specific loans, above a specific size (about £20m) required to be pre-reported to the FSA. Regular reporting of financial information on a monthly and quarterly basis would have itemised the specific volumes of lending in particular areas, loan to values, and the most significant counterparty exposures.

— With regard to Capital the FSA received annually the Society's ICAAP. This was a Board approved document setting out the Board appetite for risk, the risk management structure, the major risk mitigants, and the Society five year financial forecasts. Those forecasts included capital adequacy forecasts and stresses across a range of scenarios. The 2008 ICAAP was sent to the FSA at the end of February 2008. A meeting was held in early May to discuss a number of areas and thereafter the FSA were to submit our ICAAP to a Committee who would then determine our statutory capital targets (this is referred to in the March 2008 Arrow letter when the reference is made to SREP by 30 June 2008). In practice despite several email reminders and telephone calls from DBS this Committee never met to discuss the DBS capital requirement. (We were continuously advised that other issues were taking priority). It was not until end September 2008 when I sought a meeting myself with the FSA that capital was raised as an issue ("for the whole sector" they said). This followed the rescue of Derbyshire and Cheshire Building Societies by Nationwide.

— Our ICAAP clearly showed in 2008 that the Society's capital would withstand a 1 in 25 year recessionary event⁄allowing for the IT exceptional item and also potential loss provisions in the most extreme case of about £48m. In all scenarios in planning in September 2008 at no time was the Society's actual capital forecast to be less than the statutory requirement. The extra stress, therefore, imposed by the tripartite authority in October 2008 that led to the £20m extra capital requirement (at that time)came as a complete shock to us. The other capital issue that arose was the Society's liability of £8m to the Financial Services Compensation Scheme for the "bail out" of Bradford & Bingley and the Icelandic Banks. (It is also worth noting that this liability was of a similar amount to the IT exceptional provision made in the 2007 accounts).

— The previous ICAAP submitted in 2007 was the first such document following the implementation of new Basel Committee rules. During telephone calls and meetings the FSA were very open in their praise of this document and in particular about the Finance Director's enthusiasm, and expertise in this whole capital adequacy area (they were worried at the time about the risks to DBS of the FD leaving in view of his significant intellectual knowledge).

It is clear that the FSA had no regulatory concerns about DBS beyond those itemised in their ARROW letters. Furthermore it should be noted that at NO time did the FSA exercise their power to carry out a themed investigation in DBS into Commercial lending or Mortgage acquisitions. During my time as Chief Executive they carried out 2 themed visits on Treasury Management and 1 on Treating Customers Fairly. It is also clear from reviewing the FSA Business Plan for 2007/2008 that the issue of capital adequacy was not a major priority at that time for the FSA. Financial capability and Treating Customers Fairly were the priorities.

In conclusion DBS did not ignore any warnings from the FSA and specifically related to DBS no warnings were actually given. Furthermore there are other aspects of FSA evidence included in Lord Turner's letter that have already been called into question during our oral evidence:-

— I was never advised by the FSA of any concerns about the ability of the Society's management and was never advised of any involvement by the FSA in deliberations about the timing of CEO succession (these deliberations were started by myself in the summer of 2008 which led to the Willens recruitment).

— The decision to not acquire a mortgage portfolio from Credit Suisse in November 2007 was taken by the Society's Asset and Liability Committee at that time for commercial reasons and NOT because the FSA said NO. We do respect that the FSA had been involved in the process and made views known during telephone calls and in BSA meetings. Due diligence had not started and Board approval had not been sought.

— The timing of events in Lord Turner's letter regarding executive management changes and the production of a new business plan are wrong. The Business Plan for 2009 was approved in its initial version by the Board on 28 October 2008 when I was CEO. The FSA had already received it by then and Faulds, Willens and myself met the FSA on 29 October to discuss it. During several calls and meetings the "Willens" Plan as it became known was referred to with enthusiasm by FSA officials. Examples are "we've told the Treasury what a great bunch of guys you are and that we fully support the Willens Plan" (quote from an FSA official on 12 November 6pm in call advising me to go to HM Treasury at 4pm the following day). This was reinforced the following day,in London, by another FSA official, during a conversation at the annual Building Societies Association lunch. The subsequent editions of the plan were derivatives of the version originally approved by the FSA in October.

I remain shocked and saddened by the events leading to the demise of one of Scotland's great institutions.

It is also worth mentioning that the action that the West Bromwich Building Society recently took, with Treasury support, to convert Tier 2 debt to Tier 1 is something that would have solved the DBS problem too. It is such a pity that somebody decided, unnecessarily, to invoke the Banking Act 2009 with such haste and without proper and transparent consultation with the Society's Board.

23 June 2009

Memorandum from Nationwide Building Society

1. *Why did Nationwide not acquire the social housing loans business when it acquired the core parts of Dunfermline Building Society in March of this year? Why has it decided to do so now?*

As the Committee will be aware, the Bank of England announced on 30 March 2009 that Dunfermline's retail & wholesale deposits, branches, head office & residential mortgages had been transferred to Nationwide, following a competitive process. Simultaneously, the Bank of England transferred Dunfermline's social housing loan portfolio and some related deposits to a bridge bank, wholly owned by the Bank, to allow it to find and implement a suitable private sector solution. A financial advisor was engaged to advise on the sale of the bridge bank's business and potential bidders were identified for the Bank of England based on the financial advisor's market knowledge, suggestions from the FSA and direct approaches received from interested parties. These were then contacted and a number expressed interest in and undertook due diligence. Information was made available to interested bidders during the period from 4 May to 4 June 2009 and binding offers were received from the remaining bidders on 5 June 2009. Nationwide was the successful bidder at the end of this process.

2. *Will the Dunfermline's social housing loans business be operated within Nationwide's regional brands business?*

Nationwide will continue to employ Dunfermline's existing Social Housing team at Dunfermline's head office for the foreseeable future. These employees have continued to manage the portfolio during the period that it has been owned by the Bridge Bank, so social landlords will continue to deal with the people they know.

3. *Did Nationwide have existing loans to Scottish Registered Social Landlords before 17 June?*

Nationwide has a strong record of lending to the social housing sector across the UK, including in Scotland. However, Dunfermline was the leading lender to social housing in Scotland and we expect to retain this market leading position, thereby significantly increasing our profile in Scotland.

This acquisition is an exciting development that will enable us to strengthen our links with housing associations in Scotland even further and we will, of course, consider all future lending to housing associations in Scotland as we would consider any other social housing lending.

30 June 2009

Memorandum from the Financial Services Authority

Thank you for your letter of 25 June, asking for further FSA evidence following the Committee's session on 10 June with former board members of Dunfermline Building Society. I respond to your questions in turn. I also attach documents which provide further detail in support of our responses.

