From the Chairman
Lord Turner

The Rt Hon Alistair Darling MP
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

17 April 2009

Dear Alistair

You have asked me to write to set out key points in the development of problems at Dunfermline Building Society, and the FSA's supervisory approach.

As you know the problems which led to the Society failing 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.

To understand the full history, I therefore thought it would be useful to set out:

1. The evolution of building society freedoms to conduct different types of business.

2. The chronology of Dunfermline's diversification into the problem loan categories.

3. The chronology of the FSA's general warnings to the building society sector about the importance of maintaining the quality of their loan books and risk controls.

4. The FSA's response to emerging problems of Dunfermline over the last 18 months.

5. The possible implications for future regulatory and supervisory approaches.

1. THE EVOLUTION OF BUILDING SOCIETY FREEDOMS TO CONDUCT DIFFERENT TYPES OF BUSINESS

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 their members, but they have constrained freedom also to engage in wider sets of activities.

The regulatory framework for building societies is enshrined in an Act of Parliament rather than within the FSA rule book. I set out below the main elements of the evolution of the regulatory framework:

- Prior to the 1986 Building Societies Act, they were governed by the 1962 Building Societies Act. Special advances, which included commercial loans (and large residential loans to individuals), were restricted to 10% of their total assets.

- The 1986 Building Societies Act marginally increased their freedom[1] but still restricted commercial lending (together with other loans such as second charge mortgages and unsecured loans) to 10% of the total assets. This 10% limit was increased to 17.5% in 1988, to 20% in 1991 and to 25% in 1993.

- Further liberalisation occurred with the 1997 Building Societies Act. One of the arguments advanced for this liberalisation was to enable building societies to compete on more level terms with other financial institutions without having to forego their mutual status. The principal change in legislation relevant to Dunfermline was to expand the range of assets that were not subject to the 25% limit – the limit now applies only to lending not secured on residential property. In particular, lending on buy-to-let and housing association loans and certain other lending of a commercial nature (for example, a loan secured against a block of flats whether made to an individual or to a company) is not subject to this limit: such lending would have been covered by the restrictions in the 1962 and original 1986 Acts referred to above.

- An order under the Financial Services and Markets Act (2000) transferred the regulation of building societies from the Building Societies Commission to the FSA, but did not change these limits.

The FSA, as part of our move to a more intensive supervisory model, is working on a general code of practice for building societies, which we plan to issue by July 2009. Our current intention is that this would strongly guide building societies to be cautious over fully utilising their legal freedom with regard to non-residential assets unless they have appropriate risk controls and capabilities. It would not be appropriate, however, to introduce through FSA rules, a prohibition of commercial real estate lending or a tighter cap than the 25% limit, given that primary legislation has clearly set out the legal limits.

2. THE CHRONOLOGY OF DUNFERMLINE'S DIVERSIFICATION INTO THE PROBLEM LOAN CATEGORIES

The problems in Dunfermline's balance sheet lie in two areas. The build up of these problem areas has been:

i. Commercial real estate loans.

Substantially all of these were committed to in the period 2004-07. The build up on balance sheet was (at 31 December):

- 2004: £112m
- 2005: £169m
- 2006: £290m
- 2007: £481m
- 2008: £628m

It should be noted, however, that while there was an increase of £147m in 2008, over 90% of this was accounted for by loan drawdowns under commitments made earlier. Furthermore, of the likely losses set out in the recent KPMG report (see later), over 97% relate to loans extended prior to 30 June 2007. The Board made a decision to

[1] It also separately created the potential for conversion into a bank.

cease all commercial lending in early 2008 and the Commercial Director left in July 2008.

It should also be noted that all loans made since January 2004 were below 75% loan to value and since Q1 2006, arrears have been and continue to be below 1% (bar one quarter when they rose to 1.4%) with no repossession cases (arrears are defined as cases where the arrears balance on a loan is more than 2.5% of the outstanding balance on the loan).

Estimates of losses in the latest accounting provisions therefore reflect other potential indicators of loan impairment as well as arrears data; and the much larger losses considered in FSA stress tests are based on scenarios for the future rather than evidence from current arrears or other indicators of current credit impairment.

ii. The purchase of mortgage loans from other mortgage lenders which are principally buy-to-let portfolios.

The acquisition of these books was made between February 2004 and March 2006, with £410m being purchased from GMAC and £57m from Lehmans. At 31 December 2008 the balances had reduced to £165m and £21m respectively.

In October 2007 the Society approached the FSA to say that it wished to purchase a mortgage book from Credit Suisse for £160m. The FSA expressed supervisory concerns in relation to this purchase and the Society did not proceed.

This build up of non-traditional lending was at all times within the legal limits of diversification allowed by the Building Societies Act 1986 as amended by the 1997 Act.

