Independent Review of the Prudential Supervision of The Co-operative Bank Plc

(For the period 1 May 2008 to 22 November 2013)

Mark Zelmer

March 2019

Independent Review of the Prudential Supervision of The Co-operative Bank Plc

(For the period 1 May 2008 to 22 November 2013)

Mark Zelmer

March 2019

Presented to Parliament pursuant to Section 82 of the Financial Services Act 2012

© Bank of England 2019.

This publication is licensed under the terms of the Open Government Licence v3.0 except where otherwise stated.

To view this licence, visit http://nationalarchives.gov.uk/doc/open-government-licence/version/3 or write to the Information Policy Team, The National Archives, Kew, London TW9 4DU, or email: psi@nationalarchives.gov.uk.

Where we have identified any third party copyright information you will need to obtain permission from the copyright holders concerned.

Legal disclaimer

This Report has been prepared by Mr Mark Zelmer as the Independent Reviewer commissioned by the Prudential Regulation Authority to conduct a review in accordance with the Direction set out in Appendix 1.

The views, findings and recommendations included in this Report are entirely those of Mr Zelmer and are based upon his assessment of information provided to him by the Prudential Regulation Authority, the Financial Conduct Authority, Her Majesty's Treasury and others, including by way of meetings with relevant individuals.

The conclusions of this Report are therefore reliant upon the accuracy of the information provided to Mr Zelmer and his team during the course of the investigation and representations process, referred to in Appendix 2. No representation or warranty is provided as to the accuracy or completeness of such information.

In particular, Mr Zelmer has assumed without further verification the accuracy, completeness and reasonableness of information, views, findings and recommendations contained in (a) the report of the independent review into the events leading to The Co-operative Bank's capital shortfall by Sir Christopher Kelly published on 30 April 2014; (b) the report of the independent governance review carried out into the Co-operative Group by Lord Myners published on 7 May 2014; and (c) the report of the House of Commons Treasury Committee on Project Verde published on 21 October 2014. Where it was considered appropriate to do so, the conclusions and findings reached in those reports have been relied upon in accordance with paragraph 6(1) of the Direction of 6 March 2018.

Mr Zelmer has not conducted an audit of the information made available to him and has generally assumed the veracity of information provided to him and has not conducted a verification process in respect of that information. Public information and industry and statistical data are from sources that have been assumed to be accurate without verification.

No representation or warranty is provided as to the accuracy or completeness of any of the factual statements, findings, views and recommendations included in this Report or any such information upon which it has been based and to the fullest extent permissible by law, Mr Zelmer and the Bank of England (acting in its capacity as the Prudential Regulatory Authority) accept no liability or responsibility, whether in contract, in tort (including negligence), under statute or otherwise, in respect of any loss or damage (whether direct or indirect) suffered by any party: (i) as a result of or in connection with the content of, or any omissions from, the Report; and/or (ii) as a result of any actions taken or decisions made by any person as a consequence of the views, findings and lessons set forth in the Report. This disclaimer extends but is not limited to any references to or comments upon legal or regulatory requirements, standards, or guidance which reflect the views of Mr Zelmer only and should not be relied on. No responsibility is taken for changes in market conditions or laws or regulations and no obligation is assumed to revise this Report to reflect changes, events or conditions which occur subsequent to the date of this Report.

If and to the extent that the Report includes any legally privileged material, the inclusion is not intended to be any wider or general waiver of privilege in other material and any legally privileged material provided to Mr Zelmer has been provided for the specific purpose of carrying out his inquiry.

Acknowledgments

An investigation like this is not the work of one individual. It required the hard work of many people who were very busy behind the scenes. I would like to begin by thanking the Prudential Regulation Authority staff at the Bank of England who kindly took time out of their regular duties to promptly respond to our many requests for information and analysis. A great deal of thanks is also owed to Dr. Norval Bryson, the Senior Responsible Officer in the PRA, and all of his colleagues who worked hard to oversee the project from an administrative perspective, saving me from having to give much thought to those issues.

The consulting team at Grant Thornton, led by Paul Garbutt, were instrumental in making sure we obtained and focused on the relevant documents and in helping me prepare for the conversations with the individuals who were directly involved in The Co-operative Bank saga. Catherine Callaghan QC and Hollie Higgins at Blackstone Chambers gave us wise, independent legal advice and helped a non-Brit like me understand and navigate the report clearance process. I am also grateful for the advice provided by David Capps and Rosie Stanger of Ashurst LLP.

I would like to thank Her Majesty's Treasury, the Bank of England/Prudential Regulation Authority and the Financial Conduct Authority for supplying the requested information and for their support throughout the review process. And, I owe a deep debt of gratitude to the Independent Review team that were seconded to the project by the PRA: Ted Morris, Shelley O'Connor, Nicola Steeds, and especially Michelle Brostoff. They all worked very hard to help me digest the documentary records, prepare for and participate in the conversations, review the conversation transcripts, and prepare this Report.

Finally, I would like to thank the 22 individuals that I met with in gathering information for this review. My conversations with them were very helpful in placing the written records in proper context. I sincerely appreciate their frankness in recalling and discussing events that in some cases were not the most enjoyable parts of their professional careers.

Mark Zelmer, Independent Reviewer
Ottawa, Ontario, Canada, 30 January 2019

Contents

Executive summary ... 1

Chapter 1: Setting the scene ... 10

- Introduction ... 10
- The macroeconomic environment was very weak between 2008 and 2013 ... 12
- Meanwhile, the FSA was busy fighting many fires and overhauling its supervisory practices ... 13

Chapter 2: The Britannia and the Co-op Bank merger ... 16

- FSA stress tests at the time of the merger were fairly prescient in indicating the vulnerabilities that existed in the merged bank balance sheet ... 17
- FSA merger approval was heavily influenced by financial stability considerations ... 26
- There was minimal oversight of the Co-op Bank's M&A due diligence process ... 30
- Lessons learned and recommendations for future ... 32

Chapter 3: The Co-op Bank's loan impairment profile ... 40

- The Co-op Bank's loan impairments and provisioning levels were broadly consistent with those of its peers, but that ignores the greater refinancing risk in its loan book that surfaced in 2012 ... 40
- FSA supervisors actively pursued a wide range of issues with the Co-op Bank prior to 2013. This diluted attention from the more pressing loan impairment and capital adequacy issues ... 44
- The actions taken by the FSA following the Interim FPC provisioning recommendation in November 2012 contributed to a major increase in the Co-op Bank's loan loss provisions ... 52
- Lessons learned and recommendations for the future ... 55

Chapter 4: Change in accounting treatment for the Co-op Bank's IT platform ... 59

- Lessons learned and recommendations for the future ... 65

Chapter 5: The Verde transaction ... 67

- FSA acted appropriately in not intervening to halt the Co-op Bank's bid ... 67
- The record held by interested parties relating to Verde is largely benign ... 74
- Lessons learned and recommendations ... 76

Chapter 6: Additional observations ... 77

Appendices ... 79

- Appendix 1: HMT Direction to the PRA on 6 March 2018 ... 79
- Appendix 2: Methodology of the review ... 82

Appendix 3: Independent Review of the Co-operative Bank Protocol 85

Appendix 4: The Co-operative Group structure chart 89

Appendix 5: Tripartite Regulation - up to 1 April 2013 90

Appendix 6: The Regulatory system - as at 1 April 2013 91

Glossary of main terms, other acronyms and abbreviations 92

Mark Zelmer Biography 96

Executive summary

1. The events leading up to the near failure of The Co-operative Bank plc (the Co-op Bank or the bank) in 2013 have been well documented. The reports by Sir Christopher Kelly and Lord Myners explain in detail the failings of the bank and its Co-operative Group parent. The Treasury Select Committee (TSC) also explored the weaknesses of the bank as it sought to understand why the Co-op Bank had to abort its plans to acquire 632 branches from Lloyds Banking Group (Lloyds) in 2013 (known as Project Verde). However, one issue that those studies were not able to address was the role played by the regulatory bodies in this sorry saga. That is the subject of this Report.

2. The Prudential Regulation Authority (PRA) was directed by Her Majesty's Treasury (HMT) to examine eight issues surrounding the prudential supervision of the Co-op Bank that was carried out by the Financial Services Authority (FSA) and its prudential regulatory successor, the Prudential Regulation Authority (PRA), during the period from 1 May 2008 to 22 November 2013 (the 'Review Period'). See Appendix 1 of this Report for the HMT Direction (the 'Direction'). That period covers the merger of the Co-op Bank with Britannia Building Society (Britannia) in August 2009 and the Project Verde bidding process. In conducting my investigation and preparing this report, I have (to the best of my information and belief) taken all reasonable steps to comply with my obligations under the agreed Review Protocol in Appendix 3.

3. Major changes have taken place in prudential supervision both during the Review Period and subsequently. Consequently, in exploring the eight issues posed by the Direction, my review has also sought to determine what lessons can be learned from events during the Review Period to further enhance the PRA's current supervisory approach. It is inevitable that the conclusions drawn have been influenced by hindsight to some degree, but I have tried as far as practicable to evaluate the supervisory actions based on the information available at that time and explicitly acknowledge when observations have been based on hindsight.

4. In conducting such a review after so much time has passed, it is important to start by refreshing our memories of the economic and financial environment in which the Co-op Bank operated and was supervised. We also need to remember that supervisory policies and practices were not set in stone but instead rapidly evolved through the Review Period. That context is presented in **Chapter 1**. It reminds us that from 2008 to 2013, the FSA was busy fighting many fires on a number of fronts as it managed the failures and rescues of a large number of financial institutions in the very febrile economic environment that prevailed in the aftermath of the worst financial crisis of the post-war period. At the same time, the regulator was also fundamentally reorganising its approach to prudential supervision and preparing for the split of the organisation into the Financial Conduct Authority (FCA) and PRA that we know today.

5. My analysis of the eight questions raised in 3(2)(a)-(h) of the Direction begins in **Chapter 2**. That chapter explores the prudential oversight of the Co-op Bank in the twelve month period leading up to the merger of the bank with Britannia in August 2009. That enables me to address four of the Direction issues. Specifically: questions (a) and (b) relating to stress testing; (d) relating to the FSA's assessment of the proposed merger; and (e) the FSA's view on whether the Co-op Bank had enough information at its disposal to take an informed decision on the merger (Table 1 below provides a summary of my conclusions on all eight Direction topics).

6. The Direction posed two specific questions in relation to stress testing: (a) whether the FSA could or should have developed stress testing for the Co-op Bank sooner than it did; and

(b) whether the effective stress-testing arrangements would have led to earlier identification of the Co-op Bank's loan impairments. In my view, it would be unreasonable to say that the FSA should have developed its stress-testing approach sooner. A significant level of impairments was identified in the stress tests undertaken in 2009 as part of the FSA's assessment of the merger. While the exercises were less sophisticated than those in use today, they nevertheless produced results that were broadly consistent with those of later exercises. Consequently, the FSA approved the merger in 2009 knowing that there would be vulnerabilities in the merged bank's balance sheet and that there was a risk that the bank would need more capital in coming years.

7. That said, the Co-op Bank also suffered other losses due to conduct issues and the write down of IT expenditure over the Review Period totalling more than £600 million that were not fully identified by the stress tests. While these types of risk are better known today and receive greater attention in current stress test exercises, the inclusion of these risks in those exercises in the UK and elsewhere remains a work in progress. That led me to recommend that **the PRA and the Bank of England (BoE) should continue to evolve their stress test exercises so that they encompass a broad range of risks to which banks are exposed, and consider how best to incorporate the inherent uncertainty that would prevail as a stress scenario unfolds in real life**. (All of my recommendations can be found in Table 2).

8. Turning to broader issues surrounding the FSA's assessment of the proposed merger (point (d) of the Direction), the FSA had to form a view on the Co-op Bank/Britannia merger in the context of the unprecedented conditions that then prevailed in the UK financial system, including the fragile confidence then at play in the building society sector. The FSA approved the merger because it saw it as desirable for both the Co-op Bank itself and banking competition more generally, as well as to contain the potential risk of a major loss of confidence in the building society sector that it judged might emerge in the event that Britannia failed. The FSA and the other Tripartite authorities (HMT and BoE)[1] viewed the Co-op Bank as the best available safe harbour.

9. A key part of the context for that decision was the absence of effective resolution tools at the time that the UK authorities could deploy to manage the failures of financial institutions that encounter stress without recourse to public bailouts. In my opinion, the implementation of new resolution tools and the changes that have been made to the Financial Services Compensation Scheme (FSCS) in the wake of the financial crisis have gone a long way towards making it easier for the UK authorities to be able to successfully manage institutions like the Co-op Bank in situations where a bank encounters distress in a relatively benign environment for the financial system as a whole.

10. There is still, however, the question of whether these reforms will be sufficient in situations where the financial system as a whole or important segments thereof encounter stress, i.e. a systemic situation. Indeed, I think the likelihood of such systemic situations involving smaller institutions may in fact be greater in the future.

11. Past experience has shown that runs on deposits can happen fast in a digital world, and this risk may continue to grow with the introduction of 'Open Banking' (the requirement upon banks introduced in 2018 to allow third party providers to access bank account data, to promote competition in banking). At the first hint of any problems those third party providers may be highly motivated to move money away (or encourage their deposit clients to do so) from a potentially troubled institution, no matter how strong the deposit insurance scheme or the resolution toolkit, to protect their own reputations. Thus, I would not be

[1] See Appendices 5 and 6 for more information on the role and structure of the regulatory authorities and how they evolved over the Review Period.

surprised if smaller institutions find their deposit bases become less sticky over time and more likely to run at the first hint of troubles. Given many smaller institutions such as building societies often have similar business models, contagion risk, and hence the risk of systemic situations for those institutions and their sectors of the financial system, may well be higher in the future than has been the case up to now. That led me to recommend that **the PRA and BoE should continue to study how best to use the new resolution tools in systemic situations**. In doing so, I think they should consider how 'Open Banking' may affect their use in this regard.

12. Another important reform in the wake of the financial crisis has been the introduction of new capital and debt instruments issued by major banks and the larger building societies. These new instruments carry features that require holders of those instruments to absorb losses when the firm encounters stress and its prospective viability is in doubt. However, I am concerned that in systemic situations it may be harder to activate the loss-bearing features of these new instruments. Thus, I think that the authorities need to be aware of who would lose out when such instruments are issued and their loss-bearing features are activated. That led me to recommend that **the PRA should consider how best to balance its objective of promoting the safety and soundness of PRA-authorised firms, with its particular focus on the harm that firms can cause to financial stability, against the interests of individual classes of depositors or creditors that may end up being adversely affected or exposed to more risk in response to the actions of the authorities**.

13. I also note that while one of the issues surrounding the Britannia situation, namely the fact that wholesale depositors ranked ahead of building society members in the event a building society failed, has been solved, there is another similar issue in terms of asset encumbrance. The latter effectively prioritises a class of creditors ahead of depositors and other unsecured creditors when a bank or building society fails, which could raise questions about the quality of assets left to back depositors and the holders of instruments issued by those institutions that can be required to absorb losses (i.e. bailed-in) when the institution encounters stress. That led me to recommend that **the PRA and BoE are encouraged to take advantage of the new information on asset encumbrances and consider whether there should be some formal or informal constraints on the extent to which banks and other deposit-taking institutions can encumber their assets in normal circumstances and how best to factor encumbrances into the recovery and resolution plans for those institutions**.

14. Finally, Chapter 2 addresses the question of whether the FSA believed the Co-op Bank had enough information at its disposal to take an informed decision on the Co-op Bank/Britannia merger (point (e) of the Direction). Here, I find that the FSA supervision team did not consider the completeness of the Co-op Bank's due diligence work as part of its approval process because a detailed review of an acquiring firm's due diligence was not standard procedure for supervisors at that time. Given that the FSA executive management's view was that the merger provided potential benefits to the Co-op Bank itself and for competition in the banking sector generally, while addressing the FSA's concerns over the viability of Britannia and the building society sector, it remains moot that any concerns as to whether the Co-op Bank was making a well-informed decision on the advisability of the transaction would have influenced the outcome.

15. If the Co-op Bank had walked away from the merger, this would have been seen as a stark, public statement about the condition of Britannia. The approach taken by the FSA towards the merger, including its insistence on narrowing the scope of the clauses in the transaction that limited the Co-op Bank's ability to walk away from the transaction before it formally closed, left the Co-op Bank relatively defenceless. In hindsight, challenge by the FSA supervision team of the Co-op Bank's due diligence work might have been helpful in

mitigating that bank management's lack of risk management expertise and broader governance weaknesses.

16. How transactions such as the Co-op Bank/Britannia merger would be handled now has evolved over the past ten years. As was already reflected in the FSA's approach to its review of the Project Verde transaction, a merger or acquisition taking place today would be subject to a more thorough prudential appraisal by the PRA. However, I am struck by how little internal guidance is provided by the PRA to help its supervisors assess risks within regulated institutions. Most of the documentation surrounding the supervisory process is focused on administrative and procedural issues; not on how to assess the risks that regulated institutions are exposed to and the mitigants deployed by those institutions. That led me to recommend that **PRA supervisors would benefit from more detailed internal guidance on how to assess the risks to which regulated financial institutions are exposed and the associated mitigants, as well as on how to assess significant transactions of those institutions**.

17. **Chapter 3** explores the supervision of the Co-op Bank in the period between the Co-op Bank/Britannia merger, and the sharp increase in provisions and the emergence of the capital shortfall at the end of 2012. This enabled me to address the issue of whether the FSA supervision team should have tackled the bank's loan impairment issues sooner than it did (point (c) of the Direction).

18. When examined alongside its peers, one might think at first glance that the Co-op Bank's loan performance indicators were not outliers compared to those of its peers before the second half of 2012. However, those indicators were fairly crude. They mainly focused on the current performance of loans and the current adequacy of loss provisions, as was standard practice at the time. They did not take account of potential issues that may arise in the future, such as refinancing risk[2] that would only emerge when a loan was renewed. Unfortunately, refinancing risk was more pronounced for the Co-op Bank than its peers and this was not addressed in depth until the first quarter of 2012.

19. The broad remit of the FSA supervision team during the Review Period may have diverted their focus from the most acute issues regarding the adequacy of the bank's loan loss provisions and the fragility of its capital position. Despite being cognisant of the weak performance of the corporate loan book, I consider that the FSA's supervisors did not pay enough attention to the refinancing risk that existed in that book and, in line with standards at the time, the adequacy of loan loss provisions in the period following the merger.

20. Furthermore, I believe too much reliance was placed on the findings of the independent risk reviews commissioned during this period (such as the PwC credit book review in 2010) and on the Co-op Bank's external auditors (KPMG). This is in the context of relatively little in-house specialist prudential support for supervisors being available at the time.

21. Given the FSA's knowledge of the stress test results, and the increasingly clear direction of travel towards higher capital requirements and more stringent future loan loss provisioning expectations for banks, I firmly believe that there should have been a greater and earlier focus by the FSA on reviewing the quality of the loan book and its valuation and ensuring adequate capital was in place to cover potential losses.

22. As part of my review, I have also considered whether the FSA's messaging to banks and buildings societies in its December 2012 letters (following the November 2012 Interim

[2] Refinancing risk refers to the risk that a borrower would not be able to obtain replacement finance at the maturity of a loan. It can arise, for example, when the value of the collateral supporting a loan has declined and is no longer sufficient for the loan to qualify as a secured loan when it matures and needs to be renewed.

Financial Policy Committee provisioning recommendation) could have been conveyed differently when the impact, although not known in advance, most materially affected the Co-op Bank, an institution that had no ability to raise capital without ceasing to be a wholly mutual-owned institution. While conducting impact assessments is now a standard procedure for the PRA and the BoE more broadly when contemplating the introduction of new regulatory or macro prudential measures, this episode underscores the importance of considering how the PRA and the BoE can best help those firms adjust to the new measures. This is especially warranted for firms that do not have ready access to new capital or liquidity.

23. Much has changed in the intervening years and I am satisfied that most of the issues that arose with respect to the oversight of the Co-op Bank during the Review Period have been addressed. The introduction of the new IFRS 9 accounting standard will also promote a more forward-looking approach to loan loss provisioning that should help reveal issues such as refinancing risk more rapidly than was the case under the previous 'incurred loss' approach.

24. That said, there is still the issue of how to factor emerging policy initiatives into day-to-day supervisory activities. Here, I believe leadership and support from the top continues to be needed to ensure that supervisory plans are adjusted accordingly. That led me to recommend that **the Prudential Regulation Committee (PRC) and the executive management of the PRA should continue to play a leading role in ensuring that supervisory strategies for individual firms proactively take account of emerging regulatory developments**.

25. Effective supervision also requires a strong information management system where it is easy to store and retrieve documents and data. The PRA's records management system (FileSite) has improved the ability to store documents with the appropriate security classifications, in line with the BoE records management policy. However, my experience with this review makes me wonder how easy it is to access information when time has passed. I also experienced challenges in obtaining consistent data across institutions. In my view, a judgement-based regulator such as the PRA should be able to readily access information and consistent cross-bank data, especially for major UK banks.

26. The 2010 change in the accounting treatment for the Co-op Bank's IT platform expenditures and the ensuing implications for its capital (point (f) of the Direction) are discussed in **Chapter 4**. It is clear that the FSA was made aware of this change both from conversations with the Co-op Bank and via the corporate plans provided by the bank to the FSA. However, I could not find any evidence that this approach was questioned by the FSA. Furthermore, my conversations with former FSA supervisors confirm that there was no challenge to the treatment at that time. One reason might have been because the supervisors, who were busily addressing many other issues, did not consider how the risks/rewards could play out in economic terms; that would have argued for the bank to continue deducting the expenditures in its calculation of its regulatory capital position, regardless of where they were booked from an accounting standpoint. Had the supervisors been more attuned to the economic substance of the treatment of intangibles in 2010, the FSA could have insisted on having the IT expenditures deducted from the bank's regulatory capital position as they were incurred. Had that happened, there would not have been such a dramatic impact on the regulatory capital of the Co-op Bank in 2013, when the IT renewal programme was first suspended and eventually cancelled.

27. On the other hand, had the FSA exercised forbearance and acted to postpone the effect of the IT programme on the Co-op Bank's capital position, it would have resulted in the bank's capital resources being overstated by assets that no longer had any economic value given that the IT system was no longer useful and thus had to be written off from an accounting

standpoint. I believe that would not have been prudent given the bank's capital position was already weak as it struggled to absorb a large increase in its loan loss provisions.

28. While the PRA's supervisory practices have improved in the intervening years, the financial system is even more complex now than in the Review Period and the rules are much more stringent. Thus, I believe there are now greater incentives for firms to try to circumvent at least the spirit of the requirements, and these incentives may continue to grow as banking group structures become even more complex. The Co-op Bank at least gave some indication of its plans to the FSA when it changed its accounting treatment for its IT expenditures. Other banks may not be quite as forthcoming in the future. That led me to recommend that **the PRA should continue to pay close attention to any attempts by banks to circumvent regulatory and supervisory requirements and focus on the economic substance of transactions, not their accounting treatment or how they are funded**.

29. Even if banks do not seek to overtly circumvent regulatory requirements, the growing complexity of these requirements may give rise to a greater frequency of data reporting errors as banks strive to collect and produce regulatory data in accordance with the new regulatory requirements. That led to my final recommendation that **the PRA should consider introducing more formal third-party reviews of key prudential information supplied by banking groups through their regulatory data returns.**

30. **Chapter 5** reviews the events surrounding the Verde transaction, which addresses the final two points of the Direction ((g) and (h)). I conclude, with respect to (g), that the FSA acted reasonably in not intervening to halt the bid. It acted early and clearly in setting out its concerns both orally and in writing on a number of occasions. Indeed, the FSA's messages on Verde were noticeably clearer than previous FSA communications, reflecting the change in tone at the top of the organisation.

31. It is also important to bear in mind that it was not the case that the same bid stumbled on for two years. The terms of the proposed transaction changed significantly during the period in a way that significantly mitigated the risks to the Co-op Bank. This is a factor in reaching a view that it was reasonable for both the Co-op Bank management and the FSA to persevere.

32. I also reviewed the written records provided to me by the FSA and HMT regarding the Verde bid to address point (h) of the Direction. They show that there was a reasonably clear line between HMT and FSA, in terms of HMT not encroaching upon the FSA's remit or prudential supervision of the Co-op Bank, or indeed the supervision of Lloyds. It is also evident that the primary negotiation on terms was, as it should have been, between Lloyds and the Co-op Bank. HMT was supportive of the deal both from a public policy perspective and as a shareholder of Lloyds.

33. Nevertheless, these events highlight the need for early dialogue and information-sharing across the regulatory authorities so that they fully understand each other's thinking from the start and can take it into account in their own deliberations. This needs to be accompanied by an understanding of each of their respective roles and perspectives, which can only come through continued close engagement. This would have reduced the risk, evident in this case, that HMT was insufficiently close to the FSA's appraisal. This caused some surprise at HMT when the bid collapsed and could have made it difficult for the FSA to reject the bid at a later date, though in the event it did not reach that stage.

34. Some concluding observations that came to mind over the course of the review are offered in **Chapter 6**. They reiterate the importance of effective allocation of supervisory staff and specialists when risks are crystallising; the need for proper handover procedures when staff turnover; and good information and data systems to help supervisors take informed

decisions and defend their actions. I conclude by noting that if the UK experiences a protracted benign economic environment in the future, there is a risk that prudential oversight could fade into the background at the BoE and receive commensurately less executive attention and resources in an institution where the culture is heavily skewed in favour of macroeconomics. The PRA and the BoE may wish to consider how they can best guard against this risk in the future.

Table 1: Summary of the views of the Independent Reviewer on the questions posed in the HMT Direction

Extract from HMT Direction with views of the Independent Reviewer in bold type

3.—(1) The Investigation must assess the actions, policies and approach of the FSA and the PRA as the institutions with statutory responsibility for the prudential supervision of the Co-op Bank for the period 1st May 2008 to 22nd November 2013.

(2) The investigation must focus on —

(a) whether the FSA could or should have developed more effective arrangements for stress testing the Co-op Bank's ability to withstand challenging operating conditions sooner than it did;

While the FSA's stress tests carried out at the time of the Co-op Bank/Britannia merger were less sophisticated than those in use today, they nevertheless produced results that were broadly consistent with those of later exercises.

(b) whether the application of more effective stress-testing arrangements would have led to the Co-op Bank's loan impairments being identified sooner than was in fact the case;

The FSA approved the merger knowing there would be vulnerabilities in the merged bank balance sheet and that there was a risk that the bank would need more capital in coming years. The stress tests conducted by the FSA prior to the merger identified the vulnerabilities in the combined entity's loan book and showed significant credit impairments in stress conditions.

(c) whether the Co-op Bank's loan impairment profile, which appeared to differ from that of other banks, should have led the FSA to investigate it more closely before 2012 than was in fact the case;

The Co-op Bank loan performance was broadly similar to its peers. However, those credit risk indicators were backward looking and did not flag the inherent refinancing risk in the portfolio. I believe that in light of the vulnerabilities identified through the stress-testing exercises, there should have been a greater and earlier focus on reviewing the quality of the loan book and its valuation and ensuring adequate capital was in place to cover potential losses.

(d) why the FSA's analysis in October 2008 to January 2009 of the suitability of the proposed merger of the Britannia Building Society ("Britannia") with the Co-op Bank failed to properly account for the prudential risks attached to Britannia's assets that were subsequently identified by the PRA;

As indicated above, the FSA was broadly aware of the prudential risks associated with Britannia assets when it approved the merger, but the FSA had to form a view on the Co-op Bank/Britannia merger in the context of unprecedented conditions that prevailed in the UK financial system. It mainly approved the merger to contain the potential risk of a major loss of confidence in the building society sector that it judged might emerge in the event that Britannia failed.

(e) whether, in the FSA's view, the Co-op Bank had sufficiently comprehensive and reliable financial information at its disposal at the time of the proposed merger between the Co-op Bank and Britannia to allow it to make a properly informed decision as to the suitability of the merger in prudential terms;

The FSA supervision team did not consider the completeness of the Co-op Bank's due diligence work as part of its approval process because a detailed review of an acquiring firm's due diligence was not standard procedure for supervisors at that time.

(f) whether the FSA was made aware by the Co-op Bank of the change in the accounting treatment of the cost of the replacement of the Co-op Bank's IT platform that took place in 2010, and if it was, whether the FSA should have acted to postpone the effect of the IT programme on the Co-op Bank's capital position;

The FSA was made aware of this change both from conversations with the Co-op Bank and via the corporate plans provided by that bank to the FSA. However, I did not find any evidence of challenge to the treatment at that time. Had the supervisors been more attuned to the economic substance of the treatment of intangibles in 2010, the FSA could have insisted on having the IT expenditures deducted from capital as they were incurred. Had that happened there would not have been such a dramatic impact on the capital of the Co-op Bank in 2012 and 2013, when the IT renewal programme was first suspended and then cancelled.

I have addressed the second question on the basis of whether or not the FSA should have acted to bring forward the capital impact of the IT programme. Had the FSA acted instead to postpone the effect of the IT programme on the Co-op Bank's capital position, I believe that would have been imprudent, given the bank's weak capital base. Capital would have been overstated by assets that no longer had any economic or accounting value.

(g) whether the FSA should have intervened on prudential grounds to halt the Co-op Bank's bid to acquire 632 branches from Lloyds Banking Group, known as "Project Verde";

I believe that the FSA acted reasonably in not intervening to halt the bid. It acted early and clearly in setting out its concerns both orally and in writing on a number of occasions. The terms of the proposed transaction changed significantly during the period in a way that significantly mitigated the risks to the Co-op Bank. This is a factor in reaching a view that it was reasonable for both the Co-op Bank and the FSA to persevere.

(h) the record held by the interested parties of contacts between the seller, the bidders and the interested parties relating to the Verde bid.

The written records show that there was a reasonably clear line between HMT and FSA, in terms of HMT not encroaching upon the FSA's financial stability remit or prudential supervision of the Co-op Bank, or indeed the supervision of Lloyds. It is also evident that the primary negotiation on terms was, as it should have been, between Lloyds and the Co-op Bank. HMT was supportive of the deal both from a public policy perspective and as a shareholder of Lloyds.