Q1: *Can you confirm whether the FSA gave the Dunfermline Building Society specific warnings over its commercial lending from 2007 onwards?*

It is correct that the FSA's Arrow letter of 18 January 2006 (attachment 1), following the Arrow Visit in November 2005, noted that the Society's commercial lending operation was "well controlled". However, it is important to read this quotation in context. Our letter goes on to say:

> "We are aware that the Society plans to increase its exposure in this area and that you have recognised that the portfolio has now grown to a large enough size to warrant risk analysis across the portfolio rather than solely at the individual exposure level. We would ask that you keep us informed of your progress in this area".

In addition, the Risk Mitigation Programme (the action plan provided to the Society by the FSA as part of the Arrow process) which was appended to the above letter reflected our desire for the Society to develop its analytical capabilities:

> "The Society to provide details to FSA of the risk analysis techniques it introduces to monitor the commercial lending portfolio—Timetable: 10 June 2006".

By way of background, when the FSA conducted this Arrow visit in January 2006, the Society's commercial lending balance was £169m. This represented around 7% of its overall balance sheet. In the subsequent two and a half years the Society embarked on a new strategy to increase its exposure in this area; during the period it lent a further £459m, to bring its total exposure to the commercial property sector to £628m, representing around 20% of its balance sheet.

It is therefore clear from our January 2006 Arrow letter and accompanying Risk Mitigation Programme that the ESA had identified the risk arising from the Society's new strategy to increase significantly its exposure to commercial lending. From this time on you will see below that the FSA instituted with the Society a series of further interventions which intensified as the commercial property balances increased (the key interventions have been highlighted in bold below).

In response to the FSA's Arrow letter and mitigation programme, the Society appointed an external specialist consultant to conduct risk analysis across the portfolio; this resulted in the Society implementing improved controls over its commercial lending—which were later verified by their external auditors. We considered it reasonable in these circumstances to rely on the report of external specialist consultants (which we saw) and on the verification by the Society's external auditors.

In November/December 2007, we carried out a further Arrow assessment of the Society, the results of which we communicated in our letter of 11 April 2008 (attachment 2). As part of this work we discussed the commercial property loan portfolio with the external auditors. They told us that the Society was well controlled and suggested that the commercial loan loss provisions may not have been entirely justified, given the benign market, ie they may have been slightly higher than justified.

Whilst noting this assurance from the auditors, our supervisory team continued its work on the capital/liquidity position of the Society. The team had intended to combine the work on the 2007/08 Arrow with its review of the Society's Internal Capital Adequacy Assessment ("ICAAP") (which would cover the provisioning on commercial property), This is the FSA's normal supervisory practice, and we would have expected to be able to do this and to issue the Arrow letter shortly after the Arrow visit and the supervisory review of the ICAAP.

The Society submitted this Assessment to us in February 2008. Unfortunately, in direct contrast to the ICAAP assessment of many of its peers, the assessment was poorly prepared and put together (particularly in respect of stress testing), and despite the best efforts of the FSA to try to perform the two in tandem, due to the inadequacy of the document we were forced to ask the Society to resubmit the document. This meant that the section on capital (which covered the commercial lending risks and expected losses in a stressed environment) was decoupled from our Arrow assessment, which was completed in March 2008.

We continued working with the Society on their ICAAP following the completion of the Arrow assessment. Our well documented contemporaneous meeting notes show that we met with the Society on 2 July and provided detailed feedback on their ICAAP document. We set out to them all our concerns about the quality of this document. In particular, we explained that it was not clear from the stress testing they had performed that they had considered the impact of the economic downturn on their capital resources—in particular on their provisioning for bad debts and the losses hitting the P&L/reserves. (As the Committee is aware, these were the issues which 8 months later caused the demise of the society).

Following this meeting the Society carried out further work, and on 25 September we met them again and told them that, following our investigations, we were considering requiring the Society to hold additional capital above previous regulatory guidance to reflect the higher risks identified. At that time the Society held sufficient capital to meet this higher capital requirement, but it constrained the Society from subsequent risky growth.

This guidance was superseded by the system-wide measures taken by the Tripartite Authorities in October 2008. when we subjected all banks and building societies to a severe stress test. On the basis of the information and assessments prepared at that time, Dunfermline did not have sufficient Tier 1 capital to meet the requirements of the Credit Guarantee Scheme (at this stage it required additional capital of £20m). It is worth noting that Dunfermline Building Society was the only building society (ie 1 out of 53) by March 2009 which did not meet the requirements of the above stress test. Much of the requirement for additional capital arose—as it did in the earlier exercise—from the impairment charges likely to arise on the commercial property book in a stressed scenario.

Given the increasing gravity of the Society's position, in November 2008 we commissioned a "skilled person" (KPMG) to carry out an independent review and report to us on the adequacy of the Society's loss provisions on its commercial property loan book. KPMG submitted their report to us in early December; they recommended that the specific loan provision of £15m should be increased by £3m and that, given the characteristics of the Society's commercial book, a general provision of 15m (as proposed by the Society) should be made.

It is clear that from the series of actions described above that the FSA increased the intensity of its supervisory work on this area, despite a number of reports from external sources (ie the Society's auditors and two external firms of consultants) that the Society's commercial property lending was well controlled and the provisions may have been too high.

Q2: *On which day did the FSA communicate to Dunfermline Building Society that the stress tests had indicated that £60 million was needed to secure the Society's financial position over the next two years?*

On 25 March 2009 the Society told us that its auditors had told its audit committee that the Society would require a £60m injection of capital before they would he able to sign off the accounts. There was therefore no need for the FSA to tell the Society that their stress test had shown that £60m was needed to secure the Society's financial position.

We hope it will be helpful for the Committee if we explain the background to the various capital figures which are often quoted in the evidence.

In November 2008 the FSA told the Society (and they accept this) that they required £20 additional capital to meet the requirements of the Credit Guarantee Scheme. During the three months up to early March 2009 (three months after failing to meet the stress test required for access to the Government Guarantee Scheme) the Society approached a number of parties to try to raise the required £20m. However, by early March it was clear that the Society had exhausted all its own avenues to raise any amount of the £20m.

Therefore, despite being given at least three months by the Tripartite Authorities to try to raise the additional £20m, the Society failed to raise any additional capital. It is worth noting that again Dunfermline was alone in the building society sector—other societies were able to raise additional capital of a similar order in this period.

Jim Faulds confirmed this situation in an email to the FSA dated 8 March 2009 (attachment 3) in reply to our letter of 6 March (attachment 4), in which we had set out the perilous capital position of the Society:

> "Any prospect of public or private capital raising is, at this stage, extremely unlikely. Consequently we should all concentrate our efforts on concluding an orderly and successful merger".

By the middle of March it was clear that no other building society was prepared to merge with the whole of Dunfermline. Again, it is worth noting that the FSA had been able to identify merger partners for a number of other societies in recent years. Despite significant attempts on our part we were unable to find a willing merger partner for Dunfermline Building Society.