3. THE CHRONOLOGY OF THE FSA'S GENERAL WARNINGS TO THE BUILDING SOCIETY SECTOR ABOUT THE IMPORTANCE OF MAINTAINING THE QUALITY OF THEIR LOAN BOOKS AND RISK CONTROLS

The FSA has repeatedly warned the building society sector of the importance of maintaining asset quality, with a particular focus on non-traditional lending. I set out below a selection of the public warnings we have made:

- March 2003 – Supervisory letter to all building societies, warning them of the dangers and risks of commercial property lending.
- May 2004 – The then Chief Executive's 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, subprime and self-certified markets have properly assessed the additional risks that inevitably go with the higher margins available.'
- May 2006 – Supervisory letter 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 and, as a result of our intervention, Dunfermline declined to invest in a £160m loan book from Credit Suisse (see section 2 above)

- May 2008 – The current Chief Executive's 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.'

4. THE FSA'S RESPONSE TO EMERGING PROBLEMS OF THE DUNFERMLINE OVER THE LAST 18 MONTHS

Three phases of the FSA's interaction with Dunfermline can usefully be distinguished: 2005 to August 2007; August 2007 to October 2008; and October 2008 to March 2009.

2005 – August 2007

The FSA's ARROW Review visit[2] in November 2005 raised commercial lending as an issue and requested the society to carry out additional risk analysis of the then portfolio. The Society appointed an external consultant to do this work which was carried out in 2006; this resulted in improved controls over the Society's commercial lending. This 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 a significant IT development project (Project Destiny) which was poorly managed and controlled and subject to significant delays.

August 2007 – October 2008

After August 2007, as severe liquidity problems emerged in financial markets in the US and UK, the FSA put in place increased supervisory attention and reporting for all building societies, with the majority (including Dunfermline) being required to produce additional liquidity data on at least a weekly basis from September 2007. Key actions during the period between August 2007 and the intensification of the financial crisis in October 2008 were:

- From August 2007 the FSA was in regular contact with the Society culminating in an ARROW visit in November 2007. A key issue covered in this review was Project Destiny where a PwC report had been commissioned to report on the management and governance of the project and which concluded that weak project management was to blame. As a result, the Society was forced to write off £9.5m in respect of this IT development which had a significant impact on the year-end results. The FSA's risk mitigation programme issued in early 2008 asked the Society's senior management to review their project management procedures in the light of PwC's report.

[2] ARROW is the FSA acronym for the periodic risk review of each of our relationship-managed firms.

- In December 2007 as part of the ARROW work, the FSA discussed the Society with its auditors, who informed the FSA that overall the Society was well controlled and who suggested that the commercial loan loss provisions, given the benign market, may not have been entirely justified, i.e. may have been slightly higher than justified.

- Whilst noting this assurance from the auditors, the supervisory team continued its work on the capital/liquidity position of the Society. Building on its work from the 2007 ARROW, the FSA told the Society to resubmit its Internal Capital Adequacy Assessment (ICAAP) in early 2008 because the document provided had inadequate stress testing and also did not reflect its current strategy. In May 2008 the supervision team met with the then CEO to raise concerns about the firm's liquidity position and its resubmitted ICAAP including stress testing.

- In light of our continuing investigations between June and September 2008 a meeting was held with the Society on 25 September 2008 to discuss again its ICAAP when 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; establishing it as a regulatory minimum would have constrained subsequent risky growth.

October 2008 – March 2009

This Dunfermline specific action was, however, superseded by the system-wide measures taken by the Tripartite Authorities in October 2008. In the light of the sudden intensification of the financial crisis which had followed the collapse of Lehman Brothers, the Government in mid October established the Credit Guarantee Scheme. To establish a firm's eligibility to participate in the scheme, the Authorities 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 capital. The results of that stress test indicated that Dunfermline did not have Tier 1 capital sufficient to meet the requirements of the Credit Guarantee Scheme. To do this it would have required additional capital of £20m. Consequently Dunfermline was considered ineligible to be admitted to the Scheme. 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.

The FSA therefore commenced actions designed to find a solution to the challenges identified. These actions included:

- The FSA utilised its powers to instruct 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. The first report was completed in early December. It concluded that the specific loan provision of £15m should be increased by £3m. In addition, given the characteristics of the Society's commercial book, KPMG agreed with the Society's proposal that a general provision of £15m should be made (an increase of over £13m on the general provision at the end of 2007[3]). The second report concluded that while

[3] Many Building Societies are still permitted to prepare their financial statements in accordance with UK GAAP accounting rules rather than IFRS. Where UK GAAP is applied, and the non-mandatory FRS 26 has not been adopted, current practice allows preparers to make

the Society could be viable for another 12 months, it faced a number of execution and financial risks to the implementation of its plan.