Table 2: Recommendations

The PRA and the BoE should continue to evolve their stress test exercises so that they encompass a broad range of risks to which banks are exposed, and consider how best to incorporate the inherent uncertainty that would prevail as a stress scenario unfolds in real life.
The PRA and BoE should continue to study how best to use the new resolution tools in systemic situations.
The PRA should consider how best to balance its objective of promoting the safety and soundness of PRA-authorised firms, with its particular focus on the harm that firms can cause to financial stability, against the interests of individual classes of depositors or creditors that may end up being adversely affected or exposed to more risk in response to the actions of the authorities.
The PRA and BoE are encouraged to take advantage of the new information on asset encumbrances and consider whether there should be some formal or informal constraints on the extent to which banks and other deposit-taking institutions can encumber their assets in normal circumstances and how best to factor encumbrances into the recovery and resolution plans for these institutions.
PRA supervisors would benefit from more detailed internal guidance on how to assess the risks to which regulated financial institutions are exposed and the associated mitigants, as well as on how to assess significant transactions of those institutions.
The Prudential Regulation Committee and the executive management of the PRA should continue to play a leading role in ensuring that supervisory strategies for individual firms proactively take account of emerging regulatory developments.
The PRA should continue to pay close attention to any attempts by banks to circumvent regulatory and supervisory requirements and focus on the economic substance of transactions, not their accounting treatment or how they are funded.
The PRA should consider introducing more formal third-party reviews of key prudential information supplied by banking groups through their regulatory data returns.

Chapter 1: Setting the scene

Introduction

35. In November 2013, George Osborne, the Chancellor of the Exchequer announced that HMT would commission an independent review into events at The Co-operative Bank (hereinafter referred to as the Co-op Bank) and the actions of the relevant authorities in relation to that bank,[3] after all relevant enforcement actions[4] had been concluded.

36. This report is the response to the Direction[5] that arose from that announcement. The Direction was laid before Parliament on 6 March 2018 by the Economic Secretary to the Treasury, John Glen MP. The PRA and the BoE appointed me as the independent person to conduct the investigation. The Direction set out eight topics related to the prudential supervision of the Co-op Bank during the Review Period. This is the first time that HMT has utilised its powers to direct the PRA to conduct an independent investigation under the powers of the Financial Services Act 2012. The PRA's 2013 Policy Statement[6] outlines its approach to such investigations.

37. The review began in March 2018 and I have had access to the relevant internal documents held by the FSA successor authorities – the PRA and the FCA. I have also reviewed relevant documents held by the BoE more broadly and HMT. In addition, I met with 22 individuals from both the official and private sectors who had first-hand knowledge of the supervisory work conducted by the FSA and PRA,[7] and I commissioned requests for factual information and analysis from the appropriate experts across the PRA and the BoE to help me prepare this report.[8]

---

[3] HM Treasury and The Rt Hon George Osborne MP, "*Chancellor confirms independent inquiry into events at Co-op Bank",* 22 November 2013, accessible at https://www.gov.uk/government/news/chancellor-confirms-independent-inquiry-into-events-at-co-op-bank

[4] The PRA and the FCA gave Final Notices to the Co-op Bank on 10 August 2015. On 14 January 2016, the PRA gave Final Notices to two former executives of the bank. On 1 March 2016, the FCA gave a Final Notice to the former Chair of the bank. See PRA Final Notice to The Co-operative Bank plc, 10 August 2015, accessible at https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/enforcement-notice/en110815); FCA Final Notice to The Co-operative Bank plc, 10 August 2015, accessible at https://www.fca.org.uk/publication/final-notices/the-co-operative-bank-plc-2015.pdf; PRA Final Notice to Barry Tootell, 14 January 2016, accessible at https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/enforcement-notice/en150116a;
PRA Final Notice to Keith Brian Alderson, 14 January 2016, accessible at https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/enforcement-notice/en150116b; and FCA Final Notice to Paul John Flowers, 1 March 2018, accessible at https://www.fca.org.uk/publication/final-notices/paul-john-flowers-2018.pdf

[5] HM Treasury and John Glen MP, "*Direction to the Prudential Regulation Authority to investigate the prudential regulation of the Co-operative Bank plc during the period 2008-2013"*, 6 March 2018 (the Direction). See Appendix 1 for a copy of the Direction.

[6] Prudential Regulation Authority, "*Policy Statement Conducting statutory investigations"*, April 2013, accessible at https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2013/conducting-statutory-investigations.pdf?la=en&hash=9103A2583C580C20283888363F7C3A2E8DBE81D0

[7] The transcripts of these meetings are confidential to the Independent Reviewer and all references to the individuals he spoke with have been anonymised in accordance with the Review Protocol reproduced in Appendix 3. They are identified in this report as references only to 'Meeting Transcript A' etc.

[8] See Appendix 2 for more detail on the methodology of the review.

38. I have written this report with the assumption that the readers are familiar with the other reviews concerning the Co-op Bank that have been produced by: Sir Christopher Kelly[9] on the events leading up to the Co-op Bank's capital shortfall; Lord Myners[10] on the Co-operative Group's governance arrangements; and the TSC[11] with respect to its inquiry into Project Verde.[12]

39. Unlike the other reviews, this report does not focus upon the actions of the Co-op Bank itself, nor those of its auditors and external advisers.[13] Instead, it focuses on the prudential supervision of the Co-op Bank by the FSA and its successor (the PRA) during the Review Period. That period covers the merger of the Co-op Bank with Britannia and the bidding process to purchase 632 bank branches from Lloyds from 2011-2013 (known as Project Verde). In conducting such a review after so much time has passed it is inevitable that the conclusions I have drawn are to some degree influenced by hindsight. However, I have tried as far as possible to evaluate the supervisory actions based on the information available at the time and acknowledge when hindsight has been applied.

40. Given the major changes that have taken place in the way that banks are prudentially supervised, both during that period and subsequently, the focus of my review has been to determine what lessons can be learned from events during that time and, as a consequence, to assess whether any further changes or enhancements are required to inform the PRA's supervisory policies and practices.

41. The report is structured in six chapters. Chapters 2-5 relate to the questions set by the Direction in its Paragraph 3, section (2):

    The remainder of this chapter provides some context for the review by setting out the macroeconomic and regulatory environment that prevailed at the time.

    Chapter 2 covers the stress testing that was conducted by the FSA, which addresses points (a) and (b) of the Direction. It also addresses the Britannia merger, which covers points (d) and (e) of the Direction.

    Chapter 3 explores the post-merger environment, which addresses point (c) in the Direction.

    Chapter 4 covers point (f) in the Direction on the accounting treatment for the IT renewal programme.

---

[9] Sir Christopher Kelly, "*Failings in management and governance – Report of the independent review into the events leading to the Co-operative Bank's capital shortfall*", 30 April 2014 (the Kelly Review), accessible at https://assets.ctfassets.net/5ywmq66472jr/3LpckmtCnuWiuuuEM2qAsw/9bc99b1cd941261bca5d674724873deb/kelly-review.pdf

[10] Lord Myners, "*The Co-operative Group – Report of the Independent Governance Review*", 7 May 2014 (the Myners Review) accessible at https://assets.ctfassets.net/5ywmq66472jr/3DA9s4bHUAguMmY688cAQW/b04a23c45c971098d9735c0ba7fc4159/Report_of_the_Independent_Governance_Review.pdf

[11] House of Commons Treasury Committee, "*Project Verde*", Sixth Report of Session 2014-15, Vol.I, HC 728-I (TSC Verde Report) accessible at https://publications.parliament.uk/pa/cm201415/cmselect/cmtreasy/728/728.pdf

[12] Readers may wish to familiarise themselves with the main conclusions of these reports. The Executive summary of the Kelly Review can be found on pp.4-11 (see note 9) and the conclusions and recommendations of the TSC Verde Report can be found on pp.104-116 (see note 11).

[13] At the same time as this Review, The Financial Reporting Council (FRC) has launched an investigation under the Accountancy Scheme into the preparation, approval and audit of the financial statements of The Co-operative Bank plc, up to and including the year ended 31 December 2012.

Chapter 5 explores the failed Verde bid, which addresses points (g) and (h) in the Direction.

Chapter 6 outlines some final observations made during my review.

The Appendices provide the key background material.

The macroeconomic environment was very weak between 2008 and 2013

42. Between 2008 and 2013, the UK financial system and the economy more broadly were suffering from the aftershocks of the 2007-2008 financial crisis. That crisis severely disrupted the flow of credit in the economy. As a result, the UK experienced its deepest recession since the Second World War with close to one million job losses.[14] The ensuing recovery was also unusually sluggish compared to past post-war cycles in the UK; though consistent with the experience of other countries that have had the misfortune of undergoing a major banking crisis.[15]

43. Not surprisingly in this environment, many people and businesses struggled to make ends meet and repay their loans. The value of residential and commercial property used to secure loans also experienced sharp declines and slow recoveries.[16] UK banks and building societies thus found themselves with a growing stock of non-performing loans and having to book larger provisions for credit losses at the same time as they were striving to repair their balance sheets.[17]

44. While the Co-op Bank did not suffer as much as some of its major bank and building society competitors during the crisis, it was not immune from these post-crisis effects.[18] As discussed in Chapter 3, its non-performing loans also grew over the Review Period as did its provisions for credit losses. Weak property values meant that its loan book carried significant refinancing risks that only became apparent to the bank and its supervisors towards the end of the Review Period.[19]

45. The considerable easing in monetary conditions that took place as the BoE worked to contain the macroeconomic damage from the crisis had some drawbacks for banks like the Co-op Bank.[20] The BoE Base Rate was quickly lowered and maintained at an exceptionally low level of 0.5% throughout the Review Period and interest rates more generally were compressed by the BoE's Quantitative Easing operations. These actions put pressure on banks' net interest margins. In turn, this further hampered the ability of banks like the Co-op Bank to recover from the crisis and adjust to the new regulatory requirements for increased capital and liquidity levels that were introduced in response to the crisis.[21]

---

[14] Speech by Alex Brazier, "'*Debt Strikes Back' or 'The Return of the Regulator'?*", 24 July 2017, p.3 accessible at https://www.bankofengland.co.uk/-/media/boe/files/speech/2017/debt-strikes-back-or-return-of-the-regulator

[15] Carmen Reinhart and Kenneth Rogoff, "*Recovery from Financial Crises: Evidence from 100 episodes*", January 2014, Appendix, pp.13-15, accessible at https://scholar.harvard.edu/files/rogoff/files/recovery_from_financial_crises_for_os_0.pdf

[16] Bank of England, "*Will there be another financial crisis?*", accessible at https://edu.bankofengland.co.uk/knowledgebank/will-there-be-another-financial-crisis/

[17] PRA Records, August 2018.

[18] The Kelly Review (see note 9), p.12, para.3.3 and PRA Records, August 2018.

[19] See Chapter 3.

[20] Committee on the Global Financial System, *"Financial stability implications of a prolonged period of low interest rates",* Paper 61, July 2018, pp.8-25, accessible at https://www.bis.org/publ/cgfs61.pdf

[21] Ibid.

Meanwhile, the FSA was busy fighting many fires and overhauling its supervisory practices

46. As the events surrounding the Co-op Bank began to unfold in late 2008 and early 2009, the FSA and the other Tripartite authorities (HMT and BoE) were very busy fighting many simultaneous fires.[22] A large number of domestic and overseas financial institutions were stressed and needed to be stabilised or in some cases resolved (Table 3). Critically, the frequency and intensity of these interventions placed considerable demands on the FSA's limited prudential resources.[23] In addition, those events helped to underscore the very fragile economic environment that prevailed at the time in the UK financial system more generally.

Table 3: Key events during the financial crisis[24]

Date Announced	Organisation	Outcome
February 2008	Northern Rock	Nationalised
March 2008	Bear Stearns	Failed and purchased by JP Morgan Chase & Co.
June 2008	Catholic Building Society	Acquired by Chelsea Building Society
July 2008	Alliance & Leicester[25]	Acquired by Santander
September 2008	HBOS	Acquired by Lloyds TSB
	Bradford & Bingley	Part-nationalised, part-acquired by Santander
	Derbyshire Building Society	Acquired by Nationwide Building Society
	AIG	US Government provides emergency loan
	Lehman Brothers	Failed and sold to Barclays and Nomura[26]
	Goldman Sachs	Federal Reserve approves transformation into a bank holding company
	Morgan Stanley	Federal Reserve approves transformation into a bank holding company
	Merrill Lynch	Acquired by Bank of America
October 2008	Fortis	Fortis was split into two – the Dutch part was nationalised and the Belgian part was sold to BNP Paribas
	Royal Bank of Scotland	Part-nationalised[27]

[22] See Appendices 5 and 6 for further details on the Tripartite and the regulatory system during the Review Period.
[23] Meeting Transcript F, p.8.
[24] Table 3 sets out the dates on which events were announced, not when the event was confirmed by the FSA (where applicable). Therefore, some dates in Table 3 may vary from those noted in Bank of England, "*Financial Stability Report, June 2009, Issue No.25*", Annex, p.58, accessible at https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2009/june-2009.pdf?la=en&hash=093EA962436560768C9F07249324CEC867506158. The sources for events referred to in Table 3 which do not appear in the Financial Stability Report are given in notes 25-32 below.
[25] The Kelly Review (see note 9), Exhibit 8, p.19.
[26] Nomura Holdings, "*Presentation at Nomura Investment Forum 2008*", 2 December 2008, p.13, accessible at https://www.nomuraholdings.com/investor/presentation/data/2008_1202_pres.pdf
[27] Parliament UK, "*Briefing Paper: Bank rescues of 2007-2009*", 8 October 2018, p.6, accessible at http://researchbriefings.files.parliament.uk/documents/SN05748/SN05748.pdf

	Lloyds TSB/HBOS	Part-nationalised
	Barnsley Building Society	Acquired by Yorkshire Building Society
	Icelandic banks – Glitnir, Kaupthing, Landsbanki	Nationalised and renamed[28]
	Dexia	Nationalised[29]
	UBS[30]	Investor involvement to raise capital and ring-fence the 'bad bank'
	ING	Dutch Government injects capital
	Barclays	Announces raising of additional capital
November 2008	Scarborough Building Society	Acquired by Skipton Building Society
	Citigroup	Bailed out by the US government under the TARP program
December 2008	Cheshire Building Society	Acquired by Nationwide Building Society
January 2009	Anglo Irish Bank	Nationalised
February 2009	Allied Irish Bank[31]	AIB and Bank of Ireland were rescued by the Irish government with an arranged €7 billion rescue plan
	Bank of Ireland	
March 2009	Dunfermline Building Society	Part transferred to Nationwide Building Society under Special Resolution Regime
February 2010	Chesham Building Society[32]	Acquired by Skipton Building Society

47. While this firestorm raged, the FSA was also busy restructuring the way in which it conducted prudential supervision during the Review Period. The internal and external reviews into failures of Northern Rock and Royal Bank of Scotland exposed the dangerous inadequacies that existed in the FSA's prudential regime at the start of the crisis.[33] This led the FSA to introduce a more sophisticated continuous assessment programme for the major institutions that it supervised, retrain staff with the help of a new supervision model,[34] and bring on board a large number of technical experts to support an expanded team of front-line supervisors, while continuing to use external experts to address specific

---

[28] Citywire, "*Kaupthing nationalised as Iceland crisis intensifies*", 9 October 2008, accessible at https://citywire.co.uk/new-model-adviser/news/kaupthing-nationalised-as-iceland-crisis-intensifies/a317007

[29] Reuters, "*Dexia agrees to Franco-Belgian rescue deal*", 10 October 2011, accessible at: https://www.reuters.com/article/dexia/update-3-dexia-agrees-to-franco-belgian-rescue-deal-idUSL5E7L90W720111010

[30] Business Insider, "*UBS and Credit Suisse Bailed Out*", 16 October 2008, accessible at https://www.businessinsider.com/2008/10/ubs-and-credit-suisse-bailed-out?r=US&IR=T

[31] Reuters, "*Timeline: Ireland's string of bank bailouts*", 31 March 2011, accessible at https://www.reuters.com/article/ireland-idUSLDE72S1WL20110331

[32] Skipton Building Society, "*History of the Society*", accessible at https://www.skiptongrg.co.uk/our-big-160/history-of-the-society/

[33] Financial Services Authority, "*The failure of the Royal Bank of Scotland",* Financial Services Authority Board Report, December 2011, p.10, accessible at https://www.fca.org.uk/publication/corporate/fsa-rbs.pdf and Financial Services Authority Internal Audit Division, *"The supervision of Northern Rock: a lessons learned review – Report"*, March 2008, pp.2-9, accessible at https://www.fca.org.uk/publication/corporate/fsa-nr-report.pdf.

[34] This was known as the Supervisory Enhancement Programme (SEP).

issues through formal 'Section 166' reviews.[35] The FSA also introduced increasingly more sophisticated supervisory tools such as more rigorous stress-testing exercises that gradually played a more central role in anchoring the supervisors' capital expectations for banks. It also reorganised the way in which its resources were allocated and managed. As the Review Period progressed, FSA managers and staff became increasingly engaged in planning for and carrying out the split of the FSA into two separate bodies: the FCA for conduct issues and the PRA for prudential matters.[36] There was certainly a great deal of change at the FSA after the financial crisis, as a result of the internal and external reviews, and the Government's decision to implement a twin peaks model.

48. Meanwhile, the regulatory framework under which the FSA and subsequently the PRA operated was also being transformed. The crisis spawned a major global regulatory reform initiative that led to major changes in the definition and stringency of bank capital and liquidity requirements. That initiative also drove the development of new resolution frameworks in the UK and around the world that needed to be negotiated and implemented by the relevant regulator. This was supplemented by major changes in the UK, such as the structural reforms to major banks following the proposals of the Vickers Commission.[37]

49. As one might expect in the circumstances, the FSA's immediate priority at the beginning of the Review Period was first to enhance the oversight of major banking groups that were considered the most systemically important for the stability of the UK financial system. Once the approach to the large banking groups was implemented, the reforms were rolled out to other regulated firms based on the risks they posed to the stability of the financial system. The FSA categorised the Co-op Bank as one of the highest impact firms. However, whilst it was supervised alongside the largest UK deposit takers, it was not perceived to have the same potential systemic impact as the larger institutions. As a result, the Co-op Bank did not receive the same amount of supervisory resources as the very largest banking groups.[38]

50. To sum up, when assessing how the prudential authorities performed with respect to the issues posed in the Direction, one needs to be mindful of the unusually stressed economic and financial climate that prevailed during the Review Period and the tremendous pressures the FSA, and later the PRA, were under at the time in terms of their own internal operations. With that in mind let us now turn to those issues.

---

[35] A 'Section 166' review is a supervisory tool found in Section 166 of the Financial Services and Markets Act 2000 (FSMA). It empowers the FCA and/ or PRA to themselves appoint or, more commonly, direct that a regulated firm or member of its group appoint, a 'skilled person' to report to it on a particular matter, with the firm bearing the cost.

[36] The split was first announced in 2010. The Financial Services Act 2012 received Royal Assent in December 2012 and formally split the FSA with effect from 1 April 2013; however the FSA was running as two distinct business units for the preceding year, a period known as Internal Twin Peaks.

[37] The Independent Commission on Banking, "*Final Report Recommendations",* September 2011, pp.233-242, (the Vickers Commission) accessible at http://webarchive.nationalarchives.gov.uk/20131003105424/https:/hmt-sanctions.s3.amazonaws.com/icb%20final%20report/icb%2520final%2520report%5B1%5D.pdf

[38] Meeting Transcript F, pp.1-2.

Chapter 2: The Britannia and the Co-op Bank merger

Extract from HMT Direction:

3.—(1) The Investigation must assess the actions, policies and approach of the FSA and the PRA as the institutions with statutory responsibility for the prudential supervision of the Co-op Bank for the period 1st May 2008 to 22nd November 2013.

(2) The investigation must focus on —

(a) whether the FSA could or should have developed more effective arrangements for stress testing the Co-op Bank's ability to withstand challenging operating conditions sooner than it did;

(b) whether the application of more effective stress-testing arrangements would have led to the Co-op Bank's loan impairments being identified sooner than was in fact the case;

…

(d) why the FSA's analysis in October 2008 to January 2009 of the suitability of the proposed merger of the Britannia Building Society ("Britannia") with the Co-op Bank failed to properly account for the prudential risks attached to Britannia's assets that were subsequently identified by the PRA;

(e) whether, in the FSA's view, the Co-op Bank had sufficiently comprehensive and reliable financial information at its disposal at the time of the proposed merger between the Co-op Bank and Britannia to allow it to make a properly informed decision as to the suitability of the merger in prudential terms;

…

51. This chapter addresses the four points raised in the Direction (detailed in the above box) that relate to events leading up to the merger between the Co-op Bank and Britannia. The merger was negotiated by the two parties and reviewed by the FSA between August 2008 and August 2009.

52. Points (a) and (b) focus on stress testing and can conveniently be addressed together. The four points otherwise touch on separate issues, though what becomes apparent through this chapter is a common thread of how the FSA approached the merger, placing wider considerations of financial stability, specifically the stability of the UK building society sector, at the heart of its regulatory considerations in its review of the merger. This is very relevant in respect to how the FSA dealt with all four points, and the limited extent to which another approach would have likely affected the decision-making process.

53. The timeline below is a summary of the key points covered in this chapter.

Table 4: Timeline of key events

Date	Event
August 2008	FSA notified of proposed Co-op Bank/Britannia merger.
November 2008	FSA decided that Britannia no longer had a long-term future as an independent institution following a Fitch downgrade of the institution.
December 2008	FSA reviewed the options for Britannia and concluded that the Co-op Bank merger was the only viable option for Britannia.
January 2009	Tripartite authorities agreed on capital requirements for the combined Co-op Bank/Britannia at 8% pre-stress and 7% post-stress for Tier 1 capital ratios then in use for building societies. FSA undertook a stress test indicating that these capital requirement hurdles would be met. FSA gave 'in principle' agreement on this basis that the merger was acceptable.
March 2009	FSA concluded that the combined Co-op Bank/Britannia business would meet the FSA's minimum requirements to be authorised to carry out business, known as the Threshold Conditions.[39]
June 2009	FSA carried out a stress test ('mini Broom') on its own using readily available supervisory data. FSA reverted to the '8/6/4' test used for major banks and judged that the hurdles were met on the basis that the less harsh stress test ('Consensus' scenario) post stress outcome was over 4% over a one year horizon. However, capital would be eroded under a more stringent test ('80's U scenario').
August 2009	Co-op Bank/Britannia merger was completed.
Late 2009/early 2010	FSA carried out a more thorough stress test ('full Broom') using an 80's U scenario. It reaffirmed that Tier 1 capital would be eroded over a four year horizon before consideration of management actions.

FSA stress tests at the time of the merger were fairly prescient in indicating the vulnerabilities that existed in the merged bank balance sheet

54. In 2014 the TSC heard evidence in relation to the stress testing undertaken by the FSA. The then Chief Executive of the PRA commented that had the FSA possessed the capabilities to undertake the concurrent stress tests, as carried out later by the PRA, the Co-op Bank's extensive capital shortfall would have been identified before 2012.[40]

---

[39] See paragraph 109 for explanation of the Threshold Conditions.

[40] Oral evidence from Andrew Bailey to House of Commons Treasury Committee, 11 February 2014, "*House of Commons Treasury Committee Project Verde Sixth Report of Session 2014 -15*," Vol II, Ev 214, p.222, Q1939, accessible at https://publications.parliament.uk/pa/cm201415/cmselect/cmtreasy/728/728-ii.pdf

55. The TSC did not report in detail on the sequence of stress testing carried out by the FSA throughout the Review Period. Nor did it have the opportunity to review any records held by the Tripartite authorities in the course of its deliberations. From the timeline produced with its final report, it appears that the TSC concluded that the first detailed stress-testing work was carried out in 2012.[41] As a result, it is not surprising that it expressed an interest in learning whether the earlier application of more effective stress tests would have led to an earlier identification of the extent of the Co-op Bank's loan impairments. However, as we will see below, there were in fact stress tests conducted by the FSA in the first half of 2009 as part of its review of the merger. While those exercises were less sophisticated than those in use today, they were nonetheless consistent with global practices of the day and fairly prescient in indicating the size of potential loan book impairments and in identifying the fragility of the merged bank's capital position.

56. In the first quarter of 2009, using scenarios agreed with HMT, the FSA undertook stress tests of certain major UK bank balance sheets (the Co-op Bank and Britannia were not included in this sector-wide exercise) over a six week period as part of the introduction of the Asset Protection Scheme.[42] This was on the basis of two scenarios:

  a. a 'Consensus' scenario based on a consensus forecast of macroeconomic conditions at that time; and

  b. an '80's U' scenario modelled on the deeper and more prolonged recession experienced by the UK in the 1980's.

57. The capital positions of the major banks were then assessed against the targets agreed by the FSA of Tier 1 8%, stressed Tier 1 6% and stressed Core Tier 1 of 4%,[43] all based on the prevailing Basel II capital definitions in use at that time by the UK and in other jurisdictions. The intention in setting targets well in excess of the then prevailing requirements was in recognition of the expected tightening in global regulatory minimum standards that was expected to occur in the wake of the financial crisis. These targets were referred to as the 8/6/4 regime (for comparison, capital levels today might be three times this level).[44]

58. Initially, this was carried out by the FSA as a high level exercise, but then undertaken in a more rigorous way, bringing in prudential risk specialists to examine each bank's position in some detail. This latter exercise was termed "Project Broom".[45] Over the course of 2009, a mini-stress test using a less granular approach was carried out on a number of smaller UK banks and building societies, including the merged Co-op and Britannia (termed "mini Broom"). The scenarios used remained a Consensus and an 80's U stress test.

59. Turning to the Co-op Bank/Britannia merger in more detail, a key structural point to note was that although the Co-op Bank was itself a limited company, like building societies it could not raise Core Tier 1 capital in the market unless it was willing to dilute its mutual ownership status. Thus, in January 2009, the Tripartite authorities decided to apply the building society capital thresholds to it, stipulating that the merged entity would be

---

[41] TSC Verde Report (see note 11), p.4, paras.118-119.

[42] PRA Records, June 2018.

[43] Core Tier 1 capital, a Basel II measure, comprises the highest quality capital of a firm: common equity and retained earnings. Tier 1 capital is a broader measure that scopes in other equity instruments issued by a firm.

[44] Bank of England, "*Financial Stability Report, June 2018, Issue No.43*", p.35, accessible at https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2018/june-2018.pdf

[45] Broom was in effect a forerunner of the BoE's current concurrent stress-testing approach. The exercise was very manual and resource-intensive, and was subsequently developed.

assessed against a pre-stress Tier 1 capital ratio of 8% and a post-stress Tier 1 ratio of 7%, unlike the 8/6/4 requirement for major banks set out in paragraph 57 above, but consistent with the standards applied to building societies. This would be based on the stress scenarios used for the Asset Protection Scheme exercise referred to in paragraph 56. This was conveyed in writing to the CEO of the Co-op Bank on 19 January 2009.[46]

60. As viewed by the FSA in January 2009,[47] the merged entity's projected 2009 pre stress Tier 1 capital position was 9.5%, hence meeting the 8% requirement. The FSA noted that the capital resources of the combined entity were different to the sum of the capital in the two individual firms because Britannia's assets and liabilities would be booked into the merged firm at their prevailing fair values at the time of the merger. This assessment was also critically dependent on: (i) treating the Britannia's Permanent Interest Bearing Shares (PIBS) in the combined entity as Tier 1 capital for this purpose;[48] (ii) allowing the bank £108 million in capital benefits due to the FSA accepting some changes to the models used by Britannia to calculate its regulatory capital requirements; and (iii) allowing for a £175 million planned equity injection from the Co-operative Group parent company.

61. The projected post stress Tier 1 low-point outcome initially was 6.4%. However, it came in above 7% in all three years of the stress test after making allowance for the bank's ability to take action over the stress scenario horizon to dampen the effect of the stress on the bank ('management actions').

62. Incidentally, the Core Tier 1 stress outcome was 4.9% though, as mentioned above, this was not the benchmark for the FSA's review of the merger, which focused on the Tier 1 stress outcome. It was understood at the time that the stress scenarios were already being revised for the larger banks and the amended scenarios would be applied in due course in the FSA's assessment of the proposed merger.[49] A paper put to the FSA's Executive Committee at the time noted that further and more severe stress tests would be shared with the Committee, but I did not find any written record of their conclusions.[50]

63. The treatment of the Fair Value Adjustments (FVAs) that arose from restating Britannia's assets and liabilities to the market values prevailing at the time of the merger was a material part of the FSA's assessment of this transaction. Further detail on FVAs is set out in Chapter 3, relating to the work undertaken in the period following the merger. There were FVAs on both the asset and liability sides of the balance sheet and whilst they largely cancelled out when netted, the gross figures were both significant and likely to fluctuate over time.

64. Interestingly, from the evidence I have seen and heard, it appears that FSA senior supervision management paid little attention to a point raised by the BoE at the time[51] about the treatment of the FVAs that would arise from the merger in the capital calculations and how they essentially were bringing forward future earnings, thereby undermining the potential for the bank to accrete future capital.[52] (I use the term 'senior supervision management' throughout this report to refer to the direct management line responsible for the Co-op Bank supervision team. I have sought to distinguish this from the FSA's/PRA's wider senior management team, which I have referred to as 'executive management' or, where relevant, by citing the specific responsible executive management decision-making committee).

[46] FSA Records, 19 January 2009.
[47] FSA Records, 8 January 2009.
[48] FSA Records, 8 January 2009; 15 January 2009.
[49] FSA Records, 8 January 2009.
[50] Ibid.
[51] FSA Records, 30 November 2008.
[52] The treatment of FVAs is covered in more detail in Chapter 3, Box 3.