We therefore began detailed work with the other Tripartite Authorities to consider the merits of alternative courses of action. There were two credible options, each of which would involve public money:

- One was to use the resolution powers of the Banking Act 2009 to separate the "good assets" from the "bad assets", with a subsequent disposal of good assets to another building society or bank.
- The other was an injection of additional capital from a Building Societies Association (BSA) consortium, matched by investment of a like amount by HM Treasury. The BSA confirmed, subject to a number of conditions, that it was prepared to invest £30m on the basis of £30m matching public investment, to give a total investment of £60m. In March discussions were also held with representatives of the Scottish government about it providing £25m of funding.

To inform the choice between these options, we conducted a series of additional stress tests to identify the amount of capital required to ensure the long-term future of the Society as an independent entity. This was important because, as the Committee is aware, financial conditions (particularly in the commercial property market) had continued to worsen since the stress tests were conducted by the FSA in October 2008, when the Society was being considered for access to the Government Guarantee scheme. These latest tests showed that the injection of £60m would secure the financial position over the next two years, while alternative merger options were sought.

Q3: *Was there a specific reason why Dunfermline Building Society, unable to meet the HM Treasury before the decision was made to trigger the resolution process?*

This is of course primarily a question for HM Treasury. However, we do not accept that the Dunfermline were unable to meet HM Treasury before the decision was made to trigger the resolution process.

Nor—which is important from the FSA's perspective—do we accept Jim Faulds' evidence (Q185) on his contact with the Tripartite Authorities that

"we felt, to be perfectly honest, we were treated, sorry to keep the criminal court analogy going, like the accused. We were denied information and we were shut out".

During this period the FSA had almost daily contact with the CEO, Treasurer and Finance Director of the Society. The Chair asked for a meeting with Jon Pain and, as he admits in his evidence, "got one". Importantly, as is noted in the transcript of this inquiry (in response to Mr Roy's question 185), Jim Willens, the CEO of the Society until December 2008 and then CEO of the Society from then until March 2009 said in his evidence that:

> "I certainly had very regular contact with the FSA throughout the period October 2008 all the way through to the end of March 2009. My impression is one that the FSA were working extremely hard but were under extreme pressure and that they did everything that they could do within their powers to assist during that set of circumstances".

Jim Faulds notes (and the FSA was aware) that the Society held two meetings directly with HM Treasury, one with Lord Myners and one with Senior Officials. The FSA was not present at either meeting so further questions about that should he directed to HM Treasury.

Q4: *Were all three authorities in agreement on the course of action adopted?*

All authorities were agreed that the Society required the injection of capital as described in Question 2 above. It was entirely a matter for HM Treasury whether any public money should be applied to that end.

Further Points

We would also like to take the opportunity to correct two factual inaccuracies in the evidence that was provided by the former Directors of Dunfermline to the Committee. In answer to Q199 Jim Faulds said:

> "The FSA said that pressure was put on the board to remove executives. That is categorically 100% not true. No pressure was put on. In fact when I rang a Mr Eric Enstrom at the FSA to tell him that Graeme was moving on and we were going to appoint Jim Willens as Chief Executive, and this was mid December/he had a canary fit when I told him that. He said, 'You cannot appoint someone full time', and I thought 'I can see some writing on the wall here.'"

In his letter to the Chancellor of 17 April 2009, Lord Turner said "the FSA strongly recommended to the Board that a new Chief Executive be appointed: this occurred in December 2008". We stand by this statement, which is supported by our contemporaneous file notes of telephone conversations with both Jim Faulds and one of the Non Executive Directors of Dunfermline in the period from 15 November to 2 December 2008. In particular, our files include a note of a telephone conversation on 27 November between the FSA Head of Department responsible for the supervision of Dunfermline and a non-executive director of the Society. Our records show that the FSA was considering using powers to replace Graeme Dalziel as soon as possible, should the Board not take action on its own account within the next 24 hours.

Nor do we accept Jim Faulds' account of his telephone conversation with Eric Engstrom. Our contemporaneous note of this conversation shows that Eric Engstrom did not say that the Society "cannot appoint someone full time".

6 July 2009

ATTACHMENT 1

A LETTER FROM THE FINANCIAL SERVICES AUTHORITY, ADDRESSED TO THE BOARD OF DIRECTORS OF THE DUNFERMLINE BUILDING SOCIETY, DATED 18 JANUARY 2006, AND MARKED FOR THE ATTENTION OF GRAEME DALZIEL

Risk Assessment—Dunfermline Building Society

As you are aware, we conducted our risk assessment of Dunfermline Building Society between 9 and 11 November 2005. In this letter we summarise our findings and advise you of the actions we expect you to take.

We assessed your firm by applying our risk assessment framework—ARROW. For an explanation of this and the Threshold Ratio please see Appendix 1. Appendix 2 sets out the scope of the risk assessment, the resulting impact and probability scores and the business and control risk components of the probability score. We also attach the risk mitigation programme as Appendix 3.

Overall Assessment

We have assessed the Society as having a medium high impact to our objectives due to the size of assets and liabilities on the balance sheet. Although we are raising some issues we want you to address, we believe that fundamentally the Society's control structure is adequate and as a result, we consider that the probability score is low.

In undertaking our review we have taken account of the way the Society has introduced or implemented new business initiatives such as commercial lending and mortgage regulation; ensuring that experienced individuals and adequate procedures are in place at the outset. At the same time, however, the controls over the delivery of Project Destiny have not always been robust.

Key Issues

These are the key issues that arose from our risk assessment. We have set them out according to our view of the risk they pose, with the most significant risk first.

Corporate Governance

We found it difficult to marry the information we received during interview, with the other evidence we reviewed in terms of challenge offered by the Audit Committee. We were also surprised that information, which in our judgement and according to the Terms of Reference should he discussed or reported at the Audit Committee, was not brought to the Committee's attention. This may mean that the Audit Committee is not fully aware of the risks facing the business and therefore unable to challenge management effectively. It is important that the Non Executives, through the Audit Committee and otherwise, present an effective challenge to management.

We welcome the Society's proposal to review the effectiveness of the Committee and the reporting surrounding it and we look forward to receiving a copy of the results when finalised.

Project Destiny

Key to the Society progressing is the successful implementation of Project Destiny. We understand this will bring business benefits such as a "single customer view", the ability to manage and monitor the customer experience and in turn reduce cost (and expenses ratio). Due to numerous reasons the project has suffered delays and it is now anticipated that implementation will take place during the second half of 2006. We are aware that the Society has now taken over full control of the project and has learned lessons from the setbacks suffered so far. In order to check that the Society maintains control of the project we will wish to see a copy of the next implementation review by Internal Audit. We would also ask that the Society keeps us informed of the progress and issues on an ongoing basis.