- Meanwhile, given the challenges likely to arise in the commercial loan book and the ongoing IT issues, the FSA strongly recommended to the Board that a new Chief Executive be appointed: this occurred in December 2008. He was tasked with producing a new business plan to turn the Society around.

- In parallel the FSA sought to find a private sector solution which would ensure the financial soundness of the Society without the need for public money. 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 BSA to ensure that all credible options were assessed. Between January and March 2009 there were merger discussions with three major building societies. Two of the societies carried out full due diligence in respect of a proposed merger.

The Board of the Society wrote to the FSA in early March saying that while it was working hard to achieve a merger, it considered it could continue as an independent building society and therefore wanted the FSA to re-visit this option. The FSA explained that it believed independence was not a viable option without a significant capital injection and, in the absence of that, merger appeared the best option. By the middle of March, however, it was clear that no other building society was prepared to effect a merger with the whole of Dunfermline. Discussions continued with the BSA about the possibility of a capital injection from a consortium of building societies, but with it being clear that any BSA offer would be conditional on public money also being invested. We therefore commenced detailed joint 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 BSA consortium matched by investment of a like amount by HMT. 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, the FSA conducted a further series of stress tests to identify the amount of capital required to ensure the long-term future of the Society as an independent entity. The tests showed that the injection of £60m would secure the Society's financial position over the next two years whilst alternative merger options were sought but that £60m was not in the FSA's view sufficient to secure the Society's long-term independent future. It is worth noting that in liquidity terms there was no immediate problem: the

---

'General Provisions' rather than 'Portfolio Impairment Provisions' (PIPs) that are required under IFRS and FRS 26-compliant financial statements. While the principle behind General Provisions is similar to that which underpins PIPs (i.e. they should reflect credit impairments which are believed to have already occurred even if specific evidence of impairment is not yet apparent in specific loan files), in addition they are also based in part on the anticipation of expected future losses within the portfolio. As such, this enables management and auditors of certain building societies to make greater use of flexibility to anticipate, to some degree, emerging rather than already existing loan problems.

problems related to future possible solvency under stressed conditions; Dunfermline's situation was therefore different from that faced with Northern Rock or Bradford & Bingley.

- The two options were presented to HMT, who having regard to the alternative courses of action that are available to the Authorities, concluded that the proposal that the Treasury should inject capital alongside the BSA consortium would not best meet the objectives of:
  - protecting depositors;
  - ensuring the stability of, and public confidence in, the financial system; and
  - safeguarding the interests of taxpayers.
- Following this decision the BSA were given the option of injecting the full £60m and declined to do so. As therefore the recapitalisation option would not be available the Board of Dunfermline concluded, when told of this at lunchtime on 28 March, that the society was unable to continue as a going concern. The FSA then reached the conclusion that the society was likely to fail to satisfy threshold conditions and that it was not reasonably likely that action would be taken to rectify the situation. This decision was made by the Executive process of the FSA on Saturday 28 March. This triggered the resolution process.

5. POSSIBLE IMPLICATIONS FOR FUTURE REGULATORY AND SUPERVISORY APPROACHES

As you know, over the last 12 months, the FSA has implemented a Supervisory Enhancement Programme (SEP) which has significantly revised our supervisory approach, introducing a new model of 'intensive supervision' for major systemically important firms.

It is unclear, however, if these changes to the FSA's approach would have prevented the specific problems at Dunfermline Building Society; nor do I currently believe that the SEP should be redesigned to try to prevent such problems via even more intense firm-level supervision. Instead I suggest that the causes of the Dunfermline failure highlight the need for the major reforms to capital adequacy rules and macro-prudential analysis set out in *The Turner Review*, and that they may raise questions about the appropriate legislation governing the building society sector.

Three possible responses to the type of problems which emerged at Dunfermline could be envisaged:

i. **More intense supervision**, with FSA supervisory staff more involved in the period 2005 to 2007 in detailed analysis of loan portfolios, and issuing more detailed instructions to the Society to restrain the growth of commercial real estate lending. Such an approach might be possible, but it would entail further FSA resource investments beyond those already planned under SEP, and it is unclear that more detailed analysis of loan portfolios, given the information available at the time, would necessarily have resulted in future problems being spotted. As discussed in Chapter 2.7 of *The Turner Review*, there is no sign that the US's 'bank examiner' style of supervision, which does entail analysis of individual loan files, has been any more effective in preventing poor credit decisions by firms than the FSA's past approach. And it is not clear that FSA supervisors could have been more effective in spotting future possible credit problems at the individual firm level than were the auditors who were concerned in December 2007 that