65. The Co-op Bank commissioned its own financial and capital projections, which included stress test parameters formulated by the BoE and FSA. The bank was assisted in the undertaking of this analysis by J.P. Morgan. The results of the analysis were shared by the Co-op Bank with the FSA in late 2008.[53] This was presented in the form of a moderate stress scenario (broadly equivalent to the FSA's Consensus scenario) and a severe stress scenario (broadly equivalent to the FSA's 80's U scenario). The moderate scenario had a Tier 1 low point in 2009 of 9.1% while the severe scenario had a Tier 1 low point of 6.6% at the end of 2011 (a later low point because the severe stress assumed a more prolonged downturn). In terms of severity, the FSA's January 2009 stress test lay somewhere between these two outcomes.

66. Further work was undertaken by the FSA in June 2009 when the FSA conducted a mini Broom desktop stress test exercise applying both the 80's U and Consensus scenarios.[54] It appears that due to the resource constraints among the FSA's prudential risk specialists (organisationally, within the FSA a separate division from the front-line supervisors), the assessment was conducted by the supervisors, who, arguably, would not be expected to possess the same degree of specialist expertise for such a technical undertaking.

67. This exercise by its nature had limitations: whilst the scenarios were the same as a full Broom stress test, the FSA did not seek the detailed data required for such an exercise. Instead, it relied upon matching the merged entity against similar firms and extrapolating the expected stress outcomes accordingly. Given that there was no exact peer to the combined Co-op Bank/Britannia business, this use of proxies and the lack of granular data could only give an approximate outcome. It nevertheless was fairly prescient and broadly consistent with the results of later more sophisticated exercises. The approach taken involved:

    a. analysing, by book, the Co-op Bank and Britannia portfolios to allow each to be characterised by indexed Loan to Value and arrears levels;

    b. matching these characteristics to peer building societies that had been through a full Broom test; and

    c. applying the expected loss rates produced via Broom for the relevant "mirror" portfolios under the FSA's 80's U and Consensus scenarios.[55]

68. The stress test was applied to a longer period, looking over a five year horizon, as opposed to the three years used in the January exercise. Under the 80's U scenario, the Tier 1 stress outcome was 7.3% at the end of 2010 (roughly comparable with the January exercise). However, the impact of the more severe, prolonged stress was that Tier 1 fell to just 1.1% at the end of 2014. This was due in large part to the resulting impairments over the period of £2.8 billion mainly concentrated in the higher risk Britannia portfolio. The Core Tier 1 low point under the 80's U scenario was forecast to be -0.5%, implying that this part of the bank's capital would be eroded in that stress scenario. The impact under the Consensus forecast was less marked, but still showed a Tier 1 stress outcome falling to a low point of 6.1% in 2012/2013, after impairments of £1.55 billion (see Table 5 below).

69. Although the Tripartite authorities had decided in January 2009 to monitor the merged entity against a Tier 1 stressed ratio threshold of 7%,[56] in June the FSA's focus shifted towards the Core Tier 1 requirement of 4% for the first few years of the more benign

[53] FSA Records, 23 December 2008.
[54] FSA Records, 23 June 2009.
[55] Ibid.
[56] FSA Records, 15 January 2009.

Consensus scenario, noting that this had by this point become the benchmark across the building society sector.[57] Under the Consensus scenario, the merged entity would just meet this requirement, falling to a low of 4.3% at the end of 2012 (see Table 5). It was on this basis that the FSA gave its blessing for the merger process to continue,[58] noting, internally, that there appeared to be no alternative option to the merger.[59]

70. The results of the June 2009 exercise were not shared with the Co-op Bank or Britannia management, who were therefore unaware of the regulator's assessment of the risks in what would be the combined bank's loan book.[60] There is a lack of definitive audit trail on this point. However, the FSA did not normally share its regulatory assessments of individual firms with acquiring firms given the confidential nature of this information. There is a record that the FSA believed that any move to require the Co-op Group to inject more capital into the transaction would have had the effect of 'spooking' the bank[61] to the extent that it might abandon the transaction. But there is no evidence in the records that this influenced the FSA's decision not to share the outcomes of the June 2009 exercise with the Co-op Bank management. Because the mini Broom was not conducted in collaboration with the Co-op Bank, the exercise was unable to take any account of any management actions that might have been taken in the event of stress, so the outcomes might have been mitigated to some degree. At this time, the FSA also confirmed, internally, the need to undertake a full Broom when specialist resources were available.[62]

71. The full Broom was undertaken late in 2009, after the merger had been completed.[63] Initial conclusions were reached in November, though further work continued into 2010. This was a more thorough exercise than the mini Broom, taking data from the firm and utilising the services of the FSA's prudential risk specialists. This allowed for a far more granular approach. For example, the £8.3 billion commercial lending portfolio[64] was treated as one in the mini Broom, but subdivided into ten components with individually set probabilities of default in the full Broom exercise.[65] This allowed the later exercise to more accurately view concentrations of risk.

72. The outcome of the full Broom was, under the 80's U scenario, a complete elimination of the bank's Tier 1 capital, with the Core Tier 1 ratio plunging to -2.5% by the end of 2013 and the Tier 1 ratio to -0.3%. The exercise arrived at an impairments figure of £2.8 billion over the period, the same as the earlier mini Broom, but the capital ratios were lower as a result of the full Broom arriving at a far higher level of risk weighted assets. To allow like for like comparison with the earlier mini Broom, the outcomes in this paragraph are stated before any account was taken of management actions. Allowing for management actions considered by the Co-op Bank (which, rather optimistically in my view, given the stress environment portrayed in the scenario, included cost cutting, additional capital raising and sale of business segments), it was accepted that these could plausibly have had a positive impact of £514 million on capital over the five year term, raising Core Tier 1 ratio to 0.9% and Tier 1 ratio to 3.2%.

---

[57] FSA Records, 23 June 2009.
[58] In formal terms, this was a discussion at FSA's Executive Committee. It was not the actual decision on the merger, which took place at a later date in a different forum.
[59] FSA Records, 18 December 2008. Meeting Transcripts F, pp.2-3 and K, p.3.
[60] FSA Records, 23 June 2009.
[61] FSA Records, 8 January 2009.
[62] FSA Records, 23 June 2009.
[63] FSA Records, 10 December 2009.
[64] TSC Verde Report (see note 11), para.89, Table 3. The figure of £8.3bn is the sum of "corporate loans" for Britannia (at merger) and Co-op Bank (December 2009).
[65] FSA Records, 16 November 2009.

73. In addition to the outcomes on impairments, and hence capital ratios, the Broom exercise also raised a number of supervisory concerns regarding credit risk management, data quality, risk resource and provisioning. As noted in Chapter 3, paragraph 157 onwards, these issues were taken forward into the supervisory strategy for the bank following the merger.

74. Both the mini and full Broom exercises took some account of conduct of business risk, primarily related to Payment Protection Insurance (PPI) mis-selling, though they significantly underestimated this. The two exercises also failed to capture other losses that the Co-op Bank suffered during the Review Period.

75. The table on the next page summarises the key outcomes from the stresses discussed, adding in for completeness the 2010 and 2012 capital reviews discussed in Chapters 3 and 5 respectively.

Table 5: Summary of key Co-op Bank stress tests

	JP Morgan analysis for the Co-op Bank Board[66]	FSA analysis January 2009[67]	FSA analysis June 2009 Mini Broom[68]	FSA Full Broom 2009/2010[69]	The Co-op Bank analysis for 2010 Capital Plan[70]	FSA analysis for 2012 Capital Plan[71]
Indicative Macroeconomic Assumptions	Moderate scenario: 30% HPI[72] fall unemployment doubles	Balance sheet stresses applied consistently with October 2008 UK banks recapitalisation exercise	40% HPI fall Unemployment jumps 4.8% to approx. 11.1% 4.7% GDP decline	40% HPI fall Unemployment jumps 4.8% GDP decline	40% HPI fall Unemployment jumps to 13.7% 9% GDP decline	FSA high interest rate scenario
Impairments	Moderate scenario £863m (over 4 years) Severe scenario £1.28bn (over 4 years)	N/A	80's U £2.8 bn Consensus £1.55 bn (over 5 years)	80's U £2.8 bn (over 5 years)	N/A[73]	£2.2 bn (over 5 years)
Low point Core Tier 1[74]	Moderate scenario 2009: 7.5% Severe scenario 2011: 5.3%	2011: 4.9%	80's U 2013: -0.5% Consensus 2012: 4.3%	80's U 2013: - 2.5%	4.3%	2016: 1.3%
Low point Tier 1[75]	Moderate scenario 2009: 9.1% Severe scenario 2011: 6.6%	2011: 6.4%	80's U 2014: 1.1% Consensus 2012: 6.1%	80's U 2013: -0.3%	5.5%	2016: 1.6%

[66] December 2008. See note 53 for further detail.
[67] See note 47.
[68] FSA Records, 23 June 2009.
[69] See note 63.
[70] These outcomes are from the Co-op Bank's own ICAAP, not the FSA's assessment. FSA Records, March 2010; PRA Records, 27 September 2018.
[71] PRA Records, July 2018; August 2018.
[72] House Price Index.
[73] The capital review identifies a £1.2 billion reduction in capital from starting point, but does not break this down between credit impairments and other items. It does however say that credit impairments are the greater part of this. FSA Records, 7 June 2010.
[74] Before management actions.
[75] Before management actions.

Stress Test Conclusions

76. The TSC raised two specific questions in relation to stress testing: (a) whether the FSA could or should have developed stress testing for the Co-op Bank sooner than it did; and (b) whether the effective stress-testing arrangements would have led to earlier identification of the Co-op Bank's loan impairments. In my view, it would be unreasonable to say that the FSA should have developed its stress-testing approach sooner. A significant level of impairments was identified in the stress tests undertaken and, as I discuss below in paragraph 85, I believe it should have led the FSA supervisors to review credit exposures and valuations more aggressively, notwithstanding that the accounting standard at the time (IAS 39)[76] was based on an incurred loss model and not a stressed scenario.

77. The stress testing carried out in June 2009 to inform the assessment of the merger was not a full Broom. It is unfortunate that a full Broom was not possible, but the circumstances of the time should be considered: this was a skilled-resource intensive exercise and in the aftermath of the financial crisis the FSA was facing multiple, simultaneous demands on its scarce specialist skilled resources across the population of regulated banking entities.[77]

78. The mini Broom, whilst not sophisticated by today's stress-testing standards, nevertheless produced results that were broadly consistent with those of the later exercises in terms of overall results. The exercise did expose the vulnerabilities in the Co-op/Britannia business and showed credit impairments of £2.8 billion in the 80's U scenario, and £1.55 billion in the Consensus scenario, through its term. The actual credit impairment charge taken by the Co-op Bank during the same period amounted to approximately £1.4 billion.[78] Thus, the mini Broom exercise clearly revealed that the Co-op Bank could (just) meet a 4% post-stress Core Tier 1 threshold under the milder Consensus scenario.[79] However, getting over this hurdle required the help of what I believe with hindsight are some debatable decisions by the FSA in June 2009:

    a. granting the bank some capital relief for changes to the models used by the bank to compute its regulatory capital requirements given the FSA's concerns at the time about the adequacy of risk management practices at Britannia that are outlined in more detail in paragraph 89 below. This is also supported by the Kelly Review's comments on the adequacy of the bank's weak risk management practices underpinning much of the bank's capital problems;[80] and

    b. the treatment of the Fair Value Adjustments, which focused on the impact of the volatility of the adjustments on completion date, but did not consider the longer term point identified by the BoE that the adjustments gave full recognition up front in the capital adequacy calculations for interest rate-related valuation gains that would naturally reverse out over time and weigh against capital in future years.

79. Paragraph 60 above discusses the decision to treat Britannia's PIBS as Tier 1 capital, a decision I would regard as equally debatable. While the decision was understandable given the FSA's financial stability concerns at that time, I am not convinced that it was prudent for the FSA to

[76] The accounting standard used by banks until the implementation of IFRS 9 on 1 January 2018.
[77] See Chapter 1, Table 3 for details.
[78] Summary of impairments taken from Co-op Bank's annual financial statements, accessible at https://www.co-operativebank.co.uk/investorrelations/financialresults/previous-financial-results

£ million	2013 interim	2012	2011	2010	2009	Total
Credit	496	469	115	96	242	1418
Conduct	61	150	90	4		305
IT	148	150				298

[79] FSA Records, 23 June 2009.
[80] The Kelly Review (see note 9), pp.41-53.

reclassify these instruments for regulatory capital purposes and begin treating them as first-loss capital given that many holders of the PIBS were Britannia members.

80. As mentioned (paragraph 59) the Tripartite authorities set the standard on the basis of the 8/7 test only for the FSA to revert back to the 8/6/4 test in June 2009. A note to the Tripartite from the Britannia supervisors[81] states that the 8/6/4 test was preferable because the Co-op Bank was a diversified banking group as well as a mutual. Whilst this is true, that position had not changed since the start of the year and I did not find any conclusive reasoning for this change of view. The same note sets out a summary of the results of the Consensus scenario, but does not mention that the bank was also tested against the more severe 80's U scenario and that it failed to meet that test by a wide margin.

81. In addition to the loan impairment challenges that lay within the balance sheet, the Co-op Bank also suffered other losses over the Review Period totalling more than £600 million that were not fully captured by the stress tests. They included approximately £305 million relating to conduct issues and £298 million of IT write offs.[82] These costs were significantly underestimated by the stress tests undertaken. As noted below, at paragraph 131, this was not so much due to any shortcomings in the framework, but rather because the stress tests were reliant upon the supervisory inputs. At that time, there was a general lack of understanding of the eventual impact of conduct issues such as PPI mis-selling and a less widespread inclusion of operational risks. Even today, while these risks are better known and receive greater attention in current stress test exercises, the inclusion of these risks in those exercises in the UK and elsewhere remains a work in progress.

82. The Kelly Review[83] raised a question of how the FSA's stress testing took account of the deterioration in business environment outlook between the start of 2009 and the merger being approved by the FSA in August, noting the decline in the Co-op Bank's own assessment of the business case. Any deterioration in forward looking conditions in itself would not have affected the FSA's view, which was based on a stressed outcome that is a plausible but severe test of what might happen, rather than a forecast. As this chapter has shown, the FSA's mini Broom exercise did entail a fairly rigorous stress scenario.

83. The Kelly Review[84] also made the point that the stress test did not take account of the £205 million fall in the combined Co-op Bank/Britannia capital position over the January to July 2009 period and questioned why the stress tests were not rerun in order to do so. The stress tests were rerun in June 2009, the mini Broom, to support the paper to the FSA Executive Committee recommending an 'in principle' agreement to the merger. This exercise was based upon the April 2009[85] regulatory returns, the most recent then available, and the fall in capital resources had not at that point occurred. It is not clear that the FSA would have had different information from the returns before the merger was formally approved in late July. In my opinion, this is not a critical omission. Of greater impact is how the stress test was applied to the Co-op Bank/Britannia business, as can be seen in the difference between the mini Broom and the full Broom undertaken later in the year. And, to my mind, given the rationale for the FSA's decision, more up to date financial information would likely not have influenced the outcome.

84. In the event, I believe that the FSA Executive Committee came to its conclusion on the merger not because of any lack of stress-testing analysis of the merged business' vulnerabilities, or through the application of insufficiently severe stresses identifying capital shortcomings. Instead, it had more regard to wider questions of the FSA's priorities and systemic financial stability. This context is explored in more detail in paragraphs 95 to 97 below. The FSA Executive Committee could see that the stress tests indicated problems in future years, but it

---

[81] HMT Records, 15 July 2009.
[82] See the summary of impairments in the Co-op Bank financial statements at note 78 above.
[83] The Kelly Review (see note 9), p.25, para.3.68.
[84] Ibid.
[85] FSA Records, 23 June 2009.

saw the merger as a way of putting off addressing those issues to a later date, in the hope that market conditions might have stabilised by then.

85. However, whilst the decision by the FSA's Executive Committee to buy time might have been reasonable in the light of the systemic firestorm that was raging at the time, it is not clear that this logically followed into the supervisory course pursued over the subsequent post-merger period. In my opinion, the stress tests' forward view should have led the FSA's Co-op Bank supervision team to review aggressively the credit exposures from a valuation perspective as a matter of urgency following the merger, in order to pin down the amount of capital needed, and medium term capital raising options should have been a higher priority for the supervisory strategy. However, the Co-op Bank's capital issues were not specifically emphasised in the supervisory risk assessment letter sent by the FSA in May 2010.[86]

86. Let us now turn to broader issues surrounding the merger approval process.

FSA merger approval was heavily influenced by financial stability considerations

87. The TSC heard evidence about the outcomes of the FSA's assessment of the Co-op Bank/Britannia merger undertaken in June 2009, but it was not clear whether the FSA's analysis between October 2008 and January 2009 properly accounted for the prudential risks that in the event crystallised between then and 2013 (question (d) of the Direction). The FSA's Director of Major Retail Groups supervision division (MRGD) at the time of the merger indicated that in his view it was only evident to the FSA that the loan book assets were impaired after the risks crystallised in the 2012 and 2013 audited accounts.[87]

88. In this section I will set out the chronology of the FSA's review of Britannia during that October 2008 to January 2009 period and, for the sake of completeness in a slightly wider time frame, seek to explain how the FSA reached its conclusions on the merger between the Co-op Bank and Britannia.

89. In 2008, the FSA's Britannia supervision team undertook a review of Britannia's capital requirements. The outcomes were communicated in writing to Britannia in August 2008 and in a presentation in September 2008. The team identified a range of shortcomings in Britannia's capital planning process, including that Britannia did not have "a robust capital plan which is appropriate for the current economic conditions".[88] The Britannia's response noted the Board's "disappoint[ment]" with the Pillar 2 capital guidance set by the FSA, which at £424 million was substantially higher than the Britannia's own estimate of £120 million.[89]

90. The Britannia supervision team's review also included work on credit risk management. Whilst this does not appear to have been as extensive as the work that would be undertaken the following year as part of the Broom exercise, the team identified a range of shortcomings in credit risk management.[90] This was reflected in the FSA's formal risk assessment of the bank. Although the outcomes from that assessment were not communicated to Britannia until March 2009,[91] the planning process began in earnest in October 2008 and the FSA at that time placed among its key concerns: the viability of the business model, given the difficulty of booking more loans to the Platform Home Loans business (Britannia's intermediary mortgage lending

---

[86] FSA Records, 10 May 2010. The Kelly Review notes also that the Co-op Bank's management did not appear to be placing sufficient priority on capital management – the Kelly Review (see note 9), para 2.22.
[87] Oral evidence from Clive Adamson to House of Commons Treasury Committee, 7 January 2014, "*House of Commons Treasury Committee Project Verde Sixth Report of Session 2014 -15*", Vol II, Ev 214, p.159, Q1409, accessible at: http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/project-verde/oral/6540.html
[88] FSA Records, 14 August 2008; 11 September 2008.
[89] FSA Records, 14 October 2008.
[90] FSA Records, 2 September 2008.
[91] FSA Records, 31 March 2009.

subsidiary); the failure to tighten lending standards during the early stages of the downturn; and the likelihood of future losses.[92] In due course, these concerns would be brought out in the messages to the firm in the following March; the supervision team's presentation to the Britannia Board included a detailed comparison of arrears performance against a peer group average.[93]

91. The FSA was, during the crisis, prepared to take an active role in initiating and promoting mergers in the building society sector. The FSA, and now the PRA, had a statutory responsibility regarding mergers in line with the Building Societies Act 1986.[94] The FSA was aware of the weaknesses at a number of the societies, especially those that had moved beyond the traditional business model into higher risk exposures and to greater reliance upon wholesale funding; future consolidation in the sector was seen as possible.[95] The FSA launched an internal study[96] to consider the most appropriate business and supervisory models for the building society sector but these proposals never came to fruition.

92. Whilst the initiative for the Co-op Bank/Britannia merger came from the two firms themselves, not the regulator, the FSA was sufficiently aware of the vulnerabilities of the Britannia to immediately see, when it was notified in August 2008, that the merger was a potentially attractive option to address its concerns about Britannia. However, the FSA senior supervision management caveated this with the view that the combined entity needed to have a "sustainable business model and [to be] at least as strong as the individual entities from a capital and liquidity perspective" for the merger to work.[97] At this point, whilst Britannia's vulnerabilities were known, the FSA's view was that "no parties want[ed] this [merger] to be seen as a bail out".[98]

93. The dynamics of the situation changed on 21 November 2008 with the rating downgrade of Britannia by Fitch, which was driven largely by concerns on credit risk and the nature of Britannia's exposures.[99] When the downgrade was in prospect, but ahead of public announcement, the FSA considered the likely impact upon Britannia's funding model.[100] The FSA's view was that the impact of the downgrade on wholesale deposits was expected to be critical in a period of around four months, and this was true even if outflows were not experienced in retail deposits.[101] This led the FSA to consider the risks of the merger not proceeding – that the Co-op Bank might walk away, or that Britannia might be so destabilised that the merger would not take place – and the possible contingency plans.

94. There was particular focus by the Tripartite authorities on the Material Adverse Change (MAC) provisions in the merger agreement. These are the provisions that would have allowed the Co-op Bank to pull out of the merger in the event of any specified material changes in Britannia. The Tripartite's concern was that if the Co-op Bank walked away from the transaction, this would be seen as a stark, public statement about the condition of Britannia. Accordingly, the wish of the authorities was to draw these provisions as narrowly as possible, to include only extreme events,[102] something that did not seem to trouble the Co-op Bank management.[103] From my

---

[92] FSA Records, October 2008.
[93] FSA Records, 25 March 2009.
[94] SS19/15 PRA Supervisory Statement, "*Exercising certain functions under the Building Societies Act 1986"*, April 2015, accessible at https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2015/ss1915.pdf?la=en&hash=8202BC29C2105417F287B4965AFE1FDCE365560
[95] FSA Records, 14 August 2008.
[96] FSA Records, October 2008.
[97] FSA Records, 5 August 2008.
[98] FSA Records, 29 September 2008.
[99] Fitch Ratings, "*Fitch Takes Various Rating Actions on UK Building Societies",* 21 November 2008, accessible at https://www.fitchratings.com/site/pr/450128.
[100] FSA Records, 10 July 2008.
[101] Retail outflows were regarded as a real possibility, noting that the FSA was at the same time looking at other, more stressed institutions where this was occurring. FSA Records, 19 November 2008.
[102] FSA Records, 15 January 2009.
[103] Meeting Transcript E, p.4.

discussions, it appears that the views of the authorities were coloured by the recent experience in 2008 of the withdrawal by US private equity firm Texas Pacific Group Capital from a planned rights issue by Bradford and Bingley when a MAC provision was triggered by a rating downgrade.[104]

95. The FSA reviewed a range of possible merger partners, as well as the option of Britannia remaining as a standalone business, ahead of further discussion by the FSA Executive Committee in December 2008.[105] The conclusion was that the merger with the Co-op Bank was the only viable option; certainly it was the only one where there was any attempt to progress the deal. Nationwide, the largest building society by some margin and the vehicle for a number of rescues,[106] was still absorbing several recent acquisitions and therefore was not seen as a viable option at that time.[107] The FSA noted the strong business fit and cost synergies that might potentially be achieved from a Co-op Bank/Britannia merger, and that the Co-op Bank's funding strength would offset Britannia's weaknesses.[108]

96. In January 2009, the FSA Executive Committee gave in-principle agreement that the proposed framework for the merger was acceptable.[109] This was well in advance of any formal decision, but in effect confirmation that the transaction was on track. This was the meeting that reviewed the capital outlook in the light of stress tests, as discussed in paragraph 60.

97. The merger was also the subject of Tripartite discussions at this time.[110] The Tripartite authorities accepted the strategic rationale for the merger and the benefits from a financial stability viewpoint.[111] The authorities took steps to facilitate the merger taking place, including fast-tracking the Butterfill legislation[112] and encouraging the parties to limit the scope of the MAC provisions in the agreement to exceptional circumstances in order to reduce execution risk.[113] Even so, as noted in the Kelly Review, "the Britannia's capital position deteriorated to such an extent that in July 2009 it still came within £55 million of triggering the MAC clause".[114]

Conclusion

98. In my view, it is clear that the FSA understood the institutional weaknesses, including the funding fragility, of Britannia. This was already apparent from the work carried out by the FSA before the merger was first mooted. The stress testing undertaken for the January 2009 FSA Executive Committee discussion, whilst more limited than that undertaken later in the year, reinforced the existing awareness that capital would be a key limiting factor. However, the FSA was clearly reluctant to pursue this issue for fear that the Co-op Bank might abandon the merger and in so doing trigger the collapse of Britannia. As becomes apparent from the findings in the full Broom later in 2009 – set out in paragraph 71 above – the FSA at the start of that year did not know the precise details of the weaknesses in the credit portfolio, but it is not clear this would have made a material difference in the FSA's decision-making given the febrile condition of the financial system and the FSA's objective to ensure financial stability in the UK.

---

[104] Meeting Transcript G, p.2; Written evidence submitted by Bradford and Bingley to the House of Commons Treasury Committee HC-144-II, "*Memorandum from Bradford and Bingley"*, November 2008, paras.7-8, accessible at https://publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/144/144w119.htm
[105] FSA Records, 19 November 2008.
[106] Including the Cheshire Building Society and Derbyshire Building Society in September 2008.
[107] FSA Records, 19 November 2008.
[108] FSA Records, 17 December 2008; 18 December 2008.
[109] FSA Records, 8 January 2009.
[110] FSA Records, 19 January 2009.
[111] FSA Records, 15 January 2009.
[112] HMT Records, 3 November 2008. The Building Societies (Funding) and Mutual Societies (Transfers) Act 2007 (sometimes referred to as the Butterfill Act) is an Act of the Parliament which gives building societies new powers to merge with subsidiaries of mutuals (including banks).
[113] FSA Records, 8 January 2009; 15 January 2009; 20 January 2009.
[114] The Kelly Review (see note 9), para.3.62 (noting that the fall in capital was partly caused by a technicality being partly triggered by the delay in formally recognising new Tier 1 Capital obtained by BBS).

99. The FSA had to reach a view on the Co-op Bank/Britannia merger in the context of unprecedented conditions that prevailed in the UK financial system, including the fragile confidence then at play in the building society sector. I have already set out in Chapter 1 a list of bank and building society failures (see Table 3) and it is worth reiterating that the nadir of the crisis – with the partial nationalisation of Lloyds Bank and the RBS in the UK and the collapse of Lehman Brothers in the US – was taking place in September and October 2008, precisely at the same time that the FSA began considering this merger. A senior FSA representative during that period confirmed that the regulator, faced with this range of challenges, consciously prioritised the largest, systemically critical firms and the mutual sector as a whole, rather than still important, but lower impact, institutions such as the Co-op Bank and Britannia.[115]

100. I have set out how the FSA, HMT and the BoE, viewed the weaknesses of Britannia, which will appear stark at first reading. However, a comparison with Bradford and Bingley may be instructive. That bank faced some of the same risks – a dependence on wholesale funding and a high-risk loan portfolio – but to a very much greater degree, so as to lead to a complete collapse in confidence and heavy retail withdrawals.[116] At no stage did it appear to the Tripartite authorities that Britannia, whilst acknowledged to be troubled, was in danger of similar imminent collapse. Given the competing priorities, it may be regarded as having been a reasonable strategy for the Tripartite authorities to have sought a solution that arrested the position for Britannia at least for the time being. That said, when one is seeking a safe harbour for a troubled institution one usually expects the harbour to be larger and more sophisticated than the troubled boat. In this case the harbour in question, the Co-op Bank, was half the size of the troubled Britannia boat. The building society sector strategy noted in paragraph 91 may also have held out some hope at that time that this would provide additional time for the Co-op Bank to obtain more capital to support the troubled entity.[117]

101. There was arguably from a broader financial stability perspective a strong and legitimate interest in making the merger happen for at least three reasons:

    a. The ranking of retail depositors in building societies below senior unsecured creditors under the insolvency law that prevailed at that time left Britannia depositors vulnerable in the event that Britannia failed, with the amount of coverage by the FSCS being relatively limited.[118]

    b. The second order impacts given that a failure of Britannia (the second largest building society) in the prevailing febrile environment might potentially destabilise the entire building society sector if it triggered a general loss of confidence in building societies, as well as swamping the limited FSCS provisions.[119]

    c. The public finance perspective if the end result had been a bail out, given the very limited resolution tools available at the time (see Box 1 below).

102. This was the context for the decision taken by the FSA, and, in my view, explains its approach. Other merger partners were considered by the FSA but were not felt to be viable, while the very

---

[115] Meeting Transcript F, pp.1-2.
[116] House of Commons Treasury Committee, Seventh Report of Session 2008-2009, HC 416, "*Banking Crisis: dealing with the failure of the UK banks*", 21 April 2009, paras.19-29, accessible at https://publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/416/41605.htm
[117] Meeting Transcript F, p.5.
[118] The depositor protection scheme was very limited and gradually increased throughout the Review Period. FSCS compensation limits for UK depositors before 1 October 2007 were 100% of the first £2,000 of deposits then 90% of deposits for the next £33,000. From 1 October 2007 to 6 October 2008, this was then raised to 100% of £35,000 for each institution. From 7 October 2008, this increased to £50,000 and stood at that level until 2010.
[119] Meeting Transcript K, p.3. Although (limited) FSCS arrangements were in place, there was limited experience of arranging pay-outs to depositors, so the system had not been tested and in some people's view, was not thought to be effective.

limited resolution and depositor protection framework in existence at the time provided few alternative options and left Britannia's customers exposed. Consequently, the outcome was the unusual use of the Co-op Bank as a safe harbour; an institution considerably smaller than the troubled Britannia and ultimately incapable of managing the risks it had taken on. As a result of the merger, the depositors of Britannia were better off, and financial stability concerns at least postponed, but the creditors of the Co-op Bank at the margin were exposed to more risk. As set out in Lessons Learned and Box 1 below, subsequent developments in the resolution framework would leave the regulator today with more options.

There was minimal oversight of the Co-op Bank's M&A due diligence process

103. The TSC heard evidence about the due diligence undertaken by the Co-op Bank as part of the merger and on its behalf by its auditors, KPMG. The TSC found that the due diligence undertaken by the Co-op Bank was inadequate, in light of the losses subsequently emanating from Britannia's commercial loan book.[120]

104. I have not been asked to review the due diligence itself, but rather the FSA's view of the financial information which the Co-op Bank had at its disposal to allow it to make a properly informed decision at the time of the Britannia merger.