Commercial Lending

The Society's commercial lending operation has been very successful to date (at the same time as being well controlled). We are aware that the Society plans to increase its exposure in this area and that you have recognised that the portfolio has now grown to a large enough size to warrant risk analysis across the portfolio rather than solely at the individual exposure level. We would ask that you keep us informed of your progress in this area.

Other Issues

The implementation of the Capital Requirements Directive and International Accounting Standards will impact heavily on the Society and the industry. We would like to be kept informed of your progress in these areas.

We have seen a draft of the Society's five year strategic plan, which at the time of our visit, had yet to be agreed by the Board. Once agreed, we would be grateful to receive a copy and discuss with your senior management any control issues that may arise from your strategic direction.

Risk Mitigation Programme

The risk mitigation programme, which sets out what steps you need to take, is subject to review if there is any significant change or potential change to Dunfermline Building Society's business or control structure, or the nature of the issues identified. In line with your general obligations under the FSA Handbook, you should notify us of any such changes.

Individual Capital Ratio/Threshold Ratio

Based on the conclusions of our risk assessment of Dunfermline Building Society, we have determined that the Threshold Ratio for the Society should remain at 9.75%. Additional information on the Threshold Ratio is contained in Appendix 1.

Period to the Next Risk Assessment

On the basis of our current assessment we plan to carry out the next full risk assessment in 30 months. It is important to note that we may undertake further work at any time, or expect Dunfermline Building Society to start additional work if, for example, additional risks are identified or crystallise. In any event, we will undertake an internal interim review of the risk mitigation programme in 15 months, and will consider then whether any further action needs to be taken.

Confidentiality and Response to this Letter

This letter has been prepared for regulatory purposes only and its contents should be treated as confidential. You should copy this letter to your auditors but please discuss with us if you intend to disclose it to any other third party. This is because its contents could be misunderstood or misinterpreted if disclosed in another context.

Please confirm to me by the end of January 2006 that the Board of Dunfermline Building Society has considered this letter and has agreed to implement the sections of the risk mitigation programme in Appendix 3 which require action by you.

18 January 2006

APPENDIX 1 OF ATTACHMENT 1

ARROW RISK ASSESSMENT METHODOLOGY

The FSA's risk assessment process—ARROW—is a high-level review aimed at assessing the significance of a particular risk posing a threat to our statutory objectives. It is not an examination or audit, and may not identify all of the risks associated with current and proposed activities. The ultimate responsibility for identifying and assessing risks remains with the Board of Directors.

Our four statutory objectives were established by the Financial Services and Markets Act 2000:

— *Market Confidence*—Maintain confidence in the UK financial system;

— *Public Awareness*—Promote public understanding of the financial system;

— *Consumer Protection*—Secure the appropriate degree of protection for consumers; and

— *Reduction of Financial Crime*—Reduce the scope for financial crime.

The ARROW framework is at the core of our risk-based approach to regulation. Using the ARROW process, we consider the particular risk your firm might pose by assessing:

— the impact on our statutory objectives if the particular risk actually materialised; and

— the probability that the particular risk will materialise.

Further information can be found on our website at:

http://www.fsa.gov.uk/Pages/About/What/Approach/index.shtml

Individual Capital Ratios (ICR)/Threshold Ratios

ICR/Threshold Ratios are designed to ensure that the regulatory capital for UK banks and building societies reflects the nature and scale of the firm's or group's business, and the business and control risks to which it is exposed (as referred to in IPRU (Bank) GN 3.3.13 and IPRU (BSOC) 1.5.1G). Our assessment of the ratio should not be seen as an alternative to an internal assessment / review of the level of capital appropriate for the business needs. The ultimate responsibility for identifying and assessing risks remains with the Board of Directors. Guidance on meeting the ICR or Threshold Ratio is contained within IPRU(Bank) 4.1.2.6 and IPRU (BSOC) 1.5.2G. The reliance that can be placed on the individual guidance in this letter is described in Section 9.4 of the Supervision Manual.

APPENDIX 2 OF ATTACHMENT 1

SCOPE OF ASSESSMENT

The scope of the risk assessment includes:

Dunfermline Building Society.

Overall Assessment

The information below shows our assessment of the risks posed by Dunfermline Building Society to our statutory objectives.

Impact Assessment

Impact: Medium High

The impact score reflects the scale of the effect of Dunfermline Building Society on our statutory objectives if risk crystallises. We have calculated impact using quantitative information supplied by your firm as part of its regulatory reporting, which is assessed against impact thresholds that vary depending on the business sectors of your firm/group.

Probability Assessment

Probability: Low

The probability score reflects our assessment of the likelihood that Dunfermline Building Society will pose risks to our statutory objectives.

The risk assessment framework divides the probability assessment into business risks and control risks. The table below shows our assessment of the business and control risks within Dunfermline Building Society. We base these scores on our assessment of the information we gathered during the visit, previous supervision work and other relevant information.

A highly-scored business risk will not automatically lead to a material risk to our statutory objectives. We assess the associated control risks to establish whether there is a material net risk. If associated control risks are also highly scored, this may result in an issue in the risk mitigation programme with associated mitigating action.

	Probability Score
Overall Business Risk	Low
Strategy	Low
Market, Credit and Operational Risk	Medium Low
Financial Soundness	Low
Nature of Customers/Users and Products Services	Low
Overall Control Risk Medium	Low
Treatment of Customers	Low
Organisation	Low
Internal Systems and Controls	Medium Low
Board Management and Staff	Medium High
Business and Compliance Culture	Low
Net Risk	Low

Further information about probability scoring can be found on our website at: http://www.fsa.gov.uk/pubs/policy/bnr_firm-framework.pdf.

