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Dunfermline Building Society: Government Response to the Committee's Fifth Report - Scottish Affairs Committee Contents

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Government response

This document contains the Government's response to the Scottish Affairs Select Committee's Report on Dunfermline Building Society. The Financial Services Authority is providing their response separately to a number of points raised by the Committee's Report. The Government thanks the Committee for its work in this important area.

The response is divided into four parts, broadly following the structure of the Committee's Report.

1. Downfall of the Dunfermline Building Society

RESPONSE

A number of the conclusions and recommendations in the Committee's Report relate solely to the conduct of the Dunfermline's management and Board, and we have not sought to address these directly. The Committee should be aware that whilst the Government will continue to consider how to best protect UK depositors and taxpayers, it is important that those involved in the building society sector also contribute their views on the future of the sector. In the 'Reforming Financial Markets' paper published earlier this summer, we announced the formation of a building societies experts group. This group is considering questions raised by the problems experienced by the Dunfermline about how building society governance could be improved, as well as examining important questions around future of building society capital and how shared operating models could contribute to societies.

2. Use of the Special Resolution Regime

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)

RESPONSE

As the Committee notes, this was the first time that the special resolution regime (SRR) established by the Banking Act 2009 had been used to resolve a failing institution. It is the Government's view that the resolution of the Dunfermline Building Society was successful in meeting the SRR objectives established in section 4 of the Act.

As the Committee knows, the resolution of a failing bank or building society requires intensive coordination, cooperation and information sharing between the Authorities at each stage of the decision-making process. Each of the Authorities takes lead responsibility for specified aspects of the resolution. The FSA is responsible for making the independent regulatory decision that the institution meets the conditions (set out in section 7 of the Act) for entry into the SRR. In the case of Dunfermline, the FSA made a regulatory judgment that the Dunfermline was likely to fail its threshold conditions; and that it was not reasonably likely that action would be taken by or in respect of the Dunfermline that would enable it to meet those conditions. Following consultation with the Bank and the Treasury, the FSA therefore determined that the firm should enter the SRR. This was an independent regulatory judgment taken by the FSA, considering the threshold conditions set out in the Financial Services and Markets Act. The Bank of England is responsible for the operation of the SRR, including the decision on which of the SRR tools to use, and its implementation (with the exception of the power to take an institution into temporary public ownership). In the case of Dunfermline, having considered a range of options and consulted with the other Authorities, the Bank decided on an appropriate course of action for the building society using the SRR tools. The Treasury is responsible for decisions with implications for public funds, for ensuring the UK's ongoing compliance with its international obligations, and for matters relating to the wider public interest, and in this regard the Treasury worked closely with the other Authorities during the course of the resolution of the Dunfermline.

The Government believes that action taken by the Authorities was effective and well coordinated, resulting in a successful resolution. However, the Government will continue to keep all aspects of the operation of the Banking Act under review.

The SRR Code of practice[1] sets out further details about how the Authorities go about achieving the objectives. The Government is currently consulting with the Banking Liaison Panel (established under section 10 of the Act) on how the Code of Practice can usefully be updated to provide further guidance and clarity to industry and to the wider public around the use of the SRR powers, building in part on the experience of the Dunfermline resolution.

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)

RESPONSE

Whilst the Government shares the Committee's regret at the fate of the Dunfermline Building Society, the Government continues to value the contribution to diversity and competition in banking services that the mutuals sector brings to the UK economy. As the sector's long history shows, the traditional retail-based building society business model has been resilient to economic turbulence. However, Dunfermline ran into trouble when it strayed from this model without the expertise and capacity to fully understand and manage the risks of doing so.

The Authorities will continue to take the steps that are needed to protect depositors and consumers, ensure financial stability, and safeguard the use of public funds—and will use the Special Resolution Regime again if it is necessary. The FSA has also proposed measures (through its new sourcebook for building societies, which has just closed to consultation but is available in draft on the FSA's website) to strengthen the sector, reduce societies' future vulnerability to difficult market conditions, and ensure that societies are appropriately equipped to play a central role in UK financial services in future. If implemented, these measures should provide further protection for depositors and taxpayers by further limiting the risk of failure.

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)

RESPONSE

The Government agrees with the Committee's conclusion about the responsibility of the Dunfermline Board for the firm's predicament. The Government's responses to the issues raised by the Committee on reviewing the operation of the SRR and communication by the authorities are detailed at its response to paragraphs 45 (above) and 88 (below).

3. Were the Tripartite Authorities right to invoke the SRR?

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)

RESPONSE (PLEASE SEE ALSO THE GOVERNMENT'S RESPONSE TO PARAGRAPH 45 ABOVE)

Where a firm is in difficulty the FSA works with the firm to find solutions to the challenges that it is facing. In doing so, they explore the options for private sector solutions, which can include capital restructuring. Whether this is a viable option will depend on the circumstances of the case. The timeline of events specifically in respect of Dunfermline was set out in Lord Turner's published letter to the Chancellor of 17 April 2009.

4. Conclusion

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)

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)

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)

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)

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)

RESPONSE

The Financial Services Authority have detailed their supervisory approach to the Dunfermline in Lord Turner's letter to the Chancellor of 17th April, and are providing a separate response to the Committee's Report. As part of their duties, directors of building societies also need to be familiar with and ensure compliance with regulatory standards. Regarding communication with the firm, there are clearly risks in making explicit disclosure to building society directors—given the potential for alarm and unintended consequences of disclosure—before the Authorities had decided whether, and if so, how, to act. However, throughout this period the Authorities worked together closely developing their response. In accordance with its responsibilities under the Financial Services and Markets Act 2000 for the authorisation and regulation of financial firms, the Financial Services Authority was the lead authority for liaison with the Dunfermline Building Society's management.

Scotland Office

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1 Available from the Treasury website, www.hm-treasury.gov.uk Back