The FSA had a limited role in the transaction

105. The FSA had a formal role in certain types of merger and acquisition activity: a change of control of a regulated firm; a business banking transfer under Part VII of the Financial Services and Markets Act 2000 ('FSMA'), and a building society merger. The requirements for all three of these processes are set out in statute. The FSA did not have any explicit locus in relation to acquisitions that did not fall into one of these categories. However, following lessons learned from Royal Bank of Scotland's acquisition of ABN AMRO[121] (the acquisition of an overseas bank being an example of a transaction which did not fall into one of the formal decision-making categories), the FSA became more intrusive in relation to major transactions, relying on general intervention powers on the grounds of actual or potential breach of the Threshold Conditions, the minimum requirements that firms must meet to become and remain authorised and must be met on a continuing basis.[122]

106. The merger did not involve a formal change of control of Britannia, as under the Building Societies Act 1986, the building society was to be formally dissolved and the assets and liabilities of the Britannia transferred to the Co-op Bank. Nevertheless, regardless of this formal point, the transaction was approached in the same way that the FSA would handle a change of control and there was, in any case, a formal change in control decision to be taken with regard to Britannia's subsidiaries. In March 2009, the FSA supervision team set out to its senior supervision management their view on the FSA's responsibilities in respect of the merger and how they would approach it.[123] In their view, the FSA ought to consider the statutory tests under Section 186 FSMA, which set out the approval requirements:

a. the acquirer is a fit and proper person to have control of the authorised person;

b. the interests of consumers would not be threatened by the acquirer's control or by his acquiring control; and

c. the Threshold Conditions (see paragraph 109 below) are met and will continue to be met by the authorised firm.

---

[120] TSC Verde Report (see note 11), para.130.
[121] Financial Services Authority, *"The failure of the Royal Bank of Scotland"*, Financial Services Authority Board Report, December 2011, p.181, accessible at https://www.fca.org.uk/publication/corporate/fsa-rbs.pdf
[122] PRA Records, September 2018.
[123] FSA Records, 9 March 2009.

107. Consideration of the fitness and propriety of the Co-op Bank drew on the knowledge of the bank gained through the existing supervision work. That work had identified shortcomings in Board skills and a weak track record in operational risk management.[124] However, the FSA's approach as set out in the above paragraph, did not require that the supervisors undertake detailed work to reach a conclusion that the Co-op Bank was fit and proper. Its rationale appears to have been that the Co-op Bank, as an existing authorised and regulated bank, was fit and proper and thus would continue to be so. The FSA gave some consideration as to whether the management of the combined entity had the capabilities and organisational structure to manage the much larger business that would result from the merger as part of its assessment of Threshold Conditions. However, there was no apparent consideration of the potential misalignment of the culture or risk management from the high proportion of critical roles that would be filled by senior Britannia personnel.[125]

108. Consideration of the interests of consumers touched on some specific points (for example, Britannia had members under the age of sixteen, who could not become members of the Co-op Bank; mitigating measures were put in place on this point) but the general conclusion was that Britannia's depositors and customers would be better off under the stronger prudential position resulting from the merger.[126] The FSA considered the position of the Co-op Bank depositors, given the potential for losses arising from the Britannia business, but felt this was satisfactorily addressed by the assessment that the combined entity would continue to meet the FSA's minimum requirements, known as the Threshold Conditions.[127] Interestingly, no detailed consideration appears to have been given to the implications of the merger for the holders of Britannia's Permanent Interest Bearing Shares (PIBS). This is despite the fact that the Tripartite authorities had agreed that those instruments would continue to be treated as loss-bearing Tier 1 capital of the Co-op Bank for the purposes of stress testing; when the replacement instruments (Perpetual Subordinated Bonds) would become Tier 2 capital on the merger for other regulatory purposes. This decision, as previously noted in paragraph 79, is in my view debatable from a prudential perspective given the fact that many holders of the PIBS were retail investors. The FSA noted that both firms displayed ethical values towards their customers, who would benefit from the wider product and distribution ranges following the merger.[128]

109. The Threshold Conditions, set out in legislation, are the minimum requirements that firms must meet to become and remain authorised and must be met on a continuing basis.[129] The FSA's consideration in this transaction focused on the adequacy of funding; on capital (which has been examined above in the stress-testing work); and on management and control functions.

110. The supervision team concluded that these conditions for approval were met and FSA senior supervision management accepted the approach taken.[130]

111. The FSA review does not appear to be, to any material degree, based upon the due diligence conducted by KPMG,[131] though KPMG's input at the time of the merger on the Fair Value Adjustments, based on historic numbers, was helpful in calculating the capital position. It is also not evident that the FSA encouraged the Co-op Bank to conduct further due diligence, and given the FSA's view that the merger was desirable for both the Co-op Bank and banking competition

---

[124] FSA Records, 9 March 2009.
[125] Ibid. The Kelly Review also notes the apparent lack of top level management experience, Kelly Review (see note 9), para 3.37.
[126] FSA Records, 9 March 2009.
[127] Ibid.
[128] Ibid.
[129] FSA Handbook, "*Threshold Conditions*", December 2004, pp.13-17, accessible at http://www.fsa.gov.uk/pubs/hb-releases/rel37/rel37cond.pdf. Threshold Conditions remain an important part of the UK regulatory regime and supervisory approach, though the content has subsequently changed in detail.
[130] FSA Records, 20 July 2009; 22 July 2009.
[131] FSA Records, 20 July 2009.

as well as from a financial stability perspective, it would have had no incentive to push this. The FSA had the option of seeking further information from either of the parties, from their advisors, or from placing a requirement on the firm to produce a Skilled Person Report under Section 166 of FSMA. However, given the prevailing financial stability considerations, it is hard to see that exercising of any of these options would have influenced the decision taken.

Conclusions

112. In line with established practice at the time, the FSA supervision team did not consider the completeness of the Co-op Bank's work to assess the merger transaction as part of its decision process. Whilst the supervision team may have monitored progress, the supervisors' view on this point was not part of the proposition escalated to senior supervision management for decision. In 2014, the TSC found that the due diligence undertaken on the commercial loan book was inadequate,[132] but there is no evidence to say whether, in 2009, the FSA supervisors were of that opinion. However, given the financial stability considerations, it remains moot that any concerns on whether the Co-op Bank was making a well informed decision on the advisability of the transaction would have influenced the outcome.

113. Nevertheless, this approach by the FSA to the merger, including the Tripartite authorities' encouragement to narrow the scope of the MAC clauses which still came close to being triggered, left the Co-op Bank relatively defenceless. Indeed, it may have led the Co-op Bank – not unfairly – to place a degree of reliance upon the FSA's apparent support for the merger. Whilst the due diligence process was the bank's responsibility, not the regulator's, challenge by the FSA of the merger fundamentals might have been helpful in mitigating what the FSA perceived to be the Co-op Bank management's lack of risk management expertise and broader governance weaknesses (as set out in Chapter 3 and the Kelly Review, Chapter 6). There may have been issues of confidentiality which would have complicated disclosure, but these could have been overcome through other means (the contrast with the handling of Verde is notable:[133] the FSA was insistent that the Co-op Bank kept Lloyds informed of the FSA's concerns.[134] The dynamics and context of that transaction were however quite different).

Lessons learned and recommendations for future

114. A key part of the context for the decisions reached by the FSA and the other Tripartite authorities was the absence of effective resolution tools. In 2008/2009, the authorities had limited resolution tools available to help manage failing banks. The Banking (Special Provisions) Act 2008, passed to allow action on Northern Rock, gave HMT powers to transfer the ownership of UK-incorporated banks and building societies in certain circumstances. Whilst never intended as a general resolution regime, it provided the authorities with limited powers which were utilised during the crisis.

115. The box below sets out the changes in resolution tools implemented since 2008. In my opinion, the implementation of these new tools should go a long way towards making it easier for the UK authorities to be able to successfully resolve institutions like the Co-op Bank or Britannia in situations where a bank or building society encounters distress in a relatively benign environment for the financial system as a whole. Their aim is to avoid the need to bail out firms which have critical functions by enabling their losses to be borne by its shareholders and creditors, while ensuring the critical operations of the bank can continue.

---

[132] TSC Verde Report (see note 11), para.130.
[133] See Chapter 5.
[134] See Meeting Transcripts D, p.5 and E, p.13.

Box 1 - Resolution

The Banking Act 2009 created a resolution regime for the United Kingdom, including objectives for the UK authorities and powers for the BoE as resolution authority. The regime was further reinforced by legislation in 2014 implementing the EU Bank Recovery and Resolution Directive (BRRD).[135] The legislation provides the BoE with a set of resolution tools to step in and take action if a firm is failing or likely to fail. These tools include the ability to transfer some or all of the critical functions of a firm to a purchaser as well as a power to 'bail in' a firm; that is to say, to write down some of its liabilities and to convert debt into equity to recapitalise a failed firm.

Banks and building societies with more than 40-80,000 'transactional accounts' (that is, accounts that are regularly used by the depositor) will typically have resolution plans that require the use of resolution tools in order to continue their critical functions if they fail. For those whose total assets are in excess of £15-25 billion, the preferred resolution strategy is likely to be bail-in.[136]

If a firm has critical functions but does not have assets above this threshold, the preferred resolution strategy may involve the transfer of its deposits and other critical functions to a purchaser (or to a bridge bank pending sale to a purchaser). This is known as a 'partial transfer strategy'. For banks and building societies that are small enough not to have operations that are critical to the financial system or the wider economy, insolvency – under the Bank Insolvency Procedure – continues to be the preferred option if they fail, with retail and other eligible depositors being paid out upon failure by the FSCS.

At the start of the Review Period, in a building society insolvency, senior unsecured creditors would be repaid before retail depositors. Since 2014, as part of the UK's implementation of BRRD, and with a view to implementing the reforms recommended by Vickers, retail depositors rank senior to senior unsecured creditors.

BRRD sets out a Minimum Requirement for Own Funds and Eligible Liabilities (MREL). This is to ensure that banks have sufficient loss-absorbing and recapitalisation capacity available to implement an orderly resolution that minimises impacts on financial stability, ensures the continuity of critical functions and avoids exposing public funds to loss. The BoE published a Statement of Policy on MREL in November 2016 setting out how UK firms will implement this requirement.[137] For small institutions, MREL will be set no higher than the minimum loss absorbing capacity requirements, so for them MREL will be met simply by meeting their minimum capital requirements. For banks subject to a bail-in resolution strategy, the indicative recapitalisation amount of MREL is equal to minimum capital requirements, implying at least a 'doubling-up' approach to MREL for bail-in firms. Banks are required to meet their full MREL by 2022, by which time it is anticipated that bail-in firms will have loss absorbing resources (i.e. MREL and capital buffers) in the region of 28% of their risk-weighted assets. This will be a key milestone in enhancing the resilience of the banking system.

116. The compensation limits under the FSCS have been increased since the financial crisis. Before 1 October 2007, the first £2,000 of deposits was protected and then 90% of deposits for the next

[135] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council Text.

[136] The Kelly Review (see note 9), para 3.3. Note that before the merger with Britannia, the Co-op Bank was at the lower end of this range of total assets, though was very much in excess of the threshold of transactional accounts.

[137] Bank of England, "*The Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL) - Responses to Consultation and Statement of Policy*", November 2016, accessible at https://www.bankofengland.co.uk/-/media/boe/files/financial-stability/resolution/boe-approach-to-setting-mrel-november-2016

£33,000. From 1 October 2007 to 6 October 2008, this was then raised to 100% of £35,000 for each institution. From 7 October 2008 this increased to £50,000 then increased again to £85,000 in 2010. The limit was temporarily reduced to £75,000 in January 2016 before being raised back to £85,000 from January 2017.

117. There is still the question of whether these new resolution tools and the changes that have been made to the FSCS will be enough. Or, to put it another way, will they facilitate an orderly resolution of a troubled institution in a situation such as this, where the financial system as a whole or a significant part thereof may encounter stress without the authorities having to resort to bailouts or having to entertain unusual transactions like the one involving the Co-op Bank and Britannia? Indeed, I think the risk of such systemic situations involving smaller institutions may in fact be greater in the future. Past experience has shown that runs on deposits can happen fast in a digital world,[138] and this risk may continue to grow with the introduction of 'Open Banking' (the requirement upon banks to allow third party providers to access bank account data, introduced in 2018 to promote competition in banking).[139]

118. An important feature of many Open Banking concepts is that they essentially facilitate the introduction of third-party agents that stand between a bank and its depositors to help the latter manage their money in more effective ways. If implemented properly, Open Banking may help bolster competition and innovation in the financial sector to the betterment of consumers and the economy more generally. However, this may come at the cost of less stable deposit-taking institutions.

119. One way in which deposit-taking institutions may become less stable in the future is that their depositors may become more flighty in the event of rumours about the health of those institutions. The 2017 experience of a medium-sized Canadian trust company, Home Trust, is a useful lesson in this regard. That institution found itself the subject of public concern after it was sanctioned by securities regulators for failing to publicly disclose evidence of mortgage fraud. Making matters worse was the trust company's heavy reliance on third parties to source most of its deposits; investment firms became reluctant to place customer money with Home Trust. In the event, the depositors 'ran', and Home Trust almost failed and had to be rescued by a US investor despite the fact that most of its depositors faced minimal risk of loss under Canada's deposit insurance scheme.[140]

120. An important lesson from the Home Trust incident is that third parties may be highly motivated to move money away (or encourage their deposit clients to do so) from a potentially troubled institution at the first hint of any problems, no matter how strong the deposit insurance scheme or the resolution toolkit. Why? Because no intermediary wants to risk its reputation by having to explain to its depositor clients why their money is on deposit with a troubled institution even if the risk of actual loss is virtually nil. Thus, I would not be surprised if smaller institutions find their deposit bases become less sticky over time and more likely to run at the first hint of troubles. Given many smaller institutions like building societies often have similar business models, contagion risk, and hence the risk of systemic situations for those institutions and their sectors of the financial system, may well be higher in the future than has been the case up to now. This leads me to recommend:

---

[138] Examples are Fortis in 2008: Reuters, "*Bank savers run at the click of a mouse*" 7 October 2008, accessible at https://www.reuters.com/article/us-financial-silentrun-idUSTRE49600Z20081007 and Santander in 2012: This is Money, "S*antander UK rocked by Moody's credit rating downgrade amid Spanish banking crisis*", 18 May 2012, accessible at https://www.thisismoney.co.uk/money/news/article-2146188/Santander-UK-credit-rating-cut-Moodys-amid-Spanish-banking-crisis.html

[139] Open Banking, "*What is Open Banking?",* accessible at https://www.openbanking.org.uk/customers/what-is-open-banking/

[140] Globe and Mail, "*Home Trust ordered to step up anti-money-laundering controls*", 12 June 2017, accessible at https://www.theglobeandmail.com/report-on-business/home-trust-ordered-to-step-up-anti-money-laundering-controls/article35281956/ (with subscription).

121. **Recommendation: The PRA and BoE should continue to study how best to use the new resolution tools in systemic situations.**

122. In addition, I think the PRA and BoE should also consider how 'Open Banking' may affect the use of these tools in this regard. The BoE has acknowledged and is thinking about the potential risks of Open Banking to financial stability. For example, it was mentioned in the Governor's foreword in the PRA's Annual Report 2017/18,[141] and it has also been considered by the Financial Policy Committee.[142]

123. The recovery and resolution options for Britannia were limited because of the inherent difficulties faced by building societies in raising capital. This has to an extent been addressed by new capital instruments for mutuals (see Box 2).

Box 2 - New Capital instruments

In March 2009, the FSA and the HMT developed a new form of financial instrument to help recapitalise West Bromwich Building Society ('West Bromwich'), known as profit participating deferred shares ('PPDS'). They were issued to holders of the subordinated debt as a way of recapitalising the society as the alternative was to put West Bromwich into resolution – which would have wiped out the subordinated debt holders.[143]

PPDS were designed to be Core Tier 1 ('CT1') capital instruments under Basel III, and similar to the Permanent Interest Bearing Shares ('PIBS') already issued by building societies. Although both technically 'deferred shares', the key difference from PIBS is that PPDS contain a principal write-down feature not present in PIBS. PIBS in issue also tended to have call and interest step-up features that made them incompatible with CT1 status – most existing PIBS are therefore grandfathered and are gradually being removed from consideration as regulatory capital.

The write-down feature of PPDS is achieved through a reserve account that can move from positive through to negative, with the proportionate share of profits/losses added to/subtracted from that account (or, in the case of West Bromwich, losses reduced the reserve account to nil, with losses beyond that point deducted from the nominal amount of PPDS held): dividends (or more correctly, profit-related coupons) can only be paid if the reserve account is in surplus. The amount of coupon paid is fully discretionary (i.e. the Board determine what to pay, up to the coupon and amount available in the reserve account).

The introduction of these instruments was important because the FSA confirmed that, provided they were properly structured, they could be treated as CT1 capital. This was allowed because these instruments were deemed to be more loss-absorbing, as outlined above.

Consequently, if a building society that had issued such instruments made a loss, the share allocated to the PPDS would firstly be set off against any positive balance on the PPDS reserve account (into which undistributed profits were allocated) and, secondly, applied to reduce the principal value of the PPDS.

---

[141] PRA, "*Annual Report and Accounts*", 1 March 2016 – 1 March 2017, pp.3, 48, accessible at https://www.bankofengland.co.uk/-/media/boe/files/annual-report/2017/pra-2017.pdf?la=en&hash=4F75E5A5DC136700A1ED7563B499D38CE2F20650. At the same time the PRA is working with the wider Bank to encourage new and innovative financial technologies and understand their potential impact on business models.

[142] Bank of England, "*Financial Stability Report, November 2018, Issue No.44*", p.61, accessible at https://www.bankofengland.co.uk/financial-stability-report/2018/november-2018

[143] West Bromwich Building Society, "*Special conditions of issue of the PPDS*", 18 January 2018, accessible at https://www.westbrom.co.uk/media/WBBS/Files/PDFs/PIBS_Information/Special%20Conditions%20of%20Issue%20of%20the%20PPDS.ashx

Therefore, PPDS offer building societies more flexibility in terms of how they structure their CT1 capital to strengthen their capital base. Building societies can now do this either by issuing new PPDS or by converting existing subordinated debt into PPDS.[144] However, no PPDS have been issued in recent years, as it is seen in the market as a rescue instrument and by building societies as anti-mutual.[145]

West Bromwich has since converted its PPDS into Core Capital Deferred Shares ('CCDS') and other instruments. Nationwide developed CCDS as a common equity type instrument, and has issued two tranches to investors. Cambridge Building Society has also now issued CCDS. This instrument was not developed for recovery purposes (unlike PPDS), though it may be used that way; some types of capital instrument may convert to CCDS if the capital threshold is triggered. Write down/up features are similar to PPDS, but the CCDS coupon is subject to an absolute limit and the Boards give guidance on distribution policy (as for an equity dividend in a bank). All coupons are completely discretionary.[146]

The FCA is aware and does recognise that share instruments issued by mutual societies pose a particular risk of inappropriate distribution to ordinary retail customers. In October 2014, the FCA introduced temporary product intervention rules that restricted the retail distribution of contingent convertible securities while they consulted on permanent steps.[147] On 1 June 2015, the FCA brought in new rules limiting the scope of distribution, preventing risky instruments from being offered to non-sophisticated retail investors of ordinary means. This significantly limits the scope for consumer harm from inappropriate retail investment in these loss-absorbing instruments.[148]

124. It may, however, be harder to activate the loss-bearing features of these instruments in a systemic situation, when there are adverse market conditions and broader liquidity issues as seen during the last financial crisis. Authorities need to have a conscious awareness of who would lose out when such instruments are issued and their loss-bearing features are activated, which may impact the use of such tools within the wider sector. This leads me to recommend:

125. **Recommendation: The PRA should consider how best to balance its objective of promoting the safety and soundness of PRA-authorised firms, with its particular focus on the harm that firms can cause to financial stability, against the interests of individual classes of depositors or creditors that may end up being adversely affected or exposed to more risk in response to the actions of the authorities.**

126. There is a spectrum of ways in which this could be done in the UK context. For example, at one extreme the authorities could make it clearer to the public that their primary concern is the stability of the financial system, or segments of the system, as a whole, and explain why that may not necessarily completely overlap with protecting depositors and creditors. By contrast, at the other extreme, the UK government could even go so far as tasking the PRA with a dual mandate of pursuing the stability of the financial system with a secondary mandate to protect depositors and creditors from a prudential perspective. This would be similar to what is done on the insurance side of the PRA where it also has the objective of protecting policyholders. It

---

[144] Brodies, "*Dunfermline Building Society – was it all necessary?*", 1 January 2009, accessible at: https://brodies.com/binformed/legal-updates/dunfermline-building-society-was-it-all-necessary

[145] Meeting Transcript A, pp.1-2; PRA Records, September 2018.

[146] West Bromwich announced its plan to convert its PPDS in December 2017, "*Planned liability management exercise*", accessible at https://www.westbrom.co.uk/media/WBBS/Files/PDFs/PIBS_Information/Planned%20Liability%20Management%20Exercise.ashx

[147] FCA Policy Statement, "*Restrictions in relation to the retail distribution of contingent convertible instruments*", first published August 2014, accessible at https://www.fca.org.uk/publications/temporary-product-interventions/restrictions-relation-retail-distribution-contingent

[148] FCA Policy Statement, "*PS15/14: Restrictions in relation to the retail distribution of contingent convertible instruments*", June 2015, accessible at https://www.fca.org.uk/publication/policy/ps15-14.pdf

would also be similar to that which exists in some other jurisdictions like Australia and Canada where the prudential regulatory agency is tasked with protecting the interests of depositors and creditors of deposit-taking institutions from a prudential perspective. There are also middle ground steps that could be considered such as imposing more stringent due diligence requirements on regulated firms when they wish to pursue significant transactions.

127. In considering how best to proceed, it should be borne in mind that there has been a Memorandum of Understanding (MoU) in place between the BoE and the FCA since April 2013.[149] That MoU provides that the FCA has a mandate to pursue the protection of consumers in such events. The governance structure, including the current cross-membership of the PRC and the FCA Board, should help to promote the effective cooperation of the authorities in this area.

128. While the structural deposit subordination issue has been solved, there is another similar issue in terms of asset encumbrance, because it effectively places a class of creditors ahead of depositors and other unsecured creditors. Even with MREL (see Box 1) there is still the question of whether the best quality assets will end up with secured creditors via encumbrances, leaving the remaining lower-quality assets to back the claims of unsecured and junior creditors. If valuations of the latter assets are less certain and more vulnerable in stress, then authorities could be faced with a similar issue in the future. Fortunately, since 2014, there is now far more information available to EU and UK supervisors about banks' encumbered assets. This brings me to my next recommendation.

129. **Recommendation: The PRA and BoE are encouraged to take advantage of the new information on asset encumbrances and consider whether there should be some formal or informal constraints on the extent to which banks and other deposit-taking institutions can encumber their assets in normal circumstances and how best to factor encumbrances into the recovery and resolution plans for these institutions.**

Stress testing

130. Stress testing has become an important supervisory tool in the UK and other jurisdictions in the wake of the financial crisis and this has continued to develop in the years since the Review Period. Just as important as the 'technology' of stress testing has been the governance of how institutions embed stress testing in their business and how supervisors use it in the capital – and liquidity – requirement setting process. It is undoubtedly a complex tool and the PRA has put in place a number of processes to ensure proper use: training for supervisors; written guidance; the effective deployment of specialists in capital appraisal and decision making; peer group review of capital requirements and formal decision-making panels. Indeed, the BoE now undertakes regular concurrent stress test exercises for major UK banking groups that play an important role in determining the capital and liquidity buffers that those institutions are expected to carry.

131. Looking to the future, there still remains the need to look beyond the balance sheet risks that are currently assessed to capture the broader range of risks to which regulated firms are exposed, with the conduct risk impairments that occurred in this instance being an example. As I commented above (paragraph 81) with hindsight I believe that insufficient account was taken of the risks that were to crystallise as approximately £600 million of impairments that arose over the Review Period due to conduct issues and IT write offs. Whilst better account would be taken today of operational risks, effective integration of these kind of risks into the framework remains a work in progress. In addition, there is an inherent uncertainty in stress testing, which remains despite the advances seen since the Review Period. This can be seen in three ways:

[149] Memorandum of Understanding between the FCA and Bank of England, including the PRA, accessible at https://www.fca.org.uk/publication/mou/mou-bank-pra.pdf

a. stress tests are simulations and over-simplifications to how a crisis will evolve in practice, the most obvious limitation being that there is little coverage of second order effects;

b. despite the many judgements that contribute to a stress test, the outcome is a single number which affords a spurious accuracy (in contrast, for example, to the BoE's inflation forecasts which are expressed as a fan chart probability distribution); and

c. the original Broom stress tests were limited in sizing the cost of conduct fines and redress from, most notably, PPI. This reflected at the time an unknown future landscape, and supervisors will always have to deal with unknowns.

In combination, these are always likely to make stress test results more benign than outcomes. That leads me to recommend:

132. **Recommendation: The BoE and PRA should continue to evolve their stress test exercises so that they encompass a broad range of risks to which banks are exposed, and consider how best to incorporate the inherent uncertainty that would prevail as a stress scenario unfolds in real life.**

Mergers and acquisitions transactions

133. How transactions such as the Co-op Bank/Britannia merger would be handled has similarly evolved over the past ten years. Indeed, the FSA had already started to change in 2009; both the decision to handle the merger as if it was a formal change in control, even though it technically was not, and the extensive degree of executive and senior supervision management[150] involvement were signs of a more proactive approach that would not have been seen a year or two earlier.[151] The FSA's approach was also amended in 2009 to reflect the implementation of the Acquisitions Directive,[152] which sets out additional considerations.

134. The FSA's approach to reviewing Project Verde is an example of how the approach developed further, with a greater degree of supervisory engagement and a clearer communication by the FSA of a more strategic view of the issues that the Co-op Bank needed to address.

135. A merger or acquisition taking place today would be subject to a still more thorough prudential appraisal by the PRA.[153] This would include greater emphasis on governance, organisational structure and the management capabilities, as well as operational resilience and operational continuity in resolution. The introduction in 2016 of the Senior Managers and Certification Regime provides a stronger framework on which to base such work. The PRA's approach also involves greater emphasis on operational considerations, including the migration and impact upon operational resilience.[154] Balancing consideration of financial stability with micro-prudential issues is today facilitated by prudential supervision being under the same roof as the BoE. The core of the process remains an assessment against the minimum requirements (Threshold Conditions), but would involve greater oversight of the acquirer's due diligence and the supervisor would seek to be convinced that the acquirer understood what they were acquiring and were planning accordingly.

---

[150] See paragraph 64 for the distinction between the terms executive and senior supervision management as used in this report.
[151] Financial Services Authority, "*The failure of the Royal Bank of Scotland",* Financial Services Authority Board Report, December 2011, p.180 discussed how the FSA's approach had developed since the events covered in that review had occurred. Accessible at https://www.fca.org.uk/publication/corporate/fsa-rbs.pdf.
[152] Directive 2007/44/EC of the European Parliament and of the Council of 5 September 2007 amending Council Directive 92/49/EEC and Directives 2002/83/EC, 2004/39/EC, 2005/68/EC and 2006/48/EC as regards procedural rules and evaluation criteria for the prudential assessment of acquisitions and increase of holdings in the financial sector.
[153] Not forgetting that the FCA now brings a more focused approach to the impact on customers than previously seen, though that is outside the scope of this review of prudential supervision.
[154] PRA Records, August 2018.

136. Consideration of a change in control application is a statutory process that provides its own structure for considering how the acquiring entity will continue to meet the Threshold Conditions. Beyond that high-level benchmark, there is no internal guidance to supervisors on how to assess a merger or acquisition transaction. Indeed I was struck more generally by how little internal guidance is provided by the PRA to help supervisors assess risks within regulated institutions. Most of the documentation surrounding the supervisory process is focused on administrative and procedural issues, rather than on how to assess the risks that regulated institutions are exposed to and the mitigants deployed by those institutions. That led me to recommend:

137. **Recommendation: PRA supervisors would benefit from more detailed internal guidance on how to assess the risks to which regulated financial institutions are exposed and the associated mitigants, as well as on how to assess significant transactions of regulated financial institutions.**

138. It is difficult to determine whether such guidance would have led to different outcomes and it is true that no two transactions are identical. I also recognise that the regulatory approach has evolved since the financial crisis. Nevertheless I think that more guidance and compiling a body of precedents for consideration in such circumstances might be helpful.

Chapter 3: The Co-op Bank's loan impairment profile

Extract from HMT Direction:

3.—(1) The Investigation must assess the actions, policies and approach of the FSA and the PRA as the institutions with statutory responsibility for the prudential supervision of the Co-op Bank for the period 1st May 2008 to 22nd November 2013.

(2) The investigation must focus on—

…

(c) whether the Co-op Bank's loan impairment profile, which appeared to differ from that of other banks, should have led the FSA to investigate it more closely before 2012 than was in fact the case;

…

139. This chapter focuses on the period following the merger of the Co-op Bank with Britannia and examines point (c) from the Direction.

140. The TSC raised this point because it had concerns about the level, quality and intensity of FSA focus on the quality of the Co-op Bank's loan book following the Co-op Bank/Britannia merger. Specifically, the TSC heard evidence from the then Chief Executive of the PRA that the Co-op Bank's provisioning policy was looser than other banks.[155] The TSC considered that, in light of supervisory experience of market conditions, the Co-op Bank's 'looser' approach to recording its impairments should have been apparent to the FSA in the years running up to 2013.[156] The TSC did not have the opportunity to review all of the supervisory files for its investigation.