APPENDIX 3 OF ATTACHMENT 1

RISK MITIGATION PROGRAMME

Assessment Name: Dunfermline Building Society

Regulatory period / End Date: 30 month(s) / 01-Jun-2008

FSA regulated firms included in the assessment

FSA Firm Ref No: 158765

Firm Name: Dunfermline Building Society

Nature of Issue	*Intended Outcome*	*Action*	*Timetable*
Corporate Governance From discussions held during the visit and the documents we reviewed, there appears to be a gap between the level of discussions which take place (evidencing the challenge provided by the Committee) and that which is recorded. Further, the Terms of Reference for the Audit Committee are not being fully met, particularly with regards to the scope of reporting up to the Committee. The Society has decided to commission a review of the Committee's effectiveness.	The Audit Committee provides appropriate challenge, which is adequately documented.	The Society to review the effectiveness of the Audit Committee, including the reports it receives. A copy of the findings of the review, together with any recommendations to be provided to the FSA.	Date: 31-Mar-2006
Project Destiny The Society has made a major resource investment by deciding to introduce a new IT system ("Project Destiny"). The project has suffered major delays to date although in recent months the Society has taken closer control over the project.	Project Destiny is properly managed and controlled.	The Society to forward a copy of the next review by Internal Audit of Project Destiny. The Society to provide regular updates to FSA on Project Destiny, including progress, issues arising and implementation details.	Following the next internal Audit review Quarterly from 31-Jan-2006 to 31-Jan-2007
Commercial Lending Since the Society introduced a commercial lending operation in 2002, it has grown to become a significant element of DBS's business. DBS does not yet perform monitoring of the portfolio as a whole; it is however, considering the implementation of a credit scoring system.	The Society's commercial lending is conducted with appropriate systems and controls in place.	The Society to provide details to FSA of the risk analysis techniques it introduces to monitor the commercial lending portfolio.	Date: 30-Jun-2006
Anti-money Laundering Controls At the time of our visit the Society had recently introduced new procedures and appointed a new MLRO. This meant that we could not form a complete picture as to the adequacy of controls in this area.	The Society has appropriate controls to prevent or identify money laundering activity.	FSA to discuss with the MLRO the controls surrounding anti money laundering in order to assess their effectiveness.	By 31-Mar-2006
Complaints Handling The Society's responses to customer complaints appeared to be factually correct but somewhat legalistic in style. We understand that complaint handling has also been highlighted in the customer survey as an area that could be improved.	Customers are treated fairly in all aspects of the Society's business.	The Society to review the complaint handling procedures in the context of its work on Treating Customers Fairly. The Society to provide confirmation to the FSA of its conclusions and action taken.	Date: 31-Mar-2006

ATTACHMENT 2

A LETTER FROM THE FINANCIAL SERVICES AUTHORITY, ADDRESSED TO THE BOARD OF DIRECTORS OF THE DUNFERMLINE BUILDING SOCIETY, DATED 11 APRIL 2008, AND MARKED FOR THE ATTENTION OF GRAEME DALZIEL

Risk Assessment—Dunfermline Building Society

As you are aware, we conducted our risk assessment of Dunfermline Building Society ("Dunfermline") during 27–30 November 2007. In this letter we summarise our findings and advise you of the actions we expect you to take. Please accept my apologies for the delay in sending the output from this risk assessment.

We assessed your firm by applying our risk assessment framework—ARROW. For an explanation of ARROW please see Appendix 1. Appendix 2 sets out the scope of the risk assessment, the resulting impact and probability scores, and associated peer group comparisons. We also attach the risk mitigation programme as Appendix 3.

Overall Assessment

We conducted our assessment of Dunfermline when economic conditions were tightening, personal sector indebtedness increasing and house and commercial property prices beginning to fall. Market turbulence has created significant liquidity problems, notably in a variety of financial sectors. In addition, Dunfermline's activities are concentrated in a limited geographical area.

All of these factors mean that you face considerable challenges which we were encouraged to find that our interviewees understood and which at the time of the visit were intended to feed into your strategy for 2008. We noted your conclusions that there had been weaknesses in the management of Project Destiny. Given the external environment, it will be important that you consider whether the findings of the PWC review of Project Destiny has any relevance to the wider corporate governance arrangements for the society. Also in reflection of the changed circumstances from the date when the original ICAAP document was prepared you have made significant changes to your ICAAP. This revised document was submitted in February 2008. As a result of the review of this document we have some issues we would like to discuss and will be contacting the Board separately. Our intention is to finalise the Srep process by June 2008 and issue an ICG.

Liquidity

We are closely monitoring the adequacy of liquidity in all deposit taking businesses. The society is operating in a competitive environment. In your case we have been reassured by the comments and the information we have received from your management and your history of strong retail funding has to some degree reduced any nervousness of the markets towards you. Nonetheless, we are asking you to continue to monitor your liquidity levels and send us weekly liquidity reports until further notice and notify us of any significant changes in both your retail and wholesale funding. As a result of the current environment this issue has been scored as "H" under "environmental risks" in the ARROW probability report in Appendix 2.

Key Issues from the Risk Assessment

These are the key issues that arose from our risk assessment. We have set them out according to our view of the risk they pose, with the most significant risk first.

Treating Customers Fairly

The TCF central team accompanied us during the visit to review your approach to

Management Information (MI). They concluded that the society appears to have a good TCF culture and progress was being made towards the March TCF deadline. However, at the time of the visit, which was four months before the MI deadline, very little management information was in place. This is reflected in the "MH" score for "customer controls" in the ARROW impact and probability report which is a default score for all societies who have yet to meet the March and December 2008 deadlines. Your management was confident that the work programme planned would deliver the MI by the end of March, but we had limited evidence against which to check this. In terms of the MI deadline, the responsibility lies with the Board to review and analyse the information they receive and confirm that they are satisfied with the MI available. We will ask senior management to present their findings of their review on TCF MI to the FSA in due course.

Please also note the second deadline of the end of December 2008 where firms are expected to demonstrate to themselves and to us that they are consistently treating their customers fairly.

Project Management

Though the core business appears to be well run, reviews of the Destiny project by internal audit and PWC raised questions on the governance of this project. We want senior management to ensure that this is not a symptom of widespread systems and governance failures and senior management to confirm to the FSA that there is robust project management across the business.

Project Destiny

We understand that Destiny continues to be an important project for the society. We ask that you to provide us with six monthly updates of significant developments, including any areas where delivery has slipped.

Succession planning

During the visit we discussed Key Person risk in a number of areas particularly in finance and treasury. We learned that the society has succession planning in place however, the succession planning needs to be assessed further to ensure all key business areas are adequately covered. We ask the society to take further steps to formalise succession planning for key persons within the society.

Fraud

We understand that a number of steps were taken following the discovery of a staff fraud in Perth branch, including a review by internal audit with the help of PWC. Please provide a summary of the main actions you have taken as a result of these findings to mitigate the risk of staff or customer fraud and to give yourselves comfort that any such fraud would be identified. We want comfort that this is not a widespread issue and reflective of the culture at the society.

Other Issues

Strategy

During our visit we saw a copy of the draft strategy for 2008 which was due to be formally endorsed by the Board. The plans included developing an equity release product and acquiring an insurance broker. Please forward a copy of the strategy document for 2008 and a copy of the final Board minutes agreeing sign off of this document.

Business Continuity Planning

The society has tested its BCP arrangements. We raised concerns about the society's reserve mainframe being situated next door to the head office. You explained during the visit that this would be moved. Please confirm if this step has been taken and where the mainframe has been relocated to.

Risk Mitigation Programme

The risk mitigation programme, which sets out what steps you need to take, is subject to review if there is any significant change or potential change to Dunfermline Building Society business or control structure, or the nature of the issues identified. In line with your general obligations under the FSA Handbook, you should notify us of any such changes.

Period to the Next Risk Assessment

On the basis of our current assessment and in light of the current market conditions we plan to carry out and communicate the next full risk assessment in 24 months. It is important to note that we may undertake further work at any time, or expect Dunfermline to undertake additional work if, for example, additional risks are identified or crystallise. In such cases, we will communicate any significant changes to our risk assessment of Dunfermline Building Society to you as they arise.