Dunfermline's bad loan loss provisions might be too high rather than too low. We all now recognise that commercial real estate lending in the years 2005 to 2007 was growing at a risky rate; but we do that with hindsight, and it was not obvious to many apparently thoughtful people as late as end 2007. Rule driven approaches and/or better macro analysis are more likely therefore to be effective in offsetting problems than more intense and expensive firm-by-firm supervision.

ii. **Tighter rule-driven constraints on building society lending**. As described in Section 3 above, the FSA has over the years issued guidelines to building societies urging them to be cautious in using their freedom to diversify away from prime residential mortgage lending. And, as already mentioned, we are now developing specific guidance (to be issued in July 2009) which will set out our expectations on the additional controls and expertise required for given levels of non-traditional lending.[4] The issue is whether more formal rule driven constraints should be imposed:

- One way to do this would be for the FSA to impose rule driven constraints on the pace of any one society's diversification, while still operating within the legal framework of the 1997 Building Societies Act. This is an option which we could consider, and it might have some merit, since rapid expansion into a new lending area is often a warning sign of potentially risky lending. But it would not be a certain defence against Dunfermline type problems: it is quite possible that the Dunfermline would have been in a similar position to today even if its commercial lending portfolio had been built up slowly since the deregulations of the 1990s.

- The other would involve a revisit of the legislative framework, with, for instance, (i) a tighter definition of commercial lending: at present the definition relates to lending that is not secured on residential property but excludes, for instance, commercial lending to developers of residential property) and (ii) a tighter cap on commercial lending than the current 25% of total assets.[5] This might be justified on the grounds that building societies are less likely than large banks to have the credit skills required to do good commercial real estate lending. It is, however, worth noting that our stress tests suggest that some of our large banks extensively involved in commercial real estate lending have also ended up exposed to large potential losses.

iii. **Better macro-prudential analysis and countercyclical levers applied across the banking and building society system**. This third response would reflect the reality that major risks in the banking system can often only be spotted at the

---

[4] Although these will not have the force of rules they are expected to have a significant impact on the way in which societies diversify their lending, and will also provide a framework for the supervisors to assess how well each society is managing its lending risk. The guidance will also include a catch-all requirement that societies should pre-advise all significant diversifications (both of lending type or a move into a new business line) to allow supervisory consideration ahead of implementation.

[5] It is worth noting how this issue relates to the 'narrow banking' versus 'investment banking' debate, which is discussed in *The Turner Review*. That debate relates to whether large complex commercial banks should also be allowed to be engaged in risky proprietary trading activity. But it is worth noting that building societies already operate under a 'narrow banking' regime which restricts them not only from investment bank style trading activities, but from investment commercial banking activities. There is no debate that these constraints on societies should exist: the issue is how tight they should be.

macro level, and can only therefore be offset by across-the-board rules. As *The Turner Review* set out this would entail:

- Better macro-prudential analysis by both the Bank of England and the FSA, which might have identified the dangers growing within the banking system in the years running up to 2007, e.g. rapid credit expansion, rising property prices, and risky total system reliance on wholesale funding and funding from abroad.

- The application of countercyclical capital levers, requiring the build up of capital in good years and thus providing buffers which can be used to absorb losses in a downturn. This countercyclical capital, as discussed in *The Turner Review*, could be based on a formula (in line with the Spanish dynamic provisioning system) or could also involve some element of discretion: in either case, its operation could act to restrain very rapid growth by specific institutions.

- The application of more forward-looking loan loss accounting, with greater flexibility to anticipate future potential losses likely to arise over the economic cycle.

We now need to consider these alternative policy responses: and once this letter is in the public domain, the FSA will welcome points of view on what mix of responses is most appropriate. But my own current judgement is that the responses most likely (though still not certain) to offset future similar problems would be Option 3 (better macro analysis and countercyclical levers) and Option 2 (tighter rule driven or legislative constraints). Conversely I doubt whether still more intense supervision than envisaged in the SEP would be effective in offsetting similar problems in future if options 2 and 3 were not also pursued, and might be unnecessary if they were.

Finally I think it is important to note that any policy response which aimed entirely to exclude the possibility of the failure of an institution of DBS's size would almost certainly not be optimal. All modern systems of bank regulation and supervision allow for the possibility that, hopefully very rarely but still occasionally, a bank or society of non systemic important size may fail. And it is likely that supervision so intense or regulations so tight as to exclude this possibility entirely would impose costs on the economy greater than the periodic cost to the taxpayer or the FSCS of bank rescue. It is precisely for this reason that bank regulatory systems need to include a special resolution regime, such as introduced in the UK by the Banking Act 2009. In the case of Dunfermline, the operation of that regime was smooth and effective. That smooth operation, moreover, built on the preparatory work conducted by the FSA in the preceding months, in particular the identification of potential purchasers.

Yours sincerely

Adair Turner

ADAIR TURNER