141. To address this point, I begin by exploring how the Co-op Bank's loan impairment profile compared to that of other banks to show how some simple credit risk indicators would not have uncovered the latent refinancing risk that existed in the Co-op Bank's book. I then set out the chronology of supervisory activities from the period following the Co-op Bank/Britannia merger in August 2009, leading up to the sharp increase in loan loss provisions and the emergence of the capital shortfall in the bank's 2012 financial statements. This shows the wide range of issues that the FSA was pursuing with the bank over that period and, as a result, how attention was diverted from the more pressing loan impairment and capital adequacy issues. The description of events concludes by discussing the FSA's letter on provisioning practices in December 2012.

The Co-op Bank's loan impairments and provisioning levels were broadly consistent with those of its peers, but that ignores the greater refinancing risk in its loan book that surfaced in 2012

142. To address the issue of how the Co-op Bank's loan impairment profile compared to those of its peers, I commissioned the PRA to undertake a comparison of the loan impairments and provisioning figures of the Co-op Bank relative to its peers.[157] In doing so it was important to consider the impact the Co-op Bank/Britannia merger had on the accounting treatment for loans. As part of the merger, Britannia's assets were brought onto the Co-op Bank's balance sheet at

[155] Oral evidence from Andrew Bailey to House of Commons Treasury Committee, 11 February 2014, "*House of Commons Treasury Committee Project Verde Sixth Report of Session 2014 -15*", Vol II, Ev 214, p.222, Q1938, accessible at https://publications.parliament.uk/pa/cm201415/cmselect/cmtreasy/728/728-ii.pdf
[156] TSC Verde Report (see note 11), paras.125-126.
[157] Peers are defined as the largest four banks in the UK in Chart 1.

fair value. 'Fair Value Adjustments' (FVAs) were made to reflect expected credit losses that subsequently provided a form of protection against future loan losses in a similar manner to provisions. Box 3 provides further details on FVAs.

Box 3 - FVAs and provisioning

Loan valuations are based on discounting expected cash flows to determine their present value. Under the IAS 39 accounting standard, a credit loss is recorded when a loss event occurs that impacts the expected cash flows, for example, a borrower loses their job and is expected not to pay in full. Credit losses are usually set with reference to contractual payments and interest, however an exception must be made for acquired loans.

Loans must be recognised at fair value when they are acquired. FVAs are used to capture future credit losses and differences between contractual interest rate and current market rates at the point of acquisition. As a result FVAs reflect whether loans were acquired at a premium or discount to their historic cost, which depends on the quality of the loans and changes in market interest rates.

The credit part of the FVA is an adjustment to the expected cash flows for non-payment. It is used to inform whether future credit losses should be recorded in a bank's income statement. Credit losses are not recorded to the extent that loss events occur but the impact on expected cash flows is already reflected in the credit part of the FVA. To the extent that credit losses would have been recorded had it not been for the credit FVA, the FVA was deemed to be 'utilised'. The FVA needs to be utilised to avoid double counting credit losses captured when loans were fair valued at acquisition. The remainder of the credit FVA was 'unutilised'.

The interest part of the FVA reflects an adjustment to the discount rate. It is used to determine how much interest income should be recorded in the income statement. As time passes, the impact of discounting unwinds with the changes recognised as interest income.

As a crude estimate of what the provision balance would have been had the acquisition not taken place, you could add the 'utilised' credit part of the FVA to impairment provisions.

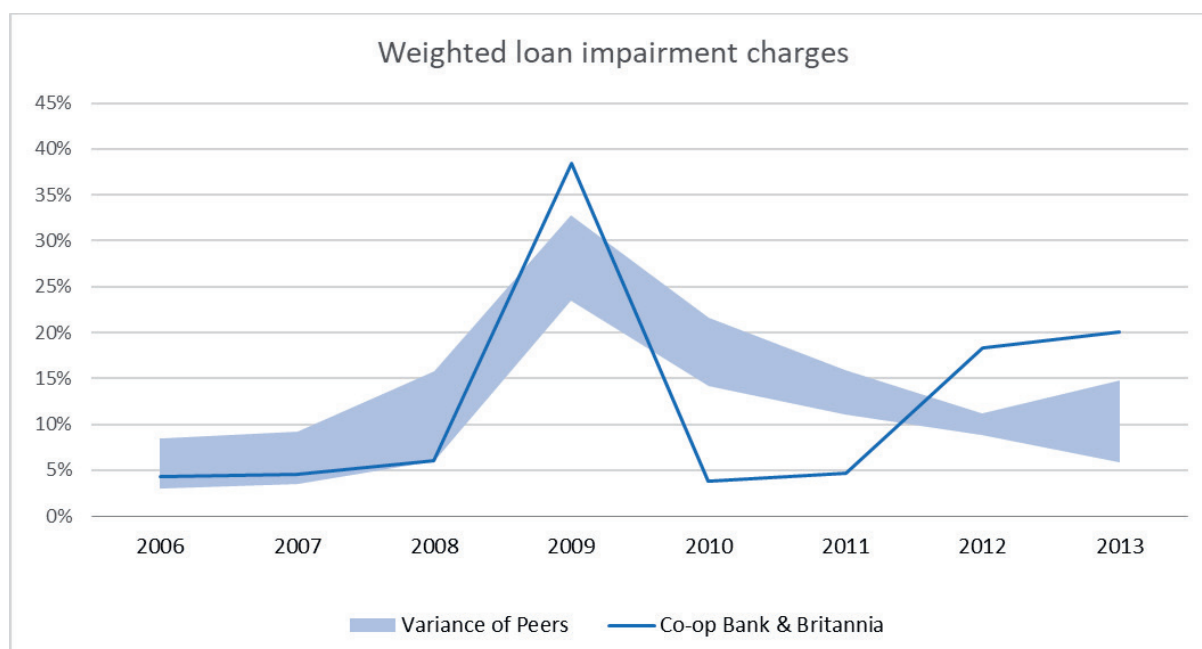
Note that there is further detail in the Kelly Review[158] on the treatment of FVAs.

143. It should be noted that despite exhaustive efforts in extracting KPMG reports to the Co-op Bank's Board Audit Committee over the relevant period, it did not prove possible to add credit-related FVA reserves to the stock of provisions (from regulatory returns) to derive an overall level of 'risk protection' – or to add utilisation of FVA reserves to the periodic charge against income for provisions. This is because, in line with practice at the time, the KPMG reports did not, in all cases, state the value of FVA reserves at the relevant reporting dates. However, the KPMG reports did include, in a seemingly broadly consistent way, a calculated assessment of the overall level of risk protection at period ends which combined available credit-related FVA reserves with the stock of provisions.

144. Taking into account the FVAs, the impairment charge profile of the Co-op Bank (combined with Britannia pre-2009) compared with its peers can be roughly illustrated as follows:

[158] The Kelly Review (see note 9), Exhibit 10, p.26.

Chart 1: Weighted loan impairment charges from 2006 to 2013



Source: Banks' annual reports. Data includes the four largest banks in the UK, using end of year impairment charge data as a percentage of total loans.

145. It appears that the Co-op Bank's impairment charge was near to, or below, the lowest of its peers in the period from 2006 to 2011, with the exception of a spike in 2009 when it exceeded the peer group, and the increase in 2012 when the full extent of the impairment to the corporate loan book became apparent. It was not possible for me to determine whether the FVAs should have been even higher in 2009, but with the benefit of knowing what happened in subsequent years, and with access to information that was not available at the time that the FVAs were assessed, the FVA adjustment may have been too small.

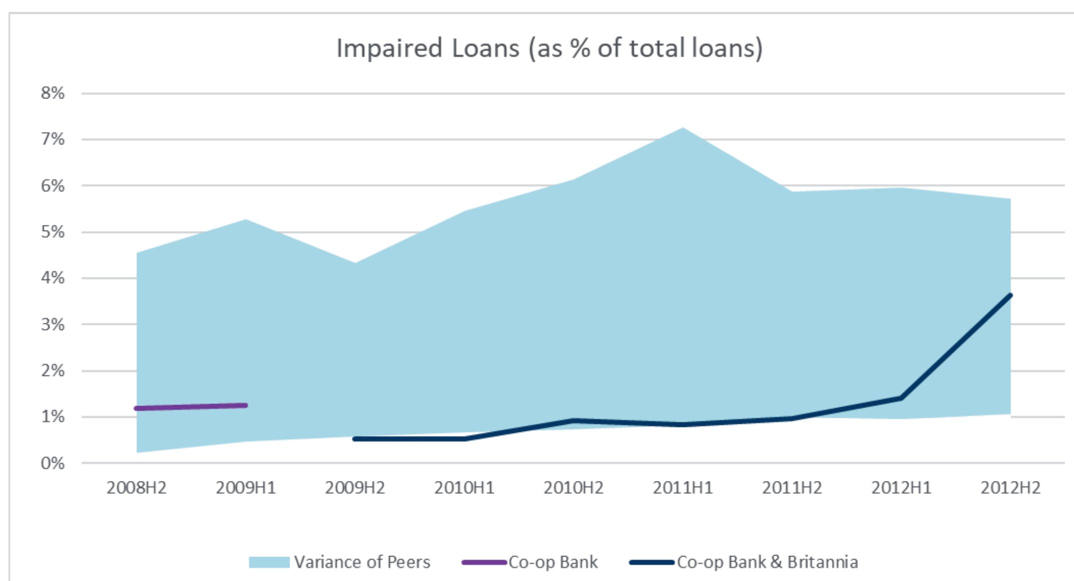
146. What is notable is the impairment charges were lower than the Co-op Bank's peers in 2010 and 2011 as the FVAs unwound.

147. The spike in the impairment charge in the second half of 2012 – in line with the increase in provisions coverage – was driven by the commercial real estate (CRE) book.

148. Charts 2 and 3 suggest that the Co-op Bank's stock of impaired loans as a share of total loans, and the extent to which those impaired loans were covered by provisions, were broadly in line with its peers.[159]

[159] Peers are defined as the largest four banks along with the eight largest building societies in the UK in Chart 2 and 3.

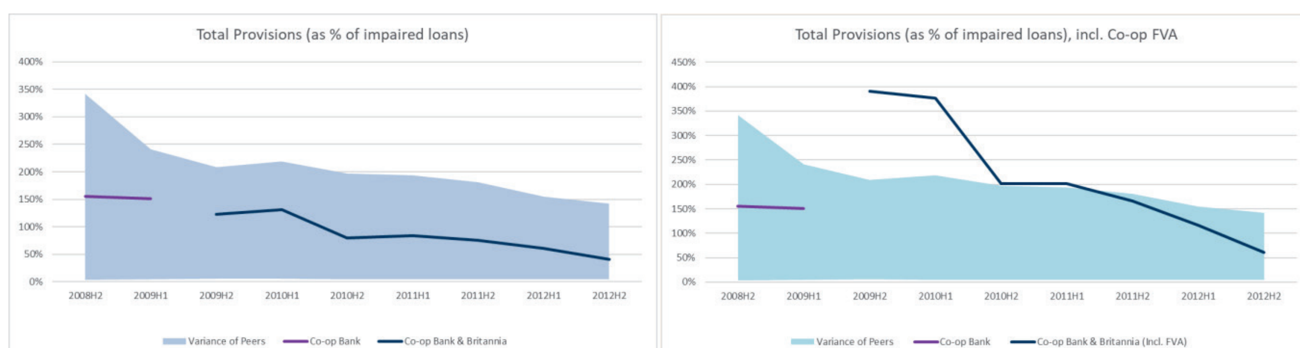
Chart 2: Impaired loans as a % of total loans



Source: Regulatory Returns

Some firms have not reported data for first half of 2008. Data for the Co-op Bank and building societies covers total loans; data for large banks covers UK Retail + UK Corporate loans only.

Chart 3: Provisions (including FVAs for the Co-op Bank) as a share of impaired loans



Source: Regulatory Returns, KPMG Audit Committee reports are used for the Co-op Bank.

Total risk protection (which includes FVA reserves), as sourced from KPMG Audit Committee reports is used for the Co-op Bank. This includes risk protection for Treasury Assets.

149. Thus, if one only looks at these peer analysis data in isolation, I would argue that the FSA could not have predicted the problems relating to the Co-op Bank's loan book. Indeed, as we will see below, the issues with respect to the commercial real estate loan exposures only came to light following the changes in provisioning practices in early 2013, following the letter sent by the FSA in 2012, which led the bank and peers to confront the latent refinancing risk in their commercial real estate loan books as part of wider changes to provisioning. That risk would not be evident in basic credit risk indicators like the ones presented here, because those metrics are inherently backward looking in nature, whereas the refinancing risk was a problem brewing for the future.

FSA supervisors actively pursued a wide range of issues with the Co-op Bank prior to 2013. This diluted attention from the more pressing loan impairment and capital adequacy issues

150. The FSA's supervisory model was radically transformed in the aftermath of the financial crisis. A more structured prudential programme was introduced from 2010, focusing on key topics covering business models, capital, liquidity, risk management and governance.[160] This sharpening of prudential supervisory focus culminated in the PRA's supervisory model, which took formal effect in April 2013.[161] The intention of the new approach was that prudential supervision should be more judgement-based, forward-looking and risk-based.[162]

151. Meanwhile, the regulatory framework underpinning prudential supervision was also being radically transformed. For example, capital requirements were overhauled with the EU's implementation of the Basel III Capital Accord[163] and new, more forward-looking loan loss provisioning standards were also under construction during the Review Period, led by the International Accounting Standards Board (IASB).[164] Many other reforms were also under way that would affect banking regulation both domestically and internationally. As noted in Chapter 2, paragraph 57, the FSA had adopted a set of stress test targets that anticipated Basel III. However, as we will see in this chapter, the wider range of these unfolding regulatory developments did not appear to be taken into account in the supervision strategy for Co-op Bank that was agreed by supervisory management.

152. Table 6 presents a timeline of key events surrounding the supervision of the Co-op Bank between August 2009 and December 2012.

---

[160] This was known as the 'Core Prudential Programme' (CPP). The FSA began to develop the CPP in 2009 for banks like Co-op Bank that were classified as very high impact firms from a systemic risk perspective.
[161] See Prudential Regulation Authority, "*The Prudential Regulation Authority's approach to banking supervision*", April 2013, Foreword, accessible at https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/approach/banking-approach-2013.pdf?la=en&hash=EE3CF43F507394DA596088664EAAAC5C6128F4F6
[162] Ibid.
[163] The Basel Committee on Banking Supervision published the first version of Basel III for comment in December 2009. See Basel Committee on Banking Supervision, "*Consultative Document – Strengthening the resilience of the banking sector*", December 2009, accessible at https://www.bis.org/publ/bcbs164.pdf?noframes
This was consulted on in the Spring of 2010 and finalised in September 2010. Basel III tightened capital requirements as compared with its predecessors. In the EU this was implemented under CRD IV from 2014.
[164] See paragraph 209 below for more detail.

Table 6: Timeline of key events

Year	Event
August 2009	Co-op Bank completes merger with Britannia – FSA aware of Britannia's vulnerabilities in its loan book
August 2009	Co-op Bank added to FSA Watchlist[165]
April 2010	Pricewaterhouse Coopers (PwC) credit review
May 2010	Risk Assessment letter and Risk Mitigation Plan includes 12 items for action[166] FSA supervisory focus on longer term issues – Governance and Relations with Regulator
July 2010	Increase in capital resources following the capital review (via downstreaming from the group)
August 2010	Co-op Bank removed from the FSA Watchlist
September 2010	Interim Risk Review[167] downgrades risk scores
August 2011	FSA strategy covers a wide range of conduct and prudential issues Business Model Analysis review Section 166 review commissioned in relation to liquidity reporting
August 2011 onwards	Project Jupiter (the sale of Co-operative Insurance Society's life business).
H2 2012	Commercial Real Estate thematic review
June 2012	Risk Assessment letter[168] and Risk Mitigation Plan sent Co-op Bank back on FSA Watchlist
December 2012	FSA letter leads to sharp increase in provisions
January 2013	FSA significantly increases capital requirements following capital review
March 2013	Co-op Bank losses announced in 2012 results

153. The FSA's supervision model required supervisory teams to be overseen by a Manager. There was no permanently appointed Manager of the team responsible for supervising the Co-op Bank and Nationwide Building Society from early 2010 until October that year; however another member of staff 'acted up' as Manager for the Co-operative Financial Services (CFS) Group (as

[165] See Glossary for explanation of the FSA's Watchlist. The Kelly Review (see note 9), paras.10.2-10.3.
[166] See note 86.
[167] FSA Records, 20 September 2010.
[168] FSA Records, 1 June 2012.

the Group was called at the time).[169] In October 2010, a new band of Senior Manager was appointed to oversee both the CFS Group and Nationwide Building Society.[170]

154. Before the new Senior Manager arrived, the CFS supervision team comprised 5 permanent staff, with another 3 new supervisors joining later that year.[171] Given the breadth of CFS' activities, the team was also tasked with the supervision of the two insurance entities within the CFS Group ('CIS' and 'CISGIL').[172]

155. From the time of the merger in 2009 through to the surge in loan loss provisions at the end of 2012, the FSA's CFS supervision team was required to address a wide range of conduct and prudential issues, with similar issues resurfacing throughout this period. Formal reviews of supervisory strategy for the Co-op Bank took place approximately six-monthly (as it did for all high impact firms).[173] While loan quality and capital adequacy featured in these reviews, the supervisors' (and the bank's) ability to focus on them was surely diluted given the long list of other issues and the limited resources available to the team over the period. As I note in paragraph 154 above, the same team was responsible for all the regulated entities in the CFS Group, so their work extended beyond solely the Co-op Bank.

156. Let us now explore the extent to which the wholesale credit portfolio of the Co-op Bank – including the legacy Britannia book – was reviewed by the FSA prior to 2012.

157. The scope of the wholesale lending portfolio review in Q4 2009, as shown in Table 7 below, included portfolios totalling some £8.4 billion, out of a total loan book of around £35 billion. The Kelly Review provides a high level breakdown of the Co-op Bank and Britannia balance sheets prior to the merger.[174] Assuming any changes over the following year were limited, the wholesale credit review encompassed around half of the Co-op Bank loan book. For Britannia, the review covered a much smaller percentage. Although 45% of Britannia's lending was a reasonably high quality, traditional mortgage business, nearly 40% was the lower quality intermediary mortgage business. However, reviews of retail portfolios did not take place at this time. That scope was consistent with the FSA's view at the time that the wholesale credit was perceived as a concern, and reflects that the retail books, including the intermediary business, had been the subject of a review commissioned by the Co-op Bank and carried out by KPMG.[175]

158. The wholesale credit portfolio of the Co-op Bank was analysed in Q4 2009,[176] based on information provided by the bank as at 31 December 2008 and 10 January 2009. Whilst the records in this respect are not complete, the work was clearly aligned to the Broom exercise carried out at the same time (see Chapter 2, paragraph 71) and is likely to have been a part of that exercise.

159. The intention was to provide a five year view of expected losses in the wholesale lending book, based on two scenarios: 80's U and Consensus, in line with the Broom stress tests (see Chapter 2). The exercise assumes a correlation between GDP growth scenarios and probability of default. It looked separately at the Co-op and Britannia books. As the below summary table illustrates, the expected loss rate for the Britannia portfolio was materially higher than that for the Co-op Bank portfolio, a reflection of the vulnerabilities in the former.

---

[169] Meeting Transcripts L, p.1 and C, p.1. From September 2011, CFS Group was known as the Co-operative Banking Group. The lead associate for the Nationwide team also acted as the Manager and reported to the Head of Department at the time.
[170] Meeting Transcript C, p.1.
[171] FSA Records, 20 September 2010.
[172] For an explanation of the Co-operative Group structure, see Appendix 4.
[173] PRA Records, September 2018.
[174] The Kelly Review (see note 9), Exhibits 2, 3 and 4.
[175] This review was judged to be thorough by the Kelly Review. The Kelly Review (see note 9), paras.4.34 - 4.40.
[176] FSA Records, undated.

Table 7: Wholesale Credit Review Portfolio Assessment

	Portfolio size	Expected Loss		80's U expected loss as % of portfolio
		Consensus	80's U	
Co-op Bank	£5.3bn	£470m	£541m	10.3%
Britannia	£3.1bn	£520m	£562m	18.1%

Source: FSA records[177]

160. The FSA compared these expected loss percentages to different peer groups, to four peer banks for the Co-op and six peer building societies for Britannia. The Co-op Bank expected loss was broadly comparable but slightly higher in terms of severity to three other banks. It was still well under the expected loss percentage of one particularly troubled institution. The expected loss for Britannia was at the upper end of its peer group, higher than four peers and lower than two.

161. The Broom stress test exercise looked at each individual portfolio and the credit practices of the Co-op Bank and Britannia. The expected losses arose primarily across commercial property and leverage loans. Whilst some weaknesses were identified in the Co-op Bank portfolio (notably that a high percentage originated from 2006-2008 and may therefore be viewed as higher risk), the review was more concerned about Britannia. The exercise noted in respect of the Britannia portfolios that:

    a. Exposures were not aggregated by borrower;

    b. There was a concentration of exposure in London and the South East (46% of the total);

    c. The quality of assessment of the subordinated portfolio was inconsistent, and the valuation of collateral frequently not up to date, so that approximately half that £415 million book was effectively unsecured;

    d. Provisioning was modest, despite the failure of some borrowers to meet interest payments in full; and

    e. Refinancing risk was assessed as high.

162. The FSA concluded that the exercise was hampered by the limitations of the Co-op Bank's management information and internal rating systems.[178] The supervision team tried to address this problem in the subsequent PwC review (see paragraph 163). This meant the assessment was based on expert view rather than data and therefore considered broad bands of quality rather than a granular assessment. Nevertheless, despite its limitations, this was a structured, high-level assessment that validated the FSA's pre-existing concerns on the weaknesses in the Britannia business. The IAS 39 accounting framework restricted provisions being made for losses that were expected but had not yet occurred. However, these restrictions would not have prevented the FSA from challenging the adequacy of provisions and imposing regulatory capital consequences had provisions been found not to reflect portfolio quality and refinancing risk.

163. As a result of its review of the wholesale lending portfolio and the shortcomings identified in credit risk management, in Q4 2009 the FSA decided to require a more detailed independent review of the corporate credit book of the merged entity.[179] It hoped to complete this in time for

[177] FSA Records, undated; PRA Records, 23 July 2018.
[178] FSA Records, 17 November 2009.
[179] Ibid.

any conclusions to be incorporated in the forthcoming statutory audit of the merged entity. The supervision team weighed the options, and considered that the process of commissioning a formal Section 166 report was not compatible with this timeframe. The review was therefore carried out by a third party, PwC, the former auditor of Britannia, but it was not a formal Section 166 review.[180] In my view and in hindsight, this meant that the FSA had insufficient control of the scope of the review, which was agreed between the Co-op Bank and PwC, although the scope included the recommendations of the FSA's prudential specialist team.[181] The PwC review covered credit governance, reviewed a sample of files, and looked at key processes such as stress testing, monitoring, reporting and portfolio analysis.[182] An extensive review of the detailed process and controls within the corporate lending book was not undertaken and – crucially – the adequacy of provisioning and the valuation of assets were not explicitly in scope.

164. The PwC report submitted in 2010 did not identify any significant areas of concern for the supervisors regarding the loan book.[183] The report was considered by the FSA as an input to the subsequent capital review and it was judged that sufficient progress had been made by the bank such that no specific capital 'add-ons' for Pillar 1 credit risk were imposed as a result.[184] However, a £420 million capital planning buffer was imposed, reflecting a forward-looking view of risks – including credit risk – that could crystallise in stress. This was in addition to FVAs held on the balance sheet for credit risk. In hindsight, had the report been a formally commissioned Section 166, and been prepared on the basis of a wider scope, a different conclusion might have been reached and the supervisors might have had an opportunity to signal that credit risk controls were a continuing material concern.

165. In my view, the supervisors did not sufficiently focus on the inherent refinancing risk in the loan book at that time, despite the relatively high loan-to-value ratios attached to many of the Co-op Bank's loans and the fact that refinancing risk was identified in the Q4 2009 FSA review of the wholesale loan book (paragraph 157 above). If interest rates had risen sharply or commercial property prices had slumped, this would have led to significant bad debts for the Co-op Bank because many of its borrowers would have had trouble refinancing their loans when they came due in such an environment. During this time the supervisors did not focus closely enough on this future refinancing risk and instead placed a great deal of reliance on the PwC report[185] and other independent risk reviews, together with external audit reports, though I recognise that reliance upon third-party expertise was a direct and understandable result of the lack of in-house specialist prudential resource available at the time.[186] That said, such use of third parties does not take away from the regulator the responsibility to critically weigh their inputs.

166. The lengthy list of supervisory priorities continued to burden the supervisory team's resources and the bank throughout 2010.[187] One reason capital adequacy was not given more weight in the Spring 2010 formal risk assessment letter to the bank was that the FSA was at the same time undertaking a separate capital review. The FSA wrote to the Co-op Bank Board with the outcome in July 2010 setting the FSA's Individual Capital Guidance for the Co-op Bank.[188] Individual Capital Guidance was set at 123% of the Pillar 1 requirement plus a £100 million fixed add on for pension risk.[189] The main reason for this additional capital buffer was concern over

[180] FSA Records, 29 April 2010.
[181] FSA Records, 18 November 2009.
[182] FSA Records, 29 April 2010.
[183] FSA Records, 29 April 2010.
[184] FSA Records, 17 June 2010.
[185] FSA Records, 29 April 2010.
[186] Meeting Transcript A, p.8.
[187] FSA Records, 10 May 2010.
[188] FSA Records, 1 July 2010. See also Chapter 5 below for the subsequent 2012 capital review.
[189] Pillar 1 is the minimum capital requirements under the Basel framework, comprising credit, market and operational risk.

the bank's large loan exposures to London and the South East and its exposure to pension risk.[190]

167. In addition to the Individual Capital Guidance, the FSA advised the bank to carry a Capital Planning Buffer of £420 million that could be drawn down in extenuating circumstances.[191] The Capital Planning Buffer, calculated on the basis of the stress test in the Co-op Bank's own capital plan rather than by the FSA, in particular presented a more significant increase in capital buffers than previously seen, leaving the bank with a far thinner surplus of capital resources over capital requirements and buffers than before.[192]

168. That said, the Capital Planning Buffer would have been much larger had FSA senior supervision management not given the bank credit for £1.15 billion in the supporting stress tests for some of the management actions that the bank proposed it could carry out in the event of stress. As noted in Chapter 2, without allowing these management actions, Tier 1 would have fallen to 5.5% post-stress and Core Tier 1 to 4.3%. The FSA panel which approved the proposal made the judgement that it was reasonable to allow a relatively broad range of management actions to be taken into account because it thought the stress test in the bank's ICAAP appeared highly conservative.[193] Taking the allowed management actions together, and noting that there were several proposed by the Co-op Bank which the FSA did not accept, I would question whether they were capable of being implemented in a timely and orderly fashion by the bank at a time of stress.

169. In fact, whilst the underlying economic assumptions were severe, the application to the loan book was not and resulted in a level of impairments much lower than in the mini or full Broom exercises. The PRA's current practice is, incidentally, to be more prescriptive in identifying impairments, but this was not so during the Review Period. With the benefit of hindsight it is regrettable that the FSA was so generous, as it resulted in another missed opportunity to confront the bank's weak capital position on a timelier basis.

170. An underlying concern in the September 2010 review was cited as "Capital – likelihood of eating into the Capital Planning Buffer (CPB) during 2010; and issues around FVA unwind".[194] The forward work plan showed that capital would be reviewed in the second quarter of 2012, with risk management and governance reviews listed as the priority workstreams in 2010 and 2011.[195]

171. Furthermore, at the September 2010 review, the supervision team proposed and senior supervision management agreed a reduction in Business Model, Prudential Capital and Liquidity risk scoring[196] (i.e. in the FSA's view the risks were less likely and less significant). This seems unusual with the benefit of hindsight and given the concerns on capital. The score was reduced by one notch, and this reflected that the FSA had completed a capital review and had agreed with the Co-op Bank that there would be a capital injection. The scoring was increased in each of the subsequent senior supervision management reviews in March 2011 (due to a number of factors including erosion of the Capital Planning Buffer and the impact of the Leek Notes (see

---

[190] FSA Records, 17 June 2010.
[191] FSA Records, 7 June 2010.
[192] Total capital resources at the end of 2009 were £2,574m. The Pillar 1 requirement was £1,513m, so Individual Capital Guidance was £1,961m (123% of Pillar 1 plus £100m). The Capital Planning Buffer advised to the bank was £420m. The capital surplus was therefore £193m. FSA Records, 7 June 2010; 1 July 2010.
[193] FSA Records, 17 June 2010.
[194] FSA Records, 20 September 2010.
[195] FSA Records, 20 September 2010.
[196] FSA Records, 20 September 2010; 2 March 2011. Risk scoring was the way in which the FSA classified the probability and impact of risks identified in the assessment, for example, Medium High, Medium Low. A reduction in risk scoring suggests that the risks had become less likely and less significant. Note that the score reflected the probability of risk crystallising, not a firm's impact score, which – broadly – reflected its size (as found in the FSA Handbook SUP 1.3 https://www.handbook.fca.org.uk/handbook/SUP/1/3.html?date=2013-03-31).

paragraph 175))[197] and September 2011 for capital and liquidity (again due to a number of factors including continued erosion of capital buffers and a potential Moody's downgrade).[198] The September 2011 review was the last senior supervision management review before the restructuring of the FSA into Conduct and Prudential business units ahead of the legal separation into the PRA and FCA (known as 'Internal Twin Peaks').

172. An August 2011 supervisory strategy document[199] set out the FSA's overall assessment of the Co-op Bank and the forward strategy for the remainder of 2011. The immediate supervisory priority was to ensure that the Co-op Bank integrated the two businesses effectively, a process that was implemented under the Co-op Bank's Banking Transformation Programme ('BTP') (see Chapter 4 for more detail).