Confidentiality and Response to this Letter

This letter has been prepared for regulatory purposes only and its contents should be treated as confidential. You should copy this letter to your auditors but please discuss with us if you intend to disclose it to any other third party. This is because its contents could be misunderstood or misinterpreted if disclosed in another context.

Please confirm to me by 30 April 2008 that the Board of Dunfermline Building Society has considered this letter and has agreed to implement the sections of the risk mitigation programme in Appendix 3 which require action by you.

11 April 2008

APPENDIX 1 OF ATTACHMENT 2

ARROW RISK ASSESSMENT METHODOLOGY

The FSA's risk assessment process—ARROW—is a high-level review aimed at assessing the significance of a particular risk posing a threat to our statutory objectives. It is not an examination or audit, and may not identify all of the risks associated with current and proposed activities. The ultimate responsibility for identifying and assessing risks remains with the Board of Directors.

Our four statutory objectives were established by the Financial Services and Markets Act 2000:

- *Market Confidence*—Maintain confidence in the UK financial system;
- *Public Awareness*—Promote public understanding of the financial system;
- *Consumer Protection*—Secure the appropriate degree of protection for consumers; and
- *Reduction of Financial Crime*—Reduce the scope for financial crime.

The ARROW framework is at the core of our risk-based approach to regulation. Using the ARROW process, we consider the particular risk your firm might pose by assessing:

- the impact on our statutory objectives if the particular risk actually materialised; and
- the probability that the particular risk will materialise.

The FSA's risk assessment process is explained in more detail in "The FSA's risk-assessment framework" document which can be found on the FSA website at the following address:

http://www.fsa.gov.uk/pubs/policy/bnr_firm-framework.pdf

A further document "The FSA's Risk-Based Approach" specifically written from the perspective of non-executive directors can be found on the FSA website at the following address:

http://www.fsa.gov.uk/pubs/other/arrowguide.pdf

APPENDIX 2 OF ATTACHMENT 2

SCOPE OF ASSESSMENT

The scope of the risk assessment includes:

FSA Firm Ref No: 158765

Firm Name: Dunfermline Building Society

Overall Assessment

The information below shows our assessment of the risks posed by Dunfermline Building Society to our statutory objectives.

Change From Last Statement

[ ]

Impact Assessment

Impact: MH

Impact is designed to capture the size of the firm or group, the potential harm it could do to our statutory objectives. It is measured for each firm attached to the risk assessment based on quantitative information supplied by your firm as part of its regulatory reporting which varies depending on the sector in which the firm operates. Impact scores for each firm are combined to produce a total impact score for the risk assessment.

Probability Assessment

The probability table reflects our assessment of the likelihood that Dunfermline Building Society will pose a risk to our statutory objectives. The rating of probability associated with a risk assessment uses a model based on three overall ratings:

— business risk—the risks inherent in the firm's business model and the environment in which it operates;

— controls—the controls the firm has in place to mitigate the business risk;

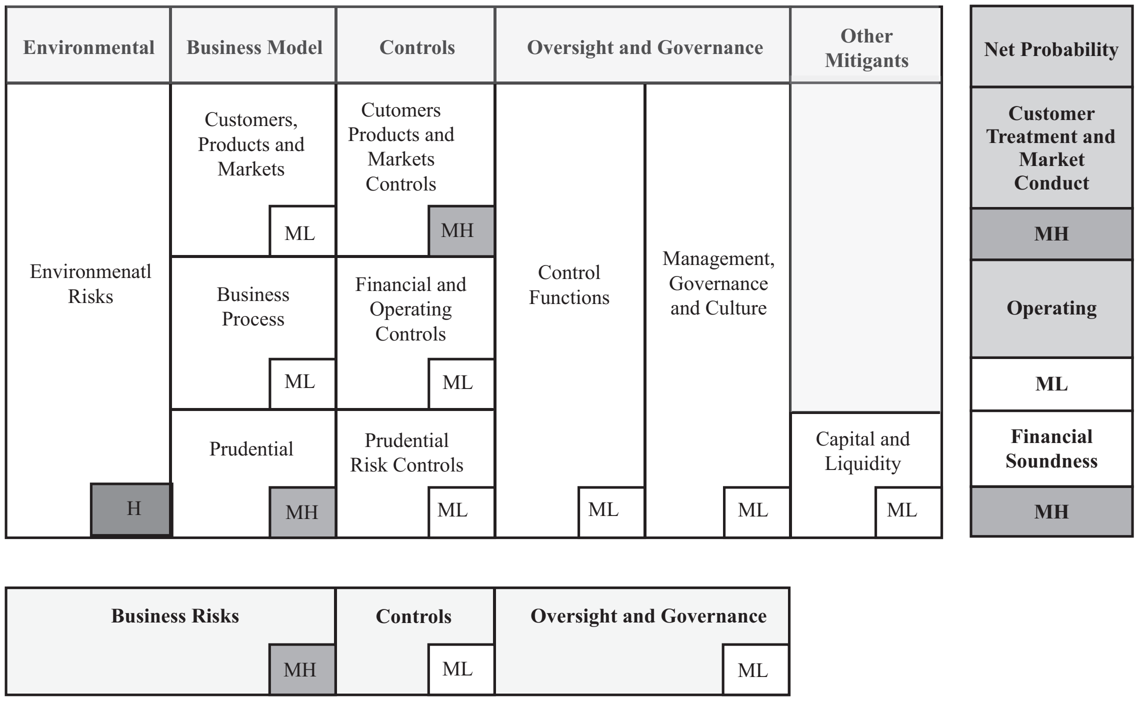
— oversight and governance—the high-level controls and arrangements the firm has in place to oversee the effectiveness of its business and to mitigate its risks.

The ten risk groups model the way the various business risks and control risks interest in the context of a firm. The probability scores recorded for these ten risk groups are aggregated in the matrix below in two dimensions:

— across each of the three rows, to produce a net risk after the application of controls and other mitigants to the inherent business risks; and

— down each of the three columns, to produce average scores for business risk, direct controls and oversight and governance.

We have also provided, for each risk group and the aggregate scores, a summary of how Dunfermline Building Society's probability assessment compares to that of your peers. The peer group is comprised of [X] members with a broadly similar business mix to Dunfermline Building Society. Peer group selection has been informed by but may not fully reflect the peers suggested by your firm; for confidentiality reasons we cannot disclose the names of firms included in the comparison. You should be aware that, while the FSA endeavours to keep all assessments materially up to date, some of the data may not fully reflect the current risk profile of all the firms with the peer group.



Please note that a highly-scored business risk will not automatically lead to a material risk to our statutory objectives. We assess the associated control risks and oversight and governance to establish whether there is a material net risk. If controls and oversight and governance are also highly scored, this may result in an issue in the risk mitigation plan with associated mitigating action.

Assessment Name:	Dunfermline Building Society	*Group Size:*	14 Assessments
Peer Group:	Banks and Mortgage Lenders - Building Societies - Group 1		
Peer Group Description:	Large Building Societies		

Environmental

Environmental Risks
H 100% / MH 0% / ML 0% / L 0%

0 firms pose greater risk
13 firms pose the same risk
0 firms pose less risk

Business Model

Customers, Products and Markets
H 0% / MH 43% / **ML 57%** / L 0%

6 firms pose greater risk
7 firms pose the same risk
0 firms pose less risk

Business Process
H 0% / MH 43% / **ML 57%** / L 0%

6 firms pose greater risk
7 firms pose the same risk
0 firms pose less risk

Prudential
H 0% / MH 50% / **ML 50%** / L 0%

7 firms pose greater risk
6 firms pose the same risk
0 firms pose less risk

Controls

Customers, Products and Markets Controls
H 0% / **MH 7%** / ML 93% / L 0%

0 firms pose greater risk
0 firms pose the same risk
13 firms pose less risk

Financial and Operating Controls
H 0% / MH 7% / **ML 86%** / L 7%

1 firms pose greater risk
11 firms pose the same risk
1 firms pose less risk

Prudential Risk Controls
H 0% / MH 36% / **ML 57%** / L 7%

5 firms pose greater risk
7 firms pose the same risk
1 firms pose less risk

Oversight and Governance

Control Functions
H 0% / MH 29% / **ML 64%** / L 7%

4 firms pose greater risk
8 firms pose the same risk
1 firms pose less risk

Management, Governance and Culture
H 0% / **MH 36%** / ML 64% / L 0%

0 firms pose greater risk
4 firms pose the same risk
9 firms pose less risk

Other Mitigants

Capital and Liquidity
H 7% / MH 21% / **ML 57%** / L 14%

4 firms pose greater risk
7 firms pose the same risk
2 firms pose less risk

Net Probability

Customer Treatment and Market Conduct
H 7% / **MH 71%** / ML 21% / L 0%

1 firms pose greater risk
9 firms pose the same risk
3 firms pose less risk

Operating
H 14% / **MH 71%** / ML 14% / L 0%

2 firms pose greater risk
9 firms pose the same risk
2 firms pose less risk

Financial Soundness
H 36% / **MH 43%** / ML 14% / L 7%

5 firms pose greater risk
5 firms pose the same risk
3 firms pose less risk

Business Risks
H 0% / **MH 100%** / ML 0% / L 0%

0 firms pose greater risk
13 firms pose the same risk
0 firms pose less risk

Controls
H 0% / MH 14% / **ML 79%** / L 7%

2 firms pose greater risk
10 firms pose the same risk
1 firms pose less risk

Oversight and Governance
H 0% / **MH 36%** / ML 64% / L 0%

0 firms pose greater risk
4 firms pose the same risk
9 firms pose less risk

Notes:

- This grid represents the FSA's assessment of the probability that your firm will pose a risk to our objectives compared to that of your peers.
- Your firm's scores are **bold and underlined**.
- An N/A score indicates that a particular risk group is outside the FSA's remit.

APPENDIX 3 OF ATTACHMENT 2

RISK MITIGATION PROGRAMME

ASSESSMENT NAME: DUNFERMLINE BUILDING SOCIETY

Regulatory period / End Date: 30 month(s) / 01-Jun-2008

Nature of issue	*Firms to which issue relates*	*Intended outcome*	*Action*	*Action by*
Treating Customers Fairly-MI The FSA have put in place a further TCF deadline for 31 March 08. The focus is on firms having adequate management information to demonstrate to themselves that they are treating their customers fairly. At the time of the visit you were confident that you would meet the deadline but still had a lot of work.	All	The firm has MI that demonstrates customers are being treated fairly.	Action type: Assessment The Board to satisfy itself that the MI it receives allows it to monitor the fair treatment of customers. Senior management to present their findings to the FSA.	30/05/2008
Project Management The PWC report on Project Destiny revealed weaknesses in project management, oversight of project and a lack of adequate technical understanding.	All	The firm has adequate project management.	Action type: Assessment Senior management to review their project management procedures in light of the PWC report and report its findings to the FSA.	30/05/2008
Project Destiny Project Destiny was introduced to bring a number of business benefits including providing a "single customer view". Due to technical problems, the society has partially written off Destiny. However, development is continuing with the remaining software.	All	The firm ensures that it keeps the FSA updated regarding Destiny every six months.	Action type: Assessment The firm to provide six monthly regular updates to the FSA regarding significant developments in Project Destiny.	30/06/2008
Succession Planning The firm has succession planning in place. However, these arrangements are informal and do not cover some key business areas.	All	Formal succession planning arrangements are in place for key areas of the business.	Action type: Assessment Senior management to formalise succession planning arrangements and inform the FSA when this has been completed.	30/06/2008
Internal Fraud A staff member of the Perth branch has confessed to a fraud which has amounted to approximately £200k. KPMG and internal audit have reviewed this area and provided a draft report. There is a risk that there are other weaknesses in controls over staff fraud.	All	The firm has adequate systems and controls in place to prevent such incident from happening again and allow identification of such activity at its earliest stage.	Action type: Assessment The firm to review the findings and recommendations provided by both KPMG and internal audit, providing the FSA with a document outlining what action it intends to take as a result of these findings and how it satisfies itself that the problems identified are not widespread.	30/05/2008

ATTACHMENT 3[2]

EMAIL FROM JIM FAULDS TO AN FSA OFFICIAL, ALSO COPIED TO JIM WILLENS

Thank you for your letter of March 6th. I shall formally respond to you shortly, but, in the meantime I wanted you to know I agree with your view that merger is the most practical resolution to our issues, despite our common preference of continued independence.

I also wish to assure you that the Dunfermline board and executive have been and remain, fully committed to supporting the merger route in order that our members' potential merger partners and we shall continue to do so.

[2] Please see Ev 53 for further context.

Any prospect of public or private capital raising is, at this stage, extremely unlikely. Consequently, we should all concentrate our efforts on concluding an orderly and successful merger. You can rely on everyone at Dunfermline to support you in your endeavours next week.

Given the above, there is no need for you to reply to my letter of 6 March.

Thank you for all your efforts on our behalf to date.

8 March 2009

ATTACHMENT 4

A LETTER FROM THE FINANCIAL SERVICES AUTHORITY, ADDRESSED TO JIM FAULDS

DUNFERMLINE BUILDING SOCIETY

Thank you for your letter of 2 March, setting out your Board's thoughts and views on the future of the society.

From the outset, the preferred outcome for the FSA would have been to secure a sustainable independent future for Dunfermline Building Society. However we also need to be realistic, and ultimately our highest concern (in accordance with our statutory objectives) has been to achieve the best possible outcome that protects the members of your Society. This is also the duty of the board of the society, and we have been seeking to work with you and the society's management to achieve this shared objective.