173. The FSA's expressed "longer term" priority was ensuring the soundness and stability of the Co-op Bank's capital position, with reference to "back-book credit risk", setting out that this was "covered by Fair Value Adjustments". The supervisory strategy document notes that "credit deterioration was significantly lower than anticipated in 2010 (especially on legacy Platform business); however the Co-op's Bank's retail and corporate property books were vulnerable to economic deterioration and rising interest rates". The document also states that management actions had been taken to restore capital but that "future options are limited". The forward strategy for the second half of 2011 was Business Model Analysis, with underlying work on Project Unity[200] and Project Jupiter.[201] Project Verde was not yet featured, although it was to become a significant distraction for both the senior management of the Co-op Bank and the supervisors (see Chapter 5). Another prudential supervisory review of capital was scheduled for the second and third quarters of 2012.

174. The FSA understood that the Co-op Bank was capital constrained. Supervisors encouraged a degree of down-streaming of capital from the group[202] (there was an injection of £180 million capital from CFS in 2010,[203] £87 million (from CIS General Reserve) in 2011[204] and £80 million (also by way of dividend from CIS) in 2012).[205] Project Jupiter itself was also primarily a capital-raising exercise. The question is whether there was enough focus on capital raising during this period. See paragraph 196 below for my thoughts on this.

175. Following the merger, the supervision team was also preoccupied with a number of initiatives driven by the Co-op Bank, including 'Project Lotus', which was the work to amortise the 'Leek notes'.[206] FSA senior supervision management was asked to consider the proposals and, following numerous exchanges, the Leek notes transaction was finally executed in March 2011.[207] A consequence of Project Lotus was that the FSA significantly increased the Co-op Bank's capital requirements in January 2013.[208]

176. Another distraction for the supervision team, highlighted in the 2011 supervisory strategy document, was an instance of liquidity mis-reporting in June 2010, which had to be followed up

---

[197] FSA Records, 2 March 2011.
[198] FSA Records, 30 September 2011.
[199] FSA Records, August 2011.
[200] Project Unity was a Co-operative Group integration initiative that consolidated common central functions and changed reporting lines.
[201] Project Jupiter was the sale of the Co-operative Life Insurance business to Royal London.
[202] Meeting Transcript A, p.4; Injections from CFS are also noted in FSA Records from August 2011.
[203] FSA Records, 2 March 2011.
[204] FSA Records, 30 September 2011.
[205] FSA Records, 18 December 2012.
[206] The Kelly Review (see note 9), Exhibit 21 and paras.11.16-11.17.
[207] Ibid.
[208] FSA Records, 15 January 2013.

by another Section 166 report.[209] Again, this highlights the breadth of issues the supervisors faced beyond the immediate credit-related issues.

177. Returning to the HMT's question (c), the FSA's review of the Co-op Bank's business model in August 2011[210] found that the Co-op Bank generated very low returns in its Corporate and Business Banking Book, which raised questions over its viability. The key reasons were the losses in the back book (Platform-Britannia), low net interest margins, high concentrations in the commercial real estate portfolio and a funding gap (the Loan to Deposit ratio was 233%). The 'validated conclusions' of this work, presented as part of the FSA's formal risk assessment of the bank in June 2012,[211] reinforced the earlier findings.

178. Mortgage arrears were found to be amongst the highest in its peer group, though declining from a Q2 2009 highpoint. The arrears data covered both Optimum (the closed book of poorer quality mortgages), the live Retail mortgage book and Platform regulated mortgages. By way of illustration, at end September 2011, total Optimum loans with arrears were 19%, largely unchanged since September 2010. By comparison, retail loans with arrears were 1.5% at end September 2011, and Platform loans with arrears were around 2% at same point in time.[212]

179. These findings were echoed in the final business model assessment validation panel in February 2012, where it was noted that the upcoming cross-sector review of commercial real estate exposures would "shed light on the Co-op Bank's capacity to write new commercial business and whether adequate provisioning levels were in place".[213] Importantly, the panel noted that the proposed review of strategic options for the commercial real estate and Optimum books should form part of the cross-sector commercial real estate review and not be a separate workstream (to avoid duplication).[214]

180. I examined the results of the 2012 cross-sector commercial real estate review amongst the UK banks,[215] including the Co-op Bank. The review found that, on a sample of 13 lenders:

   a. the Co-op Bank's UK commercial real estate portfolio was larger than average (as a percentage of Core Tier 1 capital for each firm, the Co-op Bank's commercial real estate exposures were 230% against a weighted average of 176%);[216] and

   b. the Co-op Bank's portfolio was significantly poorer in quality than average (on the basis of Non-Refinanceable UK commercial real estate as a percentage of Core Tier 1 capital for each firm, the Co-op Bank stood at 134% against a weighted average of 70%).[217]

   The review also estimated what the FSA felt provisions should be and considered the gap against the provisions actually made by each firm; the Co-op Bank scored poorly by this measure as well.

181. By this time, refinancing risk was considered and found to be partly mitigated by over half of the portfolio being structured with an amortisation schedule incorporated into the terms.[218]

---

[209] FSA Records, August 2011.
[210] FSA Records, August 2011.
[211] FSA Records, March 2012.
[212] FSA Records, November 2013.
[213] FSA Records, 29 February 2012.
[214] Ibid.
[215] FSA Records, 1 August 2012. The 2012 review of the UK commercial real estate lending market covered thirteen UK regulated firms; seven banks, five Building Societies and one Insurance Company representing approximately 52% of the total market. The focus was on assessing asset quality, refinance risk and the adequacy of provisioning. The FSA also deepened its understanding of firms' UK commercial real estate strategies.
[216] Ibid.
[217] Ibid.
[218] FSA Records, October 2012.

The actions taken by the FSA following the Interim FPC provisioning recommendation in November 2012 contributed to a major increase in the Co-op Bank's loan loss provisions

182. Prior to the financial crisis, banks' provisions for future losses in their lending operations had mainly been driven by recent loan performance. Many commentators claimed that the incurred loss model in the IAS 39 accounting standard[219] contributed to the delayed recognition of credit losses on loans.[220] One of the lessons from the crisis was the benefits of moving towards an accounting framework where loan loss provisions in any given period would be more forward-looking and based on the expected future credit performance of a loan over its remaining life – otherwise known as expected loan loss provisioning.[221] The BoE was keen to see banks apply as much forward-looking information as possible in setting their loan loss provisions even before the new accounting standards were adopted. This contributed to the FSA's decision to write to the largest UK banks and building societies in December 2012, following the Interim Financial Policy Committee's (FPC) recommendation.[222]

183. In its meeting of 21 November 2012, the Interim FPC ('interim' because it was meeting ahead of achieving formal status) recommended that the FSA take action to ensure that the capital of the UK banks and building societies reflects "*a proper valuation of their assets, a realistic assessment of future conduct costs, and prudent calculation of risk weights. Where such action reveals that capital buffers need to be strengthened to absorb losses and sustain credit availability in the event of stress, the FSA should ensure that firms either raise capital or take steps to restructure their business and balance sheets in ways that do not hinder lending to the real economy*." [223]

184. The public record of the Interim FPC meeting[224] (and the internal briefing papers prepared for that meeting)[225] do not record the Committee giving any consideration to the potential impact of this change in approach on mutuals, or banks like the Co-op that were owned by a mutual, and hence would have difficulty raising capital in response. This is not surprising given that the FPC did not at that time have any obligation to consult or undertake any formal impact analysis. I note, however, that since 1 April 2013, the FPC has been subject to section 9S (3) of the Bank of England Act 1998, which envisages that the FPC will consider the costs and benefits of complying with its recommendations and, unless considered impracticable, provide an estimate of those. The outcome of the FPC discussion was that the FSA took action to ensure the capital of UK banks and building societies reflected a proper valuation of their assets.

185. The FSA wrote to all Category 1 UK deposit takers (the eight largest UK banks and building societies, including the Co-op Bank, as well as a further thirteen high impact firms) setting out its expectations on loan loss provisioning. This letter was sent to the Co-op Bank on 20 December 2012.[226] The letter indicated that the FSA was keen to ensure that practices used to determine loan loss impairment were updated to reflect the current economic and market conditions. The purpose was to remind firms of the need to implement IAS 39 properly and to point out some of

---

[219] The accounting standard used by banks until the implementation of IFRS 9 on 1 January 2018.
[220] For example, ACCA, "*The future of financial reporting 2011: global crisis and accounting at a crossroads*", p.7, accessible at https://www.accaglobal.com/content/dam/acca/global/PDF-technical/financial-reporting/tech-tp-farsig11.pdf
[221] Eric Leman, "*Implementing the IFRS 9's Expected Loss Impairment Model: Challenges and Opportunities*", May 2015, accessible at https://www.moodysanalytics.com/risk-perspectives-magazine/risk-data-management/regulatory-spotlight/implementing-the-ifrs-9-expected-loss-impairment-model
[222] TSC Verde Report (see note 11), paras. 98-99. FSA Records, 15 November 2012.
[223] Bank of England, "*Record of the Interim Financial Policy Committee Meeting of 21 November 2012*", 4 December 2012, p.1, accessible at https://www.bankofengland.co.uk/-/media/boe/files/record/2012/financial-policy-committee-meeting-november-2012.pdf
[224] Ibid.
[225] FSA Records, 15 November 2012.
[226] FSA Records, 20 December 2012.

the implications of the economic climate at the time for a proper implementation. Firms were asked to ensure the content of the letter was taken into account in preparing 2012 and subsequent financial statements.

186. The evidence I heard from my conversations[227] indicates that the FSA did not expect the letter to result in significant changes to banks' provisions in practice. This turned out not to be the case for the Co-op Bank.

187. The expectations within the FSA's letter came as a surprise to the Co-op Bank,[228] causing it to review all of its corporate exposures which were: (i) over £0.5 million (totalling £2.5 billion); (ii) had forbearance (£230 million); or (iii) breached key metrics from the commercial real estate thematic review. The total book reviewed was £3.4 billion. The result was a dramatic increase in provisions in its 2012 accounts from £115 million to £469 million.[229] In its 2013 interim accounts, the Co-op Bank reported an increase in impairments to £496 million, of which the non-core book consisted of £330.5 million.[230]

Conclusions

188. This chapter has illustrated the broad remit of the supervision team during the Review Period; encompassing a range of group entities and a number of prudential and conduct supervisory issues in the context of a changing regulatory environment. The breadth and complexity of issues may have potentially diverted their focus from the most acute issues regarding the adequacy of the bank's loan loss provisions and the fragility of its capital position. This was before the Co-op Bank entered into negotiations with Lloyds on 'Project Verde', which proved to be a further significant distraction for both supervisors and the senior management of the Co-op Bank.

189. Despite being cognisant of the weak performance of the corporate loan book – predominantly emanating from the Britannia book – and the optimistic economic outlook of the Co-op Bank,[231] in my view, the FSA did not pay enough attention to refinancing risk, asset quality issues and the adequacy of provisions in the initial period following the merger.

190. Furthermore, I believe the supervisors at the time did not sufficiently address the latent re-financing risk within the corporate loan portfolio, despite recognising the issue and discussing it in many meetings with the bank. Moreover, perhaps in light of the limited in-house specialist resource available, too much reliance was placed on the findings of the independent risk reviews commissioned during this period (e.g. PwC credit book review in 2010)[232] and on the external auditor's reports (KPMG) provided to the FSA by the Co-op Bank.[233] Whilst the CRE visit in February 2012 reviewed the entirety of the CRE exposure, the FSA did not undertake a granular Asset Quality Review of the Co-op Bank's loan book until 2013.[234]

191. When the Co-op Bank is examined alongside its peers (as seen in Charts 2 and 3), the picture is somewhat obscured owing to the Fair Valuation Adjustments to Britannia's assets and liabilities that arose from the merger, but one might think at first glance that the Co-op Bank's loan performance indicators were not an outlier compared to peers before the second half of 2012. However those indicators were fairly crude and mainly focused on the current performance of loans and the adequacy of provisions in that context. Further, they did not take account of

---

[227] Meeting Transcripts B, pp.5-6 and P, pp.3-4.
[228] Meeting Transcript E, pp.5, 10.
[229] The Co-operative Bank plc, Financial Statement 2012, p.6 accessible at https://www.co-operativebank.co.uk/investorrelations/financialresults/previous-financial-results.
[230] The Co-operative Bank plc, Interim Financial Report 2013, p.3 accessible at https://www.co-operativebank.co.uk/investorrelations/financialresults/previous-financial-results.
[231] FSA Records, August 2011.
[232] FSA Records, 29 April 2010.
[233] FSA Records, 3 March 2010; 24 November 2010.
[234] FSA Records, 14 May 2013; 31 May 2013.

potential issues that may arise on a forward-looking basis, such as refinancing risk that would only emerge when a loan is renewed.

192. Unfortunately refinancing risk was more pronounced for the Co-op Bank than its peers and this was not fully identified until the findings of the cross-sector review of commercial real estate exposures were available in the first quarter of 2012. Furthermore, whilst the FSA did undertake analysis of the Co-op Bank's Wholesale book before 2012, there were a number of limitations to that analysis, and, as could be expected, the scope did not include Britannia's Retail books such as the high risk intermediary business.[235] Moreover, it is not clear, from the documentary evidence or from my conversations, that supervisors had enough information to distinguish between the credit-related Fair Valuation Adjustments versus the transitory interest-rate related Fair Valuation Adjustments (see Box 3 for an explanation of the difference).

193. In general I found little evidence of what today would be considered an appropriate degree of challenge of data by the supervision team, be it data produced by the firm, external auditors or third parties, particularly in the early part of the Review Period. What I have seen was in line with the accepted approach at the time and this situation was perhaps exacerbated for the Co-op Bank supervision team by particularly high staff turnover.

194. FSA executive and senior supervision management were aware of the underlying issues of the Britannia loan book at the time of the merger. The minutes of the June 2009 Executive Committee meeting, which provided in principle approval of the merger, record the request that the supervisors undertake a full Broom 'as soon as the resources allow'. This was indeed undertaken later that year, incorporating as a key strand of work a review of the wholesale lending books by the FSA's risk specialists but, as I have set out in paragraphs 163 to 169 above, the findings of the review were not fully followed up in the ensuing PwC report and the supervisory focus on loan quality appeared, at least for the time being, to have petered out with the 2010 capital review. With hindsight, it is possible that more could have been done by executive management to monitor the follow up but, as we have seen, this would have been outside the more strategic remit of the committee.

195. Whilst not conclusive in isolation, it could be argued that the level and breadth of the supervision team's workload, coupled with the suboptimal resourcing, may have compromised the ability of the supervision strategy to adequately mitigate on a timely basis the prudential risks that subsequently crystallised.[236]

196. In hindsight, perhaps the supervisors should have focused on one or two key acute issues before considering the more chronic longer-term issues. To use a medical analogy, doctors should always deal with acute issues first so that the patient lives long enough to address the chronic issues. The latter are moot if the patient dies. The point is that capital, provisions and liquidity are needed to ensure that a bank has the necessary resources to handle the consequences of decisions that have already been taken and are thus baked into the bank's balance sheet. In this case, it appears that many of the supervisory actions taken could not rectify inherent issues and could only affect future actions of the bank e.g. risk management decisions going forward would have more controls. How the approach has since developed is covered below in paragraph 200.

197. The capital raising in 2010/11 was a short-term fix and went only part of the way to addressing the shortfalls exposed by the 2009 stress tests.[237] However, with the knowledge of the stress test results, and given the increasingly clear direction of travel towards higher capital requirements and more stringent future loan loss provisioning expectations for banks, I firmly believe that there should have been a greater focus by FSA senior supervision management and

---

[235] See paragraphs 157 to 164.

[236] PRA Records, August 2018.

[237] Meeting Transcript A, p.4. The intention – with the sale of general insurance £250m and other capital injections in 2009/10 of £360m – was to raise in excess of £500m.

the supervision team on reviewing the quality of the loan book and its valuation and ensuring adequate capital was in place to cover potential losses. The fact that the Co-op Bank's capital raising options were limited, given the mutual status of its parent, should have made capital planning more of a focus.

198. As part of my review I have also considered whether the messages within the December 2012 FSA letter could have been conveyed differently when the impact, although not known in advance, materially affected an institution that had no ability to raise capital without ceasing to be a wholly mutual owned institution.

199. That led me to consider whether it would have been more appropriate to have raised the messages within the letter bilaterally with the firm in advance, before the 'public' pronouncement. However, the evidence I heard in the course of my conversations indicated that the letter represented a conscious decision by the then FSA executive management to implement the recommendations of the BoE and Interim FPC.[238] It also raises the question of whether a different communication approach should have been considered for the mutuals; for example, discussing the matter with them in advance to allow more time to consider the changes before the letter was sent. Regardless of the mode of delivery, the increased transparency on provisioning in UK deposit takers' published accounts that resulted from the Interim FPC recommendation was instrumental in exposing the issues around the valuation of assets, which as a consequence led to the public disclosure of the capital shortfall at the Co-op Bank.

Lessons learned and recommendations for the future

200. A key lesson to be drawn from this period is that supervisors should focus more on the key urgent priorities for a bank, and not necessarily follow the standard process of supervision when the firm is at risk or nearing risk of entering a crisis situation. Since 2013, PRA policy provides that if supervisors have a just reason, they can be flexible between the 'core' and 'discretionary' requirements agreed at the annual 'stocktake' meeting (Periodic Summary Meeting). This is subject to ensuring that a regulated firm respects any legal minima such as the capital requirements stipulated by the Capital Requirements Regulation.[239] The PRA should ensure that this flexibility is maintained, particularly when a regulated firm's capital or liquidity position is weak and needs to take priority over more chronic issues.

201. Since 2012, supervisors have focused on a small number of key risks when conducting their formal risk assessments of a firm.[240] The subsequent communications with a firm have also focused on those key risks, and the resulting feedback from firms and independent research[241] shows that the PRA letters are more direct with stronger language and a focus on the key risks. This should help firms' Boards to tackle any weaknesses highlighted by the Regulator. The Senior Managers and Certification Regime (SM&CR), introduced for banks in 2016, also helps to increase accountability of senior management and the PRA intends to assign firms' senior managers to be accountable for actions in letters to the largest UK deposit takers.

202. Subsequent formal risk assessment letters from the FSA to the bank in June 2012[242] (and letters relating to Verde (June and December 2011))[243] highlighted the key risks on which the Co-op Bank should focus. This supports my view that messages became clearer and more direct

[238] Meeting Transcript G, pp.8-9.
[239] Regulation (EU) No.575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.
[240] This coincides with Internal Twin Peaks.
[241] See Bank of England Staff Working Paper No. 688, "*Sending firm messages: text mining letters from PRA supervisors to banks and building societies they regulate*", October 2017, accessible at https://www.bankofengland.co.uk/working-paper/2017/sending-firm-messages-text-mining-letters-from-pra-supervisors-to-banks-building-societies
[242] FSA Records, 1 June 2012.
[243] FSA Records, 22 June 2011; 20 December 2011.

during the Review Period, however, I found that the tone of the dialogue was not always consistent across all levels of the regulator.[244] Therefore it appears that some lessons have already been learned. However, the PRA should ensure that its messages to firms are consistent at all levels.

203. I commented earlier that the breadth of responsibilities for supervisors during this period may have resulted in a lack of focus on the key issues. Changes have been made since then, predominantly the split of conduct and prudential supervision. While PRA supervisors maintain close contact with their FCA counterparts, they can focus on the key prudential risks facing a firm. The maintenance of that close dialogue with the FCA is especially important given the prudential impact of conduct failures and I have already noted the importance of taking conduct risk into account in stress testing and when setting capital requirements (Chapter 2, paragraph 131).

204. Another change since the Review Period is that insurance subsidiaries are now supervised alongside other insurance firms within the PRA, so that entities can be assessed against comparable peers. In my view, this has been a successful change and helps ensure that supervisors have the appropriate skills and resources available to do their job better.

205. Asset Quality Reviews are now a key supervisory tool for the PRA. In May 2017, the PRA agreed to the establishment of a programme of Asset Quality Reviews and coverage of major UK banks' balance sheets on a rolling three year basis. The Supervisory Risk Specialists division now has the skills and resources to undertake these reviews in-house, whereas during the Review Period, supervisors were required to supplement internal capabilities with instruction of third parties to undertake independent reviews of firms' loan books. This is a major improvement that should help avoid a repeat of some of the challenges that plagued the Co-op Bank supervisors on this front.

206. In terms of improvements made to the way capital is assessed for the largest UK banks and building societies, there are a number of features now established to enhance supervision. These include annual capital reviews; a supervisory 'Capital Day' to increase peer analysis and challenge from senior supervision management;[245] and the formation of a 'Capital Working Group' to increase knowledge sharing between supervision teams and provide the opportunity for policy specialists to discuss issues with supervisors at a working level.

207. The ability of PRA front-line supervisors to access specialist resources has also expanded since the Review Period. Some examples include:

    a. The PRA's Accounting team works closely alongside supervisors (of the major UK deposit takers) to offer expert support on accounting and audit matters. It was also noted, by one of the individuals with whom I met from the private sector, that there is now more challenge from the PRA to supervised firms and audit firms.[246] From its commencement in April 2013, the PRA adopted the FSA Code of Practice for the relationship between auditors and supervisors which specifies a minimum frequency of one meeting per annum for Category 1 and 2 firms. The Code had been adopted by the FSA in 2011.

    b. Written Auditor Reporting[247] now formalises the topics on which the PRA would like the auditors' views and requires external auditors of the largest UK banks and building

[244] Meeting Transcript E, p.2.
[245] This is aimed at the largest UK deposit takers and as such does not currently include the Co-op Bank.
[246] Meeting Transcript J, pp.3-4.
[247] Bank of England Policy Statement 1/16 "*Engagement between external auditors and supervisors and commencing the PRA's disciplinary powers over external auditors and actuaries*", February 2015, accessible at https://www.bankofengland.co.uk/prudential-regulation/publication/2015/engagement-between-external-auditors-and-supervisors-and-commencing-the-pras-disciplinary-powers

societies (defined as being with a balance sheet in excess of £50 billion) to provide written submissions on an annual basis.

c. Capital specialists are now embedded within the supervision teams for the major UK deposit takers.

d. Prudential Risk Specialists – the 'Risk Specialists' division has grown in size since the Review Period and, as a result, a number of in-depth firm reviews can now be conducted in-house.[248]

208. Again, these are welcome developments that should alleviate some of the challenges that plagued front-line supervision teams during the Review Period.

209. The most significant change to international financial reporting standards (IFRS) has been the implementation of IFRS 9, which came into force from 1 January 2018. IFRS 9 is part of a G20 commitment to implement a forward-looking loan impairment model, addressing concerns that the previous "incurred loss" approach did not allow adequate provisions to be made. The main change for banks is the introduction of an expected credit loss model which requires firms to enhance credit risk practices and governance, so as to promote an earlier identification of losses.

210. Further to my comments in paragraph 151, I was keen to understand the extent to which supervisors were aware of – and took account of – forthcoming policy developments during this period. It was evident from my conversations[249] that there was perhaps insufficient guidance from executive management to ensure supervisors were sufficiently aware of, and took account of, forthcoming policy changes, during the Review Period.

211. All supervisory divisions now have a central function (usually including a 'policy' lead) to ensure that supervisors are informed of upcoming policy developments through regular emails, learning lunches and/or specific briefing sessions. Many supervisory areas have also established working groups which include the relevant Policy representatives so that the supervisors are involved throughout the policy lifecycle; in policy development – at the early stage before policy is finalised; policy implementation – ensuring firms implement the policy as intended; and policy evaluation – which is increasingly important on the PRA's agenda. While supervisors obviously need to be made aware of key policy initiatives and their implications, leadership and support from top is needed to ensure a consistent approach across supervisory teams towards adjusting supervisory plans accordingly. This leads me to my next recommendation.

212. **Recommendation: The Prudential Regulation Committee and the executive management of the PRA should continue to play a leading role in ensuring that supervisory strategies for individual firms proactively take account of emerging regulatory developments.**

213. This cannot be done solely at discretion of supervisors. Furthermore, the PRA should ensure that this knowledge transfer is tested and validated on an ongoing basis.

214. I also believe there should be continued focus on ensuring supervisors file their records of meetings with firms. I found some discrepancies during my review of the historic events, and in particular I was surprised at the paucity of records of engagement between senior supervision FSA management and the Co-op Bank. It was unclear if this indicated that such contact was infrequent or that the record was incomplete. The record of senior level meetings was notably fuller in the latter part of the Review Period. Supervisors now have to complete a 'Note for Record' within a certain time period following a firm meeting and adherence to this requirement is monitored by senior supervision management. The PRA's records management system (FileSite)[250] has improved the ability to store documents with the appropriate security

[248] PRA Records, 12 October 2017.
[249] Meeting Transcripts A, p.4 and M, p.2.
[250] FileSite replaced for the PRA the 'Livelink' system used by the FSA.

classifications, in line with the BoE records management policy. However, my experience with this review makes me question how easy it is to access information when time has passed. Supervisors also use a new 'supervisory desktop' system called Risk and Work Manager to track progress of their firms' outstanding risk mitigation actions. The PRA should ensure that the use of this system is fully embedded amongst all its supervisors and that the information within it is used by its senior management.

215. As noted in paragraph 143, I experienced challenges in obtaining consistent data across institutions, in particular regarding the historical fair valuation adjustment data. In my view, a judgement-based regulator such as the PRA should be able to access consistent cross-bank data.

216. Further to paragraph 184, I would observe that while conducting impact assessments is now a standard procedure for the PRA and the BoE more broadly when contemplating the introduction of new regulatory or macro prudential measures, this episode underscores the importance of considering how the PRA and the BoE can best help those firms adjust to the new measures. This is especially warranted for firms that do not have ready access to new capital or liquidity.

Chapter 4: Change in accounting treatment for the Co-op Bank's IT platform

Extract from HMT Direction:

3.—(1) The Investigation must assess the actions, policies and approach of the FSA and the PRA as the institutions with statutory responsibility for the prudential supervision of the Co-op Bank for the period 1st May 2008 to 22nd November 2013.

(2) The investigation must focus on —

…

(f) whether the FSA was made aware by the Co-op Bank of the change in the accounting treatment of the cost of the replacement of the Co-op Bank's IT platform that took place in 2010, and if it was, whether the FSA should have acted to postpone the effect of the IT programme on the Co-op Bank's capital position;

…

217. Point (f) of the Direction asks whether the FSA was made aware by the Co-op Bank of the change in the accounting treatment to the cost of the replacement of the Co-op Bank's IT platform that took place in 2010; and if it was, whether the FSA should have acted to postpone the effect of the IT programme on the Co-op Bank's capital position.

218. I address whether the FSA was made aware of the change in accounting treatment in paragraph 229 below. But there is still the issue of whether the FSA should have acted to postpone the effect of the cost of replacement of the IT platform programme on the Co-op Bank's capital position, given that the IT system was no longer useful and thus had to be written off from an accounting standpoint. Here, I think it would have been imprudent for the regulator to exercise forbearance and to filter out those write-downs when computing regulatory capital for the bank; otherwise the Co-op Bank's regulatory capital position would have been overstated by assets that no longer had any economic or accounting value. That would be especially imprudent for a bank that had a weak capital position to start with and which was struggling to absorb a large increase in its loan loss provisions.

219. When I looked back at the TSC deliberations on this issue I think there might be a small mis-statement in the Direction. Instead, I think the question should be whether the FSA should have acted to bring forward the capital impact of the IT renewal programme.

220. This chapter thus proceeds on that basis and considers the extent to which the FSA was advised of the change in the accounting treatment, and if so, whether it challenged and probed the impact of that change on the Co-op Bank's capital position. I have not investigated whether this or any other accounting treatment adopted by the Co-op Bank during the review period itself was appropriate.[251]

221. Regulatory and accounting treatments often diverge. Regulatory capital calculations are generally based on more prudent assumptions than those used to prepare going concern financial accounts and this in itself is not controversial. The treatment of intangible assets is one example: it has long been standard regulatory practice to deduct intangible assets when

---

[251] At the same time as this Review, The Financial Reporting Council (FRC) launched an investigation under the Accountancy Scheme into the preparation, approval and audit of the financial statements of The Co-operative Bank plc, up to and including the year ended 31 December 2012. See note 13.

calculating a bank's regulatory capital position.[252] This is because such assets too often prove to be of ephemeral value when a bank encounters stress and needs to be resolved quickly. They are thus of limited value when it comes to protecting the depositors and creditors of a bank.

The Co-op Bank did signal the change in accounting treatment to the FSA back in 2010

222. The IT renewal programme involved the replacement of the Co-op Bank's core banking IT system and it was expanded post-merger to incorporate integration with Britannia's systems. The programme was initiated in 2006 and continued, with sporadic progress, until 2013, at which time the programme was terminated.

223. I have set out the chronology for the development of the Co-op Bank's IT renewal programme below, using the Kelly Review[253] as a guide:

Table 8: Chronology for the Co-op Bank's IT renewal programme

Year	Event
2006	Co-op Bank investigates options for upgrading core banking system
2007	Co-op Bank issues Request for Information to potential providers and determines high-level scope of 'Enterprise Platform'
2008	After shortlisting two providers, Co-op Bank selects Infosys' product 'Finacle' to provide Enterprise Platform solution (i.e. to go wider than purely core banking system).
2009	Merger with Britannia, Infosys selected as systems integrator. Costs of the IT renewal programme reside in a management services company (CFSMS) within the Group
2010	Co-op Bank changes approach and funds IT renewal programme through a loan to CFSMS (intangibles not on the bank's balance sheet so no capital deducted)
2011	Re-platforming programme incorporated within wider Banking Transformation Programme (BTP)
2012	IT renewal programme paused
2013	IT renewal programme cancelled Intangibles brought back onto balance sheet of the Co-op Bank (significant capital deduction)

224. From the outset, the Co-op Bank chose to finance its IT renewal programme through a separate sister entity, Co-operative Financial Services Management Services (CFSMS). Like the Co-op Bank, CFSMS was a wholly owned subsidiary of Co-operative Banking Group (known as Co-operative Financial Services Limited (CFS) until September 2011), whose ultimate parent

[252] Basel Committee on Banking Supervision, "*International Convergence of Capital Measurement and Capital Standards*", July 1988, p.7, accessible at https://www.bis.org/publ/bcbs04a.pdf
[253] The Kelly Review (see note 9), p.54; Exhibit 22 and paras.11.23-11.27.

company was the Co-operative Group Limited.[254] In October 2010, the Co-op Bank changed its approach to capital management with regard to this IT programme.