As you and your Board are aware, in November last year the Tripartite authorities concluded that the society did not meet the stressed capital requirement necessary to access the Credit Guarantee Scheme. This called into question the society's longer term financial stability and cast doubt over its future viability. Since then, you and your Board have made efforts to raise additional capital from private sector sources but all have been unsuccessful. In addition we have worked extensively with the Society and the BSA to try to secure an injection of capital from the largest societies. Again, as you are aware, this route proved unsuccessful despite significant efforts being made by all parties (including the society itself, the BSA and its largest members and the Tripartite authorities—and in spite of it being used successfully in respect of another similar sized society.

It has become increasingly clear from these negotiations that potential investors are uncomfortable with the high proportion of lending in your commercial and non conforming books which have above average risks for loans of these sort. These include a significant proportion of loans originated in the past two to three years at high LTVs, a lumpy commercial loan book (ie the average individual advance is much higher than is the case with other societies) and include both bought books (from mortgage lenders such as GMAC) and higher risk development/investment property lending (eg against the security of city centre blocks of flats in Manchester).

The present reality is therefore a harsh one. In its 2008 accounts your society is expecting to post a large loss (relative to asset size our expectation is that this will be much the largest in the sector). In addition the auditors have indicated to us that their report may be qualified in the absence of a capital injection or merger deal. As at today, the society only has a c£4m buffer over its interim ICG capital requirement and although we understand this will increase to nearer £10m once the £250m FRN is repaid, this buffer is extremely slim given continuing turbulent market conditions and when compared with new provisions last year alone of in excess of £30 million. The scope for further write downs, particularly against the commercial loans book, is clearly significant, and the society's regulatory capital will start to reduce next year unless (and it is considered extremely unlikely that you could achieve this) the £50m of subordinated debt can be replaced rather than amortised. Finally the society at today's date is the only "Baa" rated building society and the only large society not listed on the DMO website as eligible for the Credit Guarantee Scheme, threatening its ability to refinance wholesale funding, in particular if the society is unable to announce a long term solution to the problems it faces at the time the society announces its results. A further ratings downgrade cannot be ruled out in the future.

The reality that I have laid out above is a result of the way in which the society has been directed and managed over the past few years, and whilst the implications may not be palatable both we and the board need to face up to the consequences. In short, the scale of the problems facing the society are such that it cannot realistically expect to be able to manage its way out of the current problems in a way that provides sufficient protection to members' interests notwithstanding the changes in the executive team and to the society's strategy since last autumn.

It is for this reason that we have been encouraging your Board to consider what alternatives might be available should it not be possible to secure the preferred outcome of a sustainable independent future. As the chances of this happening become increasingly remote, we have been expecting the Board to be ever more mindful of its responsibility to the society's members and to expedite a pragmatic solution that protects their interests.

If independence is not a viable option—and it would appear not without a significant capital injection that no-one appears to be prepared to supply—then merger would, I am sure you would agree, be much preferable to "resolution" through the new Banking Act processes (which would, I agree, potentially be very expensive for both creditors of the society and for the whole building society sector as well as being destabilising for the latter). You and your Board should be only too aware that there has not been a queue of other societies wishing to merge with the society—and there are very few with the scale and resources to effect a merger without detriment to their own business. We therefore think that the Board has no option but to evaluate carefully any actual merger offers received, bearing in mind its fiduciary duty to members.

The Tripartite authorities are working hard to try to find a way forward. As you know I personally speak to Jim Willens, your CEO, on a nightly basis so we are both kept abreast of progress. We are very appreciative of the hard work and effort that the society has put in to trying to secure an independent future, and it is to the great credit of everyone involved at the society that the same effort has been applied in dealing effectively—and in a timely manner with all the due diligence work carried out by the Tripartite and by two larger societies, even though we understand that the outcome could be a disappointing one for you and your board.

I note that your letter was copied to The Rt Hon James Murphy, Secretary of State for Scotland but given the sensitive nature of some of the information contained within this letter I have not copied it to him. It is for you and your Board to determine whether you wish to share this directly with him.

6 March 2009

Memorandum from James Faulds, Former Chairman of Dunfermline Building Society

DUNFERMLINE BUILDING SOCIETY—REQUEST FOR FURTHER INFORMATION

I refer to your letter requesting further information. The £60m confidence issue.

Q: *The Bank of England told the Committee that the tripartite authorities did not feel that even a capital injection of £60m would have been enough to restore confidence in Dunfermline Building Society (DBS). What is your assessment of the level of confidence in DBS at that time?*

Whilst there can never be absolute certainty around any business plan there was support and willingness to invest in Dunfermline Building Society by both the BSA sponsored "club" of Building Societies and the Scottish Government. The plan had been independently reviewed by KPMG at the request ofthe FSA who concluded "whilst not without risk the plan was viable".

THE MORTGAGE SYSTEM

Q: *In Q209 Mr Dalziel referred to a business plan for bringing the mortgage software into production at some time in the future. How much more would it have cost to make the mortgage system operational?"*

Following introduction of the new savings platform and MI portal in 2008 the plan was to extract all efficiencies from the system and carry out any refinements. We then planned to create an agenda for future development which would include analysis of the best areas to develop, the priority order attaching to each and the relevant costing. The areas to be considered would have included Internet based savings offerings, Internet Banking and Mortgages. This analysis was to take place during 2009.

DUNFERMLINE SOLUTIONS

Q: *Which member of senior management had responsibility for over seeing the work of Dunfermline Solutions?*

The Managing Director of Dunfermline Solutions was a part of the Operations Director role. This role was held by Stewart Cooper until February 2006 and thereafter Peter Craigie until September 2008. The oversight of activity fell within the scope of the Society's Executive and Board in line with the Society's Risk Management approach.

A copy ofthe correspondence with the FSA has been sent separately.

Finally, following the evidence we gave to your committee, members may have noticed that the Tripartite Authorities saved the West Bromwich Building Society using a financial instrument which, last October, we suggested could have been used to support Dunfermline. They refused to consider this. Perhaps lessons were learned.

10 July 2009.

Email to the Clerk of the Committee from Jim Faulds, former Chairman of the Dunfermline Building Society

I have no objection to the committee publishing the e-mail [between Jim Faulds and an FSA official, dated 8 March 2009], providing a note is attached giving the content some context. This e-mail was sent when merger appeared to be the only practical solution, as the note states. My preference and that of the DBS board was independence; again stated in the note.

The board of DBS wished to assure the FSA that they would fully co-operate with the merger route and asked me to send the e-mail to the FSA. Subsequent to the above, two potential sources of capital were identified, £30 million from the Scottish Government and £30 million from a consortium of building societies; albeit the latter was contingent on HMT support. Either would have been sufficient, in my view, to secure the society's independence and therefore remove the need for a merger.

13 July 2009

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List of Reports from the Committee during the current Parliament

The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

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