225. CFSMS was used for a significant proportion of the administrative expenses (including property costs and payroll) of both the Co-op Bank and the insurance businesses.[255] It is not unusual to use a separate service company to manage operational expenses within a group structure. As noted by Sir Christopher Kelly, the Co-op Bank may initially have decided that CFSMS should fund the re-platforming programme in a belief that the programme would benefit both the bank and insurance businesses.[256] However, over time these benefits subsequently transferred solely to the bank.

226. Accounting standards on intangible assets (IAS 38) require the cost of the IT development, where relevant criteria are met, to be capitalised on the firm's balance sheet and subsequently amortised on a systematic basis over the useful life of the IT system once the system is operational. This means the cost of the IT system is offset against the benefits realised in using the IT system. The initial, upfront cost is not taken through the profit and loss account (P&L) thus reducing the impact on retained earnings. Where it comes to light that the actual future benefits to be derived are less than the remaining carrying value of the IT system, the intangible asset is deemed impaired and written down to its recoverable amount, with the impairment charge taken through P&L.[257]

227. By 2010 it was considered that the costs would reach such a level that to continue to fund it through CFSMS would breach intra-group lending limits and therefore the costs of the project would then be transferred to Co-op Bank to fund. However, in October 2010 the Co-op Bank took the decision that the costs of the IT programme would continue to be kept within CFSMS and the Co-op Bank itself would provide funds by way of a loan to CFSMS to allow this to happen.[258]

228. Had the Co-op Bank funded the IT programme itself, the intangible asset would have been on the Co-op Bank's own balance sheet, growing as it developed, and so deducted as part of bank's regulatory capital calculation throughout this period. This would be in accordance with the definition of regulatory capital principles contained in the Basel III Capital Accord and their implementation in EU law through the Banking Consolidation Directive (BCD)[259] and later the Capital Requirements Regulation.[260] However, since the asset was on the CFSMS balance sheet, no such deduction was made, even though the continuing reality was that the Co-op Bank bore the costs through a loan from the Co-op Bank to CFSMS. So instead of an intangible asset on the Co-op Bank's balance sheet that would have been deducted from capital, there was a tangible asset in the form of a receivable from CFSMS (which improved the bank's short term capital position). The full impact on capital was seen only in 2012/2013 once the project was cancelled and the costs written off.[261]

229. This was first raised in a call with a member of the Co-op Bank supervision team in October 2010[262] and followed up in a routine meeting with members of the supervision team in December

[254] TSC Verde Report (see note 11), para.151. See Co-operative Group structure chart at Appendix 4.
[255] The Kelly Review (see note 9), para.11.23.
[256] Ibid.
[257] TSC Verde Report (see note 11), para.155; PRA Records, August 2018.
[258] The Kelly Review (see note 9), para.11.27; PRA Records, August 2018.
[259] Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (BCD 2006/48), at articles 57 and 80 and Annex VI.
[260] Regulation (EU) No.575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, article 36.
[261] The TSC Verde Report (see note 11), paras.148, 151 and 155.
[262] FSA Records, 1 October 2010.

2010.[263] On both occasions, I did not find any evidence from either written documentation or from my conversations with the relevant supervisors that they probed this treatment or understood that this book entry served to change the short-term effects of the project on the bank's capital without changing the economic substance. In fact, I suspect that members of the supervision team, who as noted in Chapter 3 were busy with many other pressing issues, took comfort from the fact that the Co-op Bank would not directly fund its portion of the IT expenditures while the system was under development.

230. This evidence is contrary to the findings of the Kelly Review[264] which were included in the TSC Verde report. As outlined above in paragraph 229, I was able to uncover evidence that this change was in fact raised with the FSA on two occasions. However the focus of those discussions was on 'related party lending limit' issues, not capital. This was a distinctly separate concern, regarding the impact of the transaction in terms of the large exposure regime; it appears that there was no consideration given to the potential future impact on the bank's regulatory capital position.

231. Furthermore, the below extract from the Note for Record from the October 2010 phone conversation reinforces that, based on information provided by the Co-op Bank, the supervision team did not have a full understanding of how the IT programme was funded, because it was already within CFSMS. The Group was considering moving it to the bank but instead decided to fund it via a loan from the bank to CFSMS, something that it does not appear was understood:

"Paying for BTP & change through CFS Management Services. CFSMS is the central operations business that owns CFS staff and fixed assets. It is run to break even, charging out use of staff and facilities to the businesses. Currently BTP costs are going through the bank, but the bank noted that it would be consistent for them to be put via CFSMS. Given the impact of deductions for intangible assets this could prevent the erosion of ca. £150 million of capital in the bank over the next 2-3 years."[265]

232. In the December 2010 meeting between the bank and the FSA supervision team, 'Banking Transformation Programme' funding was on the agenda. The FSA's written plan for this meeting[266] expressed the need to clarify the funding position and associated impact on the bank's capital position. The minutes of that meeting state:

"The cost of capitalising the Banking Transformation Programme will be treated as an intangible funded by CFS Management Services, which will avoid hitting Co-op Bank's £700m Related Party Lending Limit."[267]

233. The FSA was also sent the "CFS Corporate Plan 2011-13" and "CFS Annual Plan 2011" on 23 December 2010 by email.[268] Both documents explicitly refer to the change in plan to fund the BTP project through CFSMS to improve the Bank's capital position although neither make plain the current status of the project funding and, at that stage, the proposals were yet to be finalised. Each stated:

"Alternative funding of BTP by non-regulated Group company (cumulative £250 million CT1 in 2013). The current planning assumption is that BTP intangible spend is funded by the Bank, giving rise to a deduction from capital of the carrying value of the asset. BTP is the only asset within the CFS Group assumed to be funded by the Bank; due to restrictions (under related parties lending limits) on the ability of the Bank to lend to CFS Management Services (CFSMS), which in turn means that BTP assets cannot entirely be funded by CFSMS as is the case with other CFS tangible and intangible assets. If capacity were released against this limit by not

---

[263] FSA Records, 8 December 2010.
[264] The Kelly Review (see note 9), para.11.28.
[265] FSA Records, 1 October 2010.
[266] FSA Records, December 2010.
[267] FSA Records, 8 December 2010.
[268] FSA Records, 23 December 2010.

rolling a repo transaction between the Bank and CIS and selling down in 2011 a £100 million tranche of the Co-operative Group syndicated loan, with a further £50 million sell down required in 2012 (to be finalised with Group following initial discussions), a loan of £200 million could be made from the Bank to CFSMS to enable CFSMS to fund BTP, removing the intangible deduction from the Bank regulatory capital. This treatment would bring BTP in line with other CFS asset classes."[269]

234. An FSA risk assessment background document dated 11 January 2011, states:

"Alternative funding of the Business Transformation Programme by non-regulated Group company (cumulative £250 million CT1 in 2013) – the current planning assumption is that BTP is funded by the Bank, giving rise to a deduction from capital, a loan of £200 million could be made from the Bank to CFSMS to enable CFSMS to fund BTP removing the intangible deduction from the Bank regulatory capital."[270]

235. This shows that the supervision team was aware of the proposed treatment but did not look beyond the separate point of the large exposure limits to consider the impact on the bank's capital position. Supervisors told us that at the time, there was limited access to specialist accounting support for supervisors[271] and it was not standard practice for supervisors to review in detail firms' audited accounts.

236. The information provided to the FSA by the Co-op Bank's external auditors (KPMG) in 2010 shows that the intangibles were discussed between the auditor and regulator. However, this discussion was in relation to their carrying value and potential impairment, not about the issue of to which entity the assets were booked nor whether this was appropriate from a regulatory capital perspective.[272]

237. The 2012 CFSMS accounts state:[273]

"The Company holds intangible assets of £237.7 million (2011 £326.5 million). These assets consist of computer software of £105.1 million (2011 £107.4 million) and assets in the course of construction of £132.6 million (2011 £219.1 million). The intangible assets primarily relate to the Group's ongoing implementation of a new core banking system and supporting infrastructure. During the year, a £150.0 million impairment charge has been recorded against this asset. This impairment was recharged to The Co-operative Bank plc…"

238. In late 2012, despite some internal reservations about the new IT platform for the Co-op Bank,[274] regardless of the outcome of the Verde transaction, the Co-op Bank decided not to fully write off the IT platform and instead opted only to make a £150 million provision for it in its financial statements for the year ended 31 December 2012.[275] This avoided a further loss and Core Tier 1 capital reduction at the 2012 year-end, although would have still had the indirect effect of reducing future available capital.

239. In 2013, the IT renewal programme was cancelled and in the same year the costs were brought back onto the Co-op Bank's balance sheet and the intangibles were deducted from the bank's

[269] FSA Records, December 2010.
[270] FSA Records, 11 January 2011.
[271] Meeting Transcripts A, p.8, C, p.13 and L, p.7.
[272] FSA Records, 3 March 2010; 24 November 2010.
[273] CFS Management Services Limited, Financial Statements 2012, p.1, accessible at https://beta.companieshouse.gov.uk/company/05564787/filing-history?page=3
[274] Meeting Transcript H, p.7.
[275] The Co-operative Bank plc, Financial Statement 2012, p.6, accessible at https://www.co-operativebank.co.uk/investorrelations/financialresults/previous-financial-results.

capital.[276] Unfortunately this eventuality had not been anticipated by the FSA at the outset in 2010,[277] though the evidence shows it was part of their considerations by July 2012.[278]

240. The Co-op Bank wrote off the remaining £148.4 million of IT expenditures in its financial statements for period-ended 30 June 2013.[279]

241. In summary, had the Co-op Bank supervision team understood the capital implications of the accounting treatment for the IT expenditures in 2010, it could have applied a stricter approach to deductions insofar as it was permitted to do so by EU regulatory capital requirements[280] and insisted the bank deduct those IT expenditures from capital as they were incurred, which may have led to greater scrutiny of the project by the Co-op Bank and caused an earlier decision to curtail investment. This would not have changed the ultimate impact of the project on the Bank, but would have saved the Co-op Bank from having to take the large write-offs in 2012 and 2013 at a time when it was absorbing its large credit losses.

Conclusion

242. It is clear that the Co-op Bank supervision team was aware, both from conversations with the Co-op Bank and via corporate plans provided by the Co-op Bank, of the accounting treatment for the IT expenditures. I could not find any documentation indicating that this approach was questioned by the FSA in 2010 and my conversations with former FSA supervisors and former Co-op Bank staff confirmed that there was no challenge to the treatment at that time. One reason might be because the relevant supervisors did not consider how the risks/rewards could play out in economic terms; that would have argued for the bank to continue deducting the expenditures from capital for regulatory purposes, regardless of where they were booked from an accounting standpoint.

243. This (and the evidence gained from our conversations) suggests that members of the supervision team were made aware of the Co-op Bank funding the IT renewal programme through CFSMS, albeit not explicitly and under the auspices of related party lending limits; however in my opinion, and with the benefit of hindsight, those supervisors did not sufficiently probe the capital implications of this treatment.

244. Furthermore, I could not find any documentation that explicitly states that the FSA was in agreement with the capital treatment of the IT renewal programme. The Co-op Bank did not point the supervisors to specific documents and FSA staff denied that such approval was given. Both the Co-op Bank and the auditors were of the belief that the FSA did not object to the treatment, albeit this was because the supervisors were told about it and did not object or raise concerns.[281] The supervision team was in a position to query the impact of intangibles in the 2010, 2011 and 2012 Co-op Bank accounts, but did not do so.

245. During my conversations,[282] the supervisors commented that they were not sufficiently trained or alert to such issues as accounting for intangibles.

246. Having said that, had the supervisors been more attuned to the impact of the treatment of intangibles when this was raised by the bank in 2010, and ensured appropriate treatment in the

---

[276] The Co-operative Bank plc, Interim Financial Report 2013, p.30, accessible at https://www.co-operativebank.co.uk/investorrelations/financialresults/previous-financial-results.
[277] Meeting Transcript L, pp.4-6.
[278] FSA Records, 13 July 2012.
[279] PRA, "*Final Notice to The Co-operative Bank PLC*", 10 August 2015, pp.18-19, accessible at https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/enforcement-notice/en110815. See the narrative of these changes in this notice.
[280] BCD Directive 2006/48/EC.
[281] Meeting Transcripts E, pp.6-7 and J, p.2.
[282] Meeting Transcripts C, pp.13-14 and L, p.7.

regulatory capital calculations, there would not have been such a dramatic impact on the capital of the Co-op Bank in 2013, when the IT renewal programme was eventually cancelled.

Lessons learned and recommendations for the future

247. Front-line supervisors are by nature generalists and dependent upon specialist support. However, their ability to call on and use effectively the specialist accounting support available to them depends on them being able to understand the relevance and significance of what they know and in this case they did not fully understand the implications of the way the IT costs were being treated for the regulatory capital position. Improvements in training have since been made and since 2011 there has been mandatory contact at least once a year between the supervisors, the firm and external auditors. Furthermore, the establishment of Written Auditor Reporting, whilst still evolving, goes some way to exposing supervisors to the key risks, as perceived by the auditors, facing the largest UK deposit takers.[283]

248. As an example of improved practice since the Review Period, although not applicable to the historic IT costs issue at the Co-op Bank, IFRS 9 is a significant recent development in global accounting standards that has given even greater prominence to accounting issues within prudential regulation. The PRA has established points of expertise within the supervision divisions in addition to providing training to supervisors. Whilst the impact of IFRS 9 has still to be fully embedded in day to day supervision, it is possible that this will represent a step change in supervisors' engagement with accounting issues.

249. However, the financial system is even more complex now than in the Review Period and the rules are much more stringent. Thus, I believe there are now greater incentives for firms to try to circumvent at least the spirit of the requirements, and these incentives may continue to grow with the introduction of Structural Reform[284] as group structures become even more complex. The Co-op Bank at least gave some indication of its plans to the FSA when it changed its planned accounting treatment for its IT expenditures. Other banks may not be quite as forthcoming in the future. This brings me to my next recommendation.

250. **Recommendation: The PRA should continue to pay close attention to any attempts by banks to circumvent regulatory and supervisory requirements and focus on the economic substance of transactions, not their accounting treatment or how they are funded.**

251. To its credit, the PRA has established an internal cross-Bank working group to try and monitor and mitigate attempts by PRA-authorised firms to circumvent prudential requirements. Within the PRA, this is supported by work to collect evidence of the effects of regulations on any new risks faced by individual banks by pooling intelligence gathered in different parts of the Bank as part of a horizon scanning process. Recent examples of their work have been mentioned in speeches by Sam Woods in May 2017[285] and Victoria Saporta in July 2018.[286] Nevertheless, this is an important issue that will continue to plague regulators and supervisors, and they will need to make sure they fully understand the broader group structures within which banks operate. Thus, I encourage the PRA and the BoE more generally to not let down their guard.

252. Even if banks do not seek to overtly circumvent requirements, the growing complexity in requirements may give rise to a greater frequency of data reporting errors as banks strive to

---

[283] Meeting Transcript B, p.8.
[284] The Vickers Commission (see note 37), p.9.
[285] Bank of England, Speech by Sam Woods, "*Looking both ways*" , text published 10 July 2017, accessible at https://www.bankofengland.co.uk/-/media/boe/files/speech/2017/looking-both-ways.pdf?la=en&hash=2937652C00CD056E3632841A7078723CF8C12E9F
[286] Bank of England, Speech by Victoria Saporta, "*Prudential bank regulation: present and future",* text published 4 July 2018, accessible at https://www.bankofengland.co.uk/-/media/boe/files/speech/2018/prudential-bank-regulation-present-and-future-speech-by-vicky-saporta.pdf?la=en&hash=F85C7BD791E8463C18D3BA6C803E36A8A96911B7

collect and produce regulatory data in accordance with the new regulatory requirements. This leads me to recommend:

253. **Recommendation: The PRA should consider introducing more formal third-party reviews of key prudential information supplied by banks through their regulatory data returns.**

254. There is a precedent for the larger Solvency II[287] insurance firms, where external auditors are required to provide an opinion on the Solvency and Financial Condition Report (the publication of which is required under Solvency II) and that opinion must be publicly disclosed in accordance with the PRA rules.[288]

255. This should not displace supervisory reviews of bank data. However, I believe the need for more formal assurance will only continue to rise in a world of growing complexity of capital and liquidity calculations. Requiring such assurances may also have the salutary benefit of injecting more rigour and quality into risk and liquidity data aggregation by banks, something which I understand has been a festering concern for many years.[289] In this instance, the regulatory reporting was accurate, and what would have been helpful would have been some commentary on any areas where the treatment taken by an institution differs from the norm or in some sense is applying the letter of the rules over their spirit.

256. I believe the largest global banks still have some way to go with regard to risk data aggregation which, as echoed in an article from July 2018,[290] in today's world of risks from cyber-attacks and economic downturns, should in fact be a high priority.

---

[287] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance.
[288] PRA Rulebook, "*External Audit*", accessible at http://www.prarulebook.co.uk/rulebook/Content/Part/321289/04-12-2018
[289] Meeting Transcript B, p.7.
[290] Financial Times, "*Banks' approach to risk data is deeply inadequate*", 15 July 2018, accessible at https://www.ft.com/content/bafe5844-867f-11e8-9199-c2a4754b5a0e (with subscription)

Chapter 5: The Verde transaction

Extract from HMT Direction:

3.—(1) The Investigation must assess the actions, policies and approach of the FSA and the PRA as the institutions with statutory responsibility for the prudential supervision of the Co-op Bank for the period 1st May 2008 to 22nd November 2013.

(2) The investigation must focus on—

…

(g) whether the FSA should have intervened on prudential grounds to halt the Co-op Bank's bid to acquire 632 branches from Lloyds Banking Group, known as "Project Verde"; and

(h) the record held by the interested parties of contacts between the seller, the bidders and the interested parties relating to the Verde bid.

257. This chapter considers points (g) and (h) raised in the Direction. Although both points relate to Project Verde, they are otherwise independent of each other.

FSA acted appropriately in not intervening to halt the Co-op Bank's bid

258. The Verde transaction, the proposed acquisition of 632 branches from Lloyds, was under consideration from early 2011 to April 2013; a saga that finally closed with the formal withdrawal by the Co-op Bank from the bidding process in the wake of the large losses announced in its 2012 annual results. This leads naturally to the question raised by the TSC of whether the bid should have been halted at an earlier stage.[291]

Chronology of Verde

259. Other reports, including that by the TSC, set out the events of the Verde bid. I will for completeness reiterate here the key points from the perspective of the FSA's role in the bid process. See the below timeline for a summary.

[291] I note that it was technically the Co-operative Group that was the bidding company, but for consistency with the TSC Verde Report and the Direction, I will continue to refer to the Co-op Bank for the purposes of this chapter.

Table 9: FSA's role in the Verde bid process:

Date	Event
February 2011	Credit Suisse brings deal to Co-op
May 2011	Co-op Bank discloses its interest in the Lloyds branches to the FSA
June 2011	FSA sets out in writing its concerns to Co-op Bank
July 2011	Co-op Bank makes indicative bid of £1.75 billion
Nov 2011	Co-op Bank makes second bid of £600 million
Dec 2011	FSA writes to Co-op Bank re-enforcing its concerns, following consideration by Executive Committee. Letter and response shared with Lloyds. Lloyds names Co-op Bank as preferred bidder – grants exclusivity from January 2012
April 2012	Co-op Bank withdraws from bid
Q2 2012	Co-op Bank and Lloyds re-negotiate terms
June 2012	Lloyds announces Co-op Bank as preferred and exclusive bidder, with bid restructured on revised basis
July 2012	Heads of Terms signed
April 2013	Co-op Bank withdraws bid

260. In 2009, the European Commission set out a requirement for Lloyds to divest a substantial part of its business.[292] The Independent Commission on Banking under Sir John Vickers also recommended in September 2011 that the Verde divestment should lead to a strong challenger with at least a 6% share of the personal current account market.[293]

261. After extensive planning and further negotiation with the Commission the process began in earnest in April 2011, although Credit Suisse, advisors to Lloyds, had first contacted the Co-op Bank in February.[294] From the Co-op Bank's perspective, the strategic imperative remained to achieve scale. Verde, with Lloyds' position as effectively a 'forced seller', presented a rare opportunity to further increase its scale in a major way; even if it was one that arose sooner than was ideal,[295] given the continuing work on completing the Britannia integration.

262. The Co-op Bank disclosed to the FSA its interest in acquiring Lloyds branches in May 2011, noting there was a requirement to announce a deal in 2011, though suggesting that completion could be much later.[296] This timeframe was important, because of the FSA's view that the Co-op

---

[292] Press Release by European Commission, "*State aid: Commission approves restructuring plan of Lloyds Banking Group*", 18 November 2009, accessible at http://europa.eu/rapid/press-release_IP-09-1728_en.htm
[293] The Vickers Commission (see note 37), para.8.25.
[294] TSC Verde Report (see note 11), para.18
[295] Meeting Transcript H, p.6.
[296] FSA Records, 26 May 2011.

Bank was already fully engaged on its Banking Transformation Programme and other integration projects.[297]

263. In June 2011, the FSA wrote to the Co-op Bank setting out its view of the main challenges in the key areas that the bank would have to address in executing the transaction: [298]

    a. Capital raising;

    b. Funding;

    c. Integration;

    d. Governance and risk management.

264. These messages were reiterated by the FSA in a face-to-face meeting with the Co-op Bank Board in July 2011.[299]

265. In October 2011, Lloyds announced that it had three confirmed bids and the following month the Co-op Bank presented to the FSA on their approach to the project.[300]

266. In December 2011, FSA executive management considered the Co-op Bank's proposal.[301] The areas of focus remained consistent with the communication with the Co-op Bank in June and July of that year. The FSA expressed concern about the Co-op Bank's ability (i) to successfully complete the transaction; (ii) to integrate and manage a business of this size; and (iii) to reach a suitable financial position to undertake the transaction. These views were promptly conveyed to the Co-op Bank senior management verbally[302] and in writing a week later setting out the FSA's view that "it is not clear that the Co-operative Banking Group has the ability to transform itself successfully and sustainably into an organisation on the scale that would result from acquiring the Verde assets".[303] Both this verbal feedback and the subsequent correspondence between FSA and the Co-op Bank were conveyed by the Co-op Bank to Lloyds at the FSA's request.[304]

267. Whilst the Co-op Bank had told Lloyds on 13 December 2011 that the FSA had "substantive concerns" about the bid (which the FSA then confirmed to Lloyds,[305] noting that this was before these concerns were put in writing) the following day Lloyds announced that it was entering into exclusive negotiations with the Co-op Bank as preferred bidder.[306]

268. The FSA wrote again to the Co-op Bank on 17 January 2012.[307] This letter served a different purpose. It set out the FSA's proposals for engaging with the Co-op Bank during the transaction and how the work would be structured, including weekly project management meetings between Co-op Bank and the FSA. The areas that the FSA needed to be addressed were restated, but this time with clear guidance as to the FSA's expectations on how this could be achieved. The letter in this regard was a relatively detailed road map for the regulatory engagement.

---

[297] Such as 'Project Unity' – see note 200.
[298] FSA Records, 22 June 2011.
[299] FSA Records, 30 July 2011.
[300] FSA Records, 18 November 2011.
[301] Executive Supervision and Risk Committee, at the time the FSA's highest level decision-making body on supervisory issues. FSA Records, 13 December 2011.
[302] FSA Records, 13 December 2011.
[303] FSA Records, 20 December 2011.
[304] FSA Records, 23 December 2011.
[305] FSA Records, 13 December 2011.
[306] Press release by Lloyds Banking Group, "*Lloyds Banking Group announces preferred bidder for EC mandated branch divestment (VERDE)",* 14 December 2011, accessible at https://www.lloydsbankinggroup.com/Media/Press-Releases/2011-Press-Releases/Lloyds-Banking-Group/Lloyds-Banking-Group-announces-preferred-bidder-for-EC-mandated-branch-divestment-VERDE/
[307] FSA Records, 17 January 2012.

269. This letter also raised, for the first time, the question of whether the Co-operative Group would be treated by the FSA as a financial holding company for regulatory purposes. There was, and continues to be, a requirement, originally under the Banking Consolidation Directive[308] and now under the Capital Requirements Regulation[309] requiring capital to be held at a consolidated level. In this case, it would be held at Co-op Group level, including the non-financial businesses, because, under Verde, the banking activities would have met the 'balance of business' threshold set out in the Directive. This point continued to be discussed between the FSA, the Co-op Bank and HMT through the course of the year.[310]

270. In April 2012, the Co-op Bank decided to pull out of the Verde transaction. As a result of this, during the second quarter of 2012 the Co-op Bank and Lloyds renegotiated the transaction and sought to agree terms which were designed to address some of the regulatory and business challenges,[311] and improving the business economics. This is important because the transaction envisaged was substantially different from this point on (see paragraph 273 below for the FSA's perspective of the key differences).

271. At the end of April 2012, Lloyds announced the end of the Co-op Bank's exclusivity, given the renewed interest from an alternative bidder, NBNK.[312] However, the Co-op Bank remained a participant in the bid process.

272. In June 2012, the FSA advised the Co-op Board that the bank would be placed on the FSA Watchlist.[313] The key driver for this decision, conveyed with the periodic risk assessment, was the continuing complexities of the Verde bid. One might ask whether it was appropriate to allow a firm on the Watchlist to proceed with the bid, but this would be a circular argument: the Co-op Bank was on the Watchlist precisely because of the challenges arising from Verde.

273. In the same month, after further discussion between the parties, Lloyds announced that the Co-op Bank was to be the preferred and exclusive bidder and that the parties were shortly due to sign heads of terms of a sale and purchase agreement, aiming for completion late the following year.[314] This prospect led the FSA executive management in July to consider whether to intervene to prevent the Co-op Bank entering into the heads of terms, seen as a significant milestone in the process. The FSA noted the key changes to the structure of the transaction, which from the FSA's perspective were:[315]

    a. The balance sheet to be acquired had been revised down from £37 billion to £25 billion;

    b. The funding gap had been eliminated; and

    c. The businesses were to be integrated on to the Verde platform, maintained by Lloyds under a service agreement (removing the risks of migrating customers to an unproven Co-op Bank IT platform).

---

[308] Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast).
[309] Regulation (EU) No.575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012.
[310] FSA Records, 26 March 2012; HMT Records, 29 June 2012.
[311] FSA Records, 11 July 2012.
[312] Press release by Lloyds Banking Group, "*Lloyds Banking Group updated on Project Verde",* 27 April 2012, accessible at https://www.lloydsbankinggroup.com/Media/Press-Releases/2012-Press-Releases/Lloyds-Banking-Group/Lloyds-Banking-Group-update-on-Project-Verde/
[313] The Kelly Review (see note 9), paras.9.26.
[314] Press release by Lloyds Banking Group, "*Project Verde- update"*, 27 June 2012, accessible at https://www.lloydsbankinggroup.com/Media/Press-Releases/2012-Press-Releases/Lloyds-Banking-Group/Project-Verde-update/
[315] FSA Records, 11 July 2012.

The FSA also noted the progress made under each of the headings advised to the Co-op Bank the previous year though concluded that "fundamental concerns over the bid remained". On this basis, the FSA advised the Co-op Bank that whilst there remained "considerable ground to cover", the FSA would not intervene to prevent the signing of the heads of terms with Lloyds,[316] which actually took place on 19 July.

274. At the Co-op Bank July Board meeting, the two deputy chairmen voted against proceeding with the Verde transaction. One of them, Vice Chairman Rodney Baker-Bates, resigned from the Board later that month.[317] The FSA was not aware of this vote or the reasons for his resignation – which was presented as a 'retirement' – until undertaking an exit interview with him at the end of August.[318]

275. In August 2012, the FSA began work on a review to reset the Co-op Bank's capital requirements. This was to be undertaken as an assessment of the bank as it then was, disregarding for these purposes the potential changes which would arise if Verde was followed through. The FSA was nevertheless aware of the sensitivity and impact of the outcome, and accordingly escalated the decision making to a more senior level.[319] In November 2012, whilst this work was still in progress, the FSA met the Co-op Bank to convey early the likely outcome that there would be a material increase in capital requirements and to manage the bank's expectations.[320] The formal outcome was agreed by FSA in December 2012[321] and conveyed in a letter to the Co-op Bank in January 2013.[322]

276. I have described before in Chapter 3, paragraph 166, the outcome of the FSA's earlier capital review, undertaken in 2010. The FSA's Individual Capital Guidance to the Co-op Bank at that time was set at 123% of Pillar 1 plus a fixed add-on of £100 million to reflect pension risk. An additional Capital Planning Buffer was set at £420 million.

277. In January 2013, the Individual Capital Guidance increased to 134% of Pillar 1 plus fixed add-ons of £474 million to reflect pension risk, transition risk and PPI liabilities. The Capital Planning Buffer was set at £1,260 million. This represented an increase of £480 million in Individual Capital Guidance, plus Capital Planning Buffer increase of £840 million, a combined increase totalling £1.32 billion.[323] The increase in the Capital Planning Buffer was largely driven by the performance of the Britannia assets in a stress situation and the fair value unwinds from the Leek notes, though also because it looked at a five year horizon, as opposed to one year in the 2010 capital review.

278. The Kelly Review has already noted the Co-op Bank's shortcomings in capital planning, attributed to optimistic planning assumptions, the corporate culture, a weak planning process, poor management information and the limited planning horizon,[324] which go some way to explain why the FSA's capital planning outcome was out of line with the Co-op Bank management's views on capital requirements as has been relayed to me by one of the individuals with whom I spoke.[325]

279. The FSA's capital planning review calculated a deficit over the total capital requirements (including Capital Planning Buffer) of £923 million. However, at that point the FSA calculated a

---

[316] FSA Records, 13 July 2012.
[317] TSC Verde Report (see note 11), paras.40, 69.
[318] FSA Records, 30 August 2012.
[319] FSA Records, 11 December 2012. The decision was reserved to Prudential Supervision and Risk Committee (PSRC), a sub-committee of ESRC covering the Prudential Business Unit under Internal Twin Peaks.
[320] FSA Records, 16 November 2012.
[321] FSA Records, 18 December 2012.
[322] FSA Records, 15 January 2013.
[323] FSA Records, 11 December 2012.
[324] The Kelly Review (see note 9), para.12.36.
[325] Meeting Transcript E, p.9.

surplus over Individual Capital Guidance (that is excluding Capital Planning Buffer) of £340 million.[326] This distinction is important. Individual Capital Guidance is the FSA's guidance on the qualitative requirements under a rule (at that time in GENPRU 1.2.26 R in the FSA Handbook) and the FSA Executive Committee was advised that to fail to comply with that guidance would imply a breach of this rule and call into question a bank's compliance with the Threshold Conditions and hence ability to continue operating.[327] The Capital Planning Buffer is, as the name suggests, a buffer that is meant to be utilised in certain circumstances; in formal terms it is set through 'guidance', not a rule, and any 'breach' is a matter for normal supervisory dialogue.

280. The Co-op Bank's capital resources quickly depleted as a result of the issues identified in the 2012 annual results, published in March 2013.[328] These were the impairments arising from the FSA's letter regarding the Interim FPC recommendation on provisioning policy sent to the Co-op Bank at the end of 2012.[329] This is covered in more detail in Chapter 3, paragraphs 182 to 187.

281. The combination of credit impairments, IT write off and Payment Protection Insurance provisions led to a loss before tax of £674 million.[330] The FSA calculated that the surplus over Individual Capital Guidance plunged to £188 million taking these results into account.[331] The Co-op Bank's management's focus, strongly encouraged by the regulator, moved towards taking action to address the capital position.[332] The following month, the Co-op Bank formally withdrew from the Verde bid.

282. The Kelly Review explores at some length the complex interaction between the simultaneous deterioration in the Co-op Bank's capital resources and the increase in its capital requirements.[333]

The FSA's approach

283. The FSA was mindful of the potential public interest perspective of the Co-op Bank, as a mutually owned entity, becoming a more substantial bank with almost 7% of the personal current account market. The FSA was required under FSMA to 'have regard to' competition; from when the PRA took on the supervisory role from April 2013 it has had competition as a secondary objective. For practical purposes relevant to this review, the position has been very similar under both regulators. As the TSC heard from the then PRA Chief Executive, competition would only be pursued in a manner consistent with the primary objective of safety and soundness of the financial system.[334]

284. The FSA's role was that of regulator. It supervised firms, but was always cognisant of the need not to stray into the role of management. The TSC heard the evidence of the PRA's then Chief Executive that the Co-op Bank's Verde bid was "not necessarily doomed to failure".[335] The regulator's view throughout the period was that, although there remained significant hurdles to be overcome, it was possible that those concerns could potentially be satisfactorily addressed, and this was more likely once the proposal had been restructured in mid-2012.

[326] FSA Records, 18 December 2012.
[327] FSA Records, 4 March 2013.
[328] The Co-operative Bank plc, Financial Statement 2012, p.6 accessible at https://www.co-operativebank.co.uk/investorrelations/financialresults/previous-financial-results
[329] FSA Records, 20 December 2012.
[330] See note 328.
[331] Based on pre-publication disclosure to the FSA by Co-op Bank; the final results differed marginally. FSA Records, 4 March 2013.
[332] For example, FSA Records, 11 February 2013.
[333] The Kelly Review (see note 9), Exhibit 28, p.101.
[334] TSC Verde Report (see note 11), para.260, citing the oral evidence from Andrew Bailey, to the House of Commons Treasury Committee, 11 February 2014, HC 300-xi, Q1988.
[335] Ibid., para.72.

285. With hindsight, it is more apparent that those concerns could never have been satisfactorily addressed in two key regards that crystallised in early 2013:

  a. the negative impact on the capital position arising from the provisions announcement in the 2012 full-year results (covered in Chapter 3); and

  b. the governance and management shortcomings, that became more starkly obvious as the bid collapsed[336] and would surely have made the integration task beyond the Co-op Bank's capabilities.

286. From the time the 2012 full-year results were broadly known to the Co-op Bank management, which I would take as being after the end of the year but well before the March publication, the bid ceased to be feasible. Arguably, the revised capital guidance in January 2013 was as material in undermining the viability of the bid.[337] Whilst the bid lived on until it was formally withdrawn in April 2013, this was by then a forlorn hope and in my opinion, Sir Christopher Kelly is right to say that the eventual withdrawal should not have come as a surprise to Lloyds or in my mind to anyone else.[338]

Conclusion

287. The TSC asks if the FSA should have intervened to halt the bid if the shortcomings discussed in earlier chapters had been known. This is axiomatic: if the Co-op Bank had declared the large capital shortfall at an earlier point, then the bid would clearly have ceased earlier to be viable to both the Co-op Bank management and the FSA. This would also have brought forward the loss of confidence by the regulator in the bank's management. The conclusion of this chapter must in part repeat that of Chapter 3: if the FSA had forced the bank to confront the impairments issue – and other write downs – earlier, then in my view this would brought forward the denouement.

288. Given the relevance of revised capital requirements, in hindsight it would have been helpful if the FSA had been able to send the formal letter sooner than they did on 15 January 2013. However, it was understandable and probably sensible that the recommendation on setting Individual Capital Guidance was escalated to a more senior decision-making committee, even if this did lead to some additional delay. It was also proactive of the supervision team to give an early indication to the Co-op Bank in November 2012.[339] Even though the FSA had not taken a formal decision at that point, the supervision team was only able to convey the message that there would be a material increase to the Co-op Bank's capital requirements and not the detailed outcome. The message was not fully understood or acted on by the bank's management at that point.

289. Without that consideration of a possible counterfactual history and without applying hindsight, I believe the FSA was reasonable in not intervening to halt the bid earlier. It acted early and clearly in setting out its concerns both verbally and in writing on a number of occasions.

290. Was the FSA's message clear? As the Kelly Review concludes, the regulator's numerous interventions on Verde "do not appear to have been interpreted [by the Co-op Bank] as the warnings they were undoubtedly intended to be".[340] In fact, the FSA's messages on Verde were noticeably clearer than previous FSA communications, reflecting the change in tone at the top of

---

[336] The Co-operative Bank plc, Annual report and accounts 2013, pp.32-33, accessible at https://www.co-operativebank.co.uk/assets/pdf/bank/investorrelations/financialresults/bank-r-and-a.pdf and Press Release by The Co-operative Bank plc, *"Management Announcement"*, 15 February 2013, accessible at https://www.co-operativebank.co.uk/news/2013/130215-management-annoucement. The Co-op Bank had by June 2013 a new Chair, Chief Executive and Chief Financial Officer as well as new Chairs of the Board's Audit and Risk Committees.
[337] Meeting Transcript E, p.9.
[338] The Kelly Review (see note 9), para.9.33.
[339] FSA Records, 16 November 2012.
[340] The Kelly Review (see note 9), para.9.11.

the organisation. As noted in the FSA executive management discussion in July 2012 (paragraph 273 above) the bank appeared to be making progress in addressing the issues identified by the regulator, so there was no indication from the Co-op Bank that the message was not understood.

291. I have heard an argument that the Co-op Bank Board might have been more likely to sit up and take notice of the FSA's messages had there been intervention by top FSA management (by which was meant the FSA's Chairman or Chief Executive), with whom the Co-op Bank Board rarely had contact,[341] but I reject this as conjecture; the evidence that I have seen demonstrates that the Co-op Bank Board was committed to the bid.

292. Importantly, as noted in paragraph 273 above, it was not the case that the same bid stumbled on for two years. The terms of the proposed transaction changed significantly during the period in a way that significantly mitigated the risks to the Co-op Bank. This is an important factor in reaching a view that it was reasonable for both Co-op Bank management and the FSA to continue to persevere.

293. The FSA was very closely engaged with the deal, to the extent of having weekly meetings, as we have seen in paragraph 268. There is an argument that the FSA was so close to the transaction and the bank's attempts to address its concerns that it might have made it difficult to say no at the end of the process (although, in the end, they did not have to because the bid collapsed). But there were a number of occasions where executive management were asked to take formal stock – notably December 2011 and July 2012 – and the FSA's governance processes, seen above in the involvement of FSA executive management, ensured that this brought into the discussion the fresh perspective of executive management outside those individuals directly responsible for supervising the bank. There is also the question of whether the encouragement from HMT towards a successful execution of Verde would have made it harder for FSA to intervene to halt the process; this is considered in the section below.

The record held by interested parties relating to Verde is largely benign

294. The TSC heard allegations from Lord Levene of political interference to the public detriment in the Verde deal. The TSC heard oral evidence from the Chancellor, the former Governor of the BoE and other witnesses that the Government had not brought any undue pressure to bear on the Verde commercial negotiations. Whilst the TSC rejected the allegations, it noted that it did not have access to the records of the Government's contacts with the interested parties and HMT has therefore asked that the records be reviewed.

295. I have already reviewed in the first part of this Chapter the FSA's supervisory engagement in the Verde process. As stated in paragraph 283 above, the FSA was mindful of the potential public interest perspective of the Co-op Bank, as a mutually owned entity, becoming a more substantial bank with almost 7% of the personal current account market. This was in the context of the FSA's requirement to 'have regard to' competition. There is no evidence in the records I have reviewed that this consideration ever became the determining factor in the FSA's decision making.

296. The TSC heard evidence from the then CEO of the PRA that "nobody leant on [him]" during the process.[342] I have found no evidence in the FSA's records that that the FSA was "leant on" during the Verde process. This is also supported by the meetings I have had with interested parties.[343]

---

[341] Meeting Transcript E, p.13.
[342] TSC Verde Report (see note 11), para.260 citing the oral evidence given by Andrew Bailey, taken before the Treasury Select Committee, 11 February 2014, HC 300-xi, Q1958.
[343] Meeting Transcripts E, pp.9-10 and K, pp.24-29.

297. I have been provided with copies of external HMT communications as well as correspondence – incoming and outgoing – between HMT and other interested parties, notably Lloyds, the Co-op Bank and the FSA.

298. It is clear, as one might expect under the circumstances, that ministers and officials paid close attention to the progress being made in the bid and were in regular contact with the interested parties. Since the crisis, successive Governments' overarching objective with regards to the assets acquired during the financial sector interventions, including the shareholding in Lloyds, had been: *"… protecting and creating value for the taxpayer as shareholder, paying due regard to the maintenance of financial stability and acting in a way that promotes competition."* This objective was clearly articulated in the mandate of UK Financial Investments (UKFI, an arm's length institution established to manage the UK's state owned financial holdings).[344]

299. In support of this objective, HMT wished to see the transaction pushed through to successful completion, though the decision to make the Co-op Bank the preferred bidder in December 2011 was taken by Lloyds[345] and the negotiation thereafter was conducted primarily between Lloyds and the Co-op Bank.

300. UKFI operated at arm's length from government and its activities were governed by its Board, which was accountable to the Chancellor of the Exchequer and – through the Chancellor – Parliament. Ministerial oversight of UKFI and its management of the Government's financial assets was, like other areas of policy, delegated by the Chancellor of the day to one of the Department's junior ministers. In 2013 it was part of the ministerial portfolio of the Financial Secretary to the Treasury (FST). There are two internal HMT records of telephone calls between the FST and the CEO of Lloyds, Antonio Horta-Osorio, to which I would draw attention.

301. On 30 May 2012, FST spoke to the CEO of Lloyds and said that "the Chancellor of the Exchequer had asked him to call to emphasise from a public policy perspective and as a main shareholder the Government's support for the deal going ahead".[346]

302. Two weeks later, on 14 June 2012, FST spoke again to the CEO of Lloyds. In the course of that conversation, FST said that "there is also a lot of encouragement from Government (as biggest shareholder) to LBG to complete the deal".[347] HMT was prepared in early 2012 to intercede with the EU Commission, if requested, to seek to vary the terms of the transaction to make it more viable for the Co-op Bank (though I do not know if this was ever actually done).[348]

303. HMT was also closely engaged in discussions with the FSA in 2012 on the question of whether the Co-operative Group would be designated as a financial holding company. This was regarded as an obstacle for the deal and one which HMT explored ways to overcome. HMT's own legal team held a different interpretation of the European legislation[349] and explored the option of issuing formal directions to the FSA on this point. It should be noted that this was not against the FSA's views on prudential grounds; their interpretation was that the Co-operative Group was unfortunate to be caught by this legislation and that a financial holding company designation in this instance would have little prudential benefit.[350]

304. There is reference in the HMT records of the Chancellor "being supportive of issuing a direction, and being very tough on the FSA".[351] There is no evidence that this was acted upon in practice and no resulting change is evident in tone of the engagement with the FSA. Furthermore, from

---

[344] UK Financial Investments Ltd, *"UKFI Framework Document"*, 1 October 2010, accessible at http://www.ukfi.co.uk/releases/UKFI_FD_20101001.pdf
[345] HMT Records, 13 December 2011.
[346] HMT Records, 30 May 2012.
[347] HMT Records, 14 June 2012.
[348] HMT Records, 25 January 2012.
[349] HMT Records, 8 June 2012.
[350] FSA Records, 21 March 2012.
[351] HMT Records, 28 May 2012.

my conversations with FSA executive and senior management in post at the time, they assured me that there was no undue influence from third parties regarding the Verde process.[352]

Conclusions

305. I have reviewed the records provided to me by the FSA and by HMT. I can of course only draw conclusions on the basis of what has been provided, though I can also say that there are no indications that the records provided to me are incomplete. I note, however, in Appendix 2, that HMT documents have been provided on the basis of search outcomes, which means that there will inevitably be a degree of subjectivity in that judgement.

306. The records show that there was a reasonably clear line between HMT and FSA, in terms of HMT not impinging on the FSA's remit in terms of financial stability or prudential supervision of the Co-op Bank, or indeed the supervision of Lloyds.

307. It is evident that the primary negotiation on terms was, as it should have been, between Lloyds and the Co-op Bank. In support of its long established and public objectives with regard to its financial sector assets, HMT was supportive of the deal both from a public policy perspective and as a shareholder of Lloyds.

308. Lord King, the Governor of the BoE during the Review Period, wrote to the TSC[353] in 2014 to address the allegations made by Lord Levene of political interference in the Verde bid process. The notes of the two meetings that the Governor had with Lord Levene were provided at that time, confirming the Governor's interpretation in his own oral evidence. The TSC was able to weigh the evidence and to draw its conclusions in its report and I have not therefore carried out any further review of the BoE records in this regard.

Lessons learned and recommendations

309. These events highlight the need for early dialogue and information-sharing across the regulatory authorities so that they each fully understand the thinking of each other from the start and can take it into account in their own deliberations. This needs to be accompanied by an understanding of each other's roles and perspectives, which can only come through continued close engagement. This would have reduced the risk, evident in this case, that HMT was insufficiently close to the regulator's appraisal; as I conclude above there was sufficient distance to ensure no 'treading on toes', but possibly at the price of a lack of comprehension of the difficulties the FSA saw. This meant some surprise at HMT when the bid collapsed and could have made it difficult for the FSA to have rejected the bid at a later date, though in the event it did not reach that stage.

310. Although the system of regulation has since changed,[354] relevant authorities (including the FCA where appropriate) should continue to engage early and regularly on firm-specific issues where necessary. A degree of challenge from other authorities is healthy and often beneficial and that should not be lost now that the PRA is part of the BoE.

311. As I have already recommended in Chapter 2, it might be helpful to provide more guidance to supervisors on how to review significant transactions. Although the process had clearly improved by the time of Verde in terms of the depth of engagement (as, using other examples, the FSA noted in the RBS report)[355] such transactions are sufficiently challenging that this may be of value.

---

[352] Meeting Transcripts F, p.9, G, p.7, and K, pp.24-29.
[353] TSC Verde Report (see note 11), p.121, item 37 (Letter from Lord King of Lothbury, dated 12 March 2014).
[354] See Appendix 6 for a summary of the regulatory system post-April 2013.
[355] Financial Services Authority, *"The failure of the Royal Bank of Scotland"*, Financial Services Authority Board Report, December 2011, p.185, accessible at https://www.fca.org.uk/publication/corporate/fsa-rbs.pdf

Chapter 6: Additional observations

312. The preceding chapters have offered several observations in addition to my formal conclusions and recommendations. I have reproduced those observations below to help ensure that readers do not lose track of them.

313. In Chapter 2 (paragraph 122) I note that the PRA and BoE should consider how ‘Open Banking’ may affect the use of resolution tools in systemic situations.

314. As stated in Chapter 3 (paragraph 200), I believe that supervisors should focus more on the key urgent priorities for a bank, and not necessarily follow the standard process of supervision when the firm is at risk or nearing risk of entering a crisis situation. Since 2013, PRA policy provides that if supervisors have a just reason, they can be flexible between the ‘core’ and ‘discretionary’ requirements agreed at the annual ‘stocktake’ meeting (Periodic Summary Meeting). This is subject to ensuring that a regulated firm respects any legal minima such as the capital requirements stipulated by the Capital Requirements Regulation.[356] The PRA should ensure that this flexibility is maintained, particularly when a regulated firm’s capital or liquidity position is weak and needs to take priority over more chronic issues.

315. As set out in Chapter 3 (paragraph 214), I suggest there should be continued focus on ensuring supervisors file their records of meetings with firms. I found some discrepancies during my review of the historic events, and in particular I was surprised at the paucity of records of engagement between senior supervision FSA management and the Co-op Bank. It was unclear if this indicated that such contact was infrequent or that the record was incomplete. The record of senior level meetings was notably fuller in the latter part of the Review Period. The PRA should ensure that the use of the new Risk and Work Manager ‘supervisory desktop’ system is fully embedded amongst all of its supervisors and that senior management are seen to ‘use’ the information contained within the system, to further reinforce its importance to supervisors. The Risk and Work Manager system should also help to improve access to key regulatory information for each firm; however it will be vital for the PRA to ensure that supervisors input the relevant data in a consistent and timely manner and that supervisors and regulatory policy staff can readily access the information when needed.

316. As noted in Chapter 3 (paragraph 216), I observed that while conducting impact assessments is now a standard procedure for the PRA and the BoE more broadly when contemplating the introduction of new regulatory or macro prudential measures, the impact of these measures on the Co-op Bank during the Review Period underscores the importance of the PRA and the BoE considering how they can best help firms adjust to these measures. This is especially warranted for firms that do not have ready access to new capital or liquidity.

317. Finally, in Chapter 5 (paragraph 310), I note that although the regulatory system has since changed, relevant authorities (including the FCA where appropriate) should continue to engage early and regularly on firm-specific issues where necessary.

318. Let me now close with some final observations that came to mind over the course of this review.

319. A key observation from my review was the importance of the ability for the PRA and BoE to quickly and effectively re-allocate supervisory staff when required. This was evident not only during the Review Period when additional resources should have been directed to the Co-op Bank supervision team, but also from my experience conducting this review. In my view, the PRA and BoE could still do more to improve the flexibility of its staff, including both supervision

[356] Regulation (EU) No.575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

resource and specialist skills, such as Resolution experts. This finding was also observed in the recent BoE Independent Evaluation Office report on Resolution.[357]

320. Secondly, I found little evidence of a formal handover process in place for supervisors during the Review Period, though I recognise that the lack of documentary evidence can tell us little about what information was conveyed during face to face verbal briefings that took place. An effective handover is particularly important in times of significant staff turnover, such as 2008-2010, when insufficient attention to staff handovers could potentially result in key risks being overlooked. I am aware that with the introduction of the Risk and Work Manager system, information sharing between supervisors should improve and thus make handovers more effective; however the PRA should satisfy itself that appropriate arrangements are embedded going forward.

321. As noted above and in Chapter 3, my team and I found it difficult to access historic data and supervisory guidance from the legacy FSA filing system. I appreciate that there have been a number of organisational changes that have added to the complexity of document retrieval, but this has been an issue when gathering evidence for my review.

322. Frankly, it would have been much harder to access the information on our own had we not had recourse to Grant Thornton's systems, which are specifically designed to help us retrieve relevant documents. Going forward, the PRA and BoE should ensure that there is sufficient investment in records management systems and ensure that supervisors follow the necessary records management practices so that they can make better use of the information in their day-to-day operations. It would also help ensure that future reviews are not similarly hindered.

323. Better data would also help supervisors to make comparisons with other regulated firms (peer analysis) and, together with better access to precedents (as highlighted above), should contribute to more effective judgement-based supervision. That would also have the salutary benefit of making it easier for the PRA to defend itself in the event of any judicial reviews of its actions. And, it could help the PRA take more informed stances when negotiating regulatory changes at the international level.

324. Finally, if the UK experiences a protracted benign environment in future, there is a risk that prudential oversight could fade into the background at the BoE and receive commensurately less Executive attention and resources in an institution where the culture is heavily skewed in favour of macroeconomics. This is somewhat akin to what happened in the FSA prior to the 2008 financial crisis, where prudential oversight appears to have been a side-show relative to the FSA's conduct oversight activities, but in a different context. Therefore the PRA and the BoE may wish to consider how they can best guard against this risk in the future.

[357] Bank of England, "*Evaluation of the Bank of England's resolution arrangements – Banks, building societies and major investment firms*", June 2018, p.22, accessible at https://www.bankofengland.co.uk/report/2018/independent-evaluation-office-report-evaluation-of-the-boes-resolution-arrangements

Appendices

Appendix 1: HMT Direction to the PRA on 6 March 2018

A detailed Direction initiating the review and setting out its scope and parameters was laid before Parliament by the Treasury on 6 March 2018.

Direction to the Prudential Regulation Authority to investigate the prudential regulation of the Co-operative Bank plc during the period 2008 – 2013

The Treasury give the following direction in exercise of the powers conferred by Sections 77(1) and (2) and 78(5) and (6) of the Financial Services Act 2012 ("the Act").

In accordance with Section 77(1) of the Act, the Treasury consider that it is in the public interest that the Prudential Regulation Authority ("the PRA") should undertake an investigation into the relevant events relating to the Co-operative Bank plc ("the Co-op Bank") and it does not appear to the Treasury that the PRA has undertaken or is undertaking an investigation into those events.

Direction

The Relevant Events

1. In this direction, "the relevant events" means the prudential supervision, with reference to the specific matters set out in paragraph 3 below, of the Co-op Bank—

(a) by the Financial Services Authority ("the FSA") during the period 1st May 2008 to 31st March 2013; and

(b) by the PRA during the period 1st April 2013 to 22nd November 2013.

The Investigator

2.—(1) The PRA must appoint an independent person ("the Investigator") to carry out an investigation ("the Investigation") into the relevant events and the circumstances surrounding the relevant events.

(2) Before appointing the Investigator, the PRA must obtain the approval of the Treasury to the appointment.

Scope of the Investigation

3.—(1) The Investigation must assess the actions, policies and approach of the FSA and the PRA as the institutions with statutory responsibility for the prudential supervision of the Co-op Bank for the period 1st May 2008 to 22nd November 2013.

(2) The investigation must focus on—

(a) whether the FSA could or should have developed more effective arrangements for stress testing the Co-op Bank's ability to withstand challenging operating conditions sooner than it did;

(b) whether the application of more effective stress-testing arrangements would have led to the Co-op Bank's loan impairments being identified sooner than was in fact the case;

(c) whether the Co-op Bank's loan impairment profile, which appeared to differ from that of other banks, should have led the FSA to investigate it more closely before 2012 than was in fact the case;

(d) why the FSA's analysis in October 2008 to January 2009 of the suitability of the proposed merger of the Britannia Building Society ("Britannia") with the Co-op Bank failed to properly account for the prudential risks attached to Britannia's assets that were subsequently identified by the PRA;

(e) whether, in the FSA's view, the Co-op Bank had sufficiently comprehensive and reliable financial information at its disposal at the time of the proposed merger between the Co-op Bank and Britannia to allow it to make a properly informed decision as to the suitability of the merger in prudential terms;

(f) whether the FSA was made aware by the Co-op Bank of the change in the accounting treatment of the cost of the replacement of the Co-op Bank's IT platform that took place in 2010, and if it was, whether the FSA should have acted to postpone the effect of the IT programme on the Co-op Bank's capital position;

(g) whether the FSA should have intervened on prudential grounds to halt the Co-op Bank's bid to acquire 632 branches from Lloyds Banking Group, known as "Project Verde"; and

(h) the record held by the interested parties of contacts between the seller, the bidders and the interested parties relating to the Verde bid.

(3) In sub-paragraph (2)(h)—

"the seller" means Lloyds Banking Group plc and UK Financial Investments Ltd.;

"the bidders" means the Co-op Bank, the Co-operative Group and NBNK Investments plc;

and

"the interested parties" means the FSA and the Treasury.

The conduct of the Investigation

4.—(1) The PRA must cooperate with the Financial Conduct Authority and the Treasury to facilitate the disclosure to the Investigator of such information as the Investigator considers is relevant to the scope of the Investigation.

(2) The duty in sub-paragraph (1) does not apply in respect of any information which is subject to any legal restriction on its disclosure.

5. The Investigation must be conducted in accordance with the statement of policy that the PRA has prepared in accordance with Section 80(1) of the Act.

6.—(1) The Investigator may rely upon any conclusions reached relating to the relevant events and circumstances surrounding the relevant events set out in—

(a) the report of the independent review into the events leading to the Co-op Bank's capital shortfall by Sir Christopher Kelly published on 30th April 2014;

(b) the report of the independent governance review carried out into the Co-operative Group by Lord Myners published on 7th May 2014;

(c) the report of the House of Commons Treasury Committee on Project Verde published on 21st October 2014; and

(d) such other reports, notices or other publications as the Investigator considers appropriate.

(2) The Investigator may rely on any evidence gathered during the preparation of the documentation referred to in sub-paragraph (1)(a) to (d) above.

The duration of the Investigation

7.—(1) Subject to sub-paragraph (2), the Investigation must be completed within a period of 1 year beginning on the date upon which the Investigator is appointed.

(2) If the Investigator considers that it will not be possible to complete the Investigation within the 1 year period mentioned in subparagraph (1), the PRA must inform the Treasury of—

(a) the reasons for the delay in the conclusion of the Investigation; and

(b) a revised target date for the conclusion of the Investigation.

Reporting

8. On completion of the Investigation, the PRA must as soon as reasonably practicable make a written report to the Treasury—

(a) setting out the Investigator's findings and conclusions;

(b) setting out the lessons (if any) that the PRA considers that it should learn from the Investigation; and

(c) making such recommendations (if any) as the PRA considers appropriate.

06 March 2018

John Glen MP

Economic Secretary to the Treasury

Her Majesty's Treasury

Appendix 2: Methodology of the review

Project Governance

1. Dr Norval Bryson, an external member of the PRC, was appointed by the PRC as the Senior Responsible Officer to oversee the conduct and progress of the Review, and to ensure the required Report was submitted within the terms of HMT's Direction and within the stipulated timeframe and to budget. Mr David Thorburn, an ex-external member of PRC was the Senior Responsible Officer of the Review prior to his resignation from the PRC in March 2018. He led the recruitment process that led to my appointment as the Independent Reviewer.

2. A Protocol[358] was agreed between the Independent Reviewer, the PRA, FCA and HMT in relation to the governance and interaction between the parties. The protocol includes details about the independent reviewer's meetings; handling of the transcripts; legal privilege and confidentiality; the representations process; reporting; and publication of the final report. This appendix sets out my approach to each of these aspects.

Document discovery provided a comprehensive picture of the prudential supervisory actions between 2008 and 2013

3. When the review began, an initial set of documents was provided to me that had been compiled by the PRA during a previous internal review. While my team and I were reviewing those documents, we also worked with the PRA to establish the complete set of records available within the PRA and FCA for the task at hand. Given the focus of the review was on reviewing the oversight of the Co-op Bank from a period more than 5 years ago to draw lessons to enhance current prudential supervisory practices, and given that FSA policy was for all relevant emails to be saved, I decided that we would try and respect the personal privacy of affected individuals as much as possible. Thus, we decided not to request access to individual email accounts unless our review of documents gave rise to questions that could only be resolved by doing so. In the end I believe we had enough information at our disposal to conduct the review without having to request access to email accounts.

4. The PRA shared a number of folders which it considered housed the majority of the relevant records. These were securely uploaded to a secure internet-based platform managed by Grant Thornton on our behalf.

5. The PRA then applied some key search terms to the broader file structures under our oversight. This was to give us satisfaction that, in scaling down the task in hand, relevant files had not been inadvertently excluded. In total, the PRA provided over 150,000 documents. When potential gaps in the document record were identified, for example a gap in a sequence of regular meetings, the PRA records management specialists undertook targeted searches of the PRA file structures under our oversight to provide further documents or confirm no such record existed.

6. HMT also supplied a large number of documents, primarily relating to item (h) of the Direction but also those still available with respect to the Co-op Bank/Britannia merger. These documents were identified internally by HMT by individuals that did not have any past dealings with Co-op Bank related issues on the basis of various search terms agreed

[358] Bank of England Protocol, *"For the conduct of the investigation into events at the Co-operative Bank PLC pursuant to the Direction from HM Treasury to the Prudential Regulation Authority"*, 12 June 2018 and amended on 25 July 2018, accessible at https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervision/co-operative-bank-supervision-review/review-protocol.pdf?la=en&hash=F47FCC6E935CB56E3259AE688D27E0D6C224E257 and Appendix 3.

with my team and me, rather than being complete file uploads. In total, HMT provided 372 documents (including emails and documents).

7. I am satisfied that this approach was sufficient to meet the needs of this review. It enabled me to obtain a thorough understanding of the supervisory actions and decisions that had taken place during the Review Period and the recorded rationales underpinning them. This gave me a solid basis upon which to move on to the next phase of the review where I met with key individuals from the official and private sectors who had first-hand knowledge of the events surrounding the Co-op Bank during the Review Period.

Conversations with key individuals helped to flesh out the written records and further explain what transpired on the supervisory front over the Review Period.

8. In addition to reviewing the documentary record, I identified and met separately with 22 key individuals from the Review Period, both from within the regulator and the private sector. The individuals included supervisors from the Review Period, prudential specialists, former FSA Directors, former Executive members of the Regulator, former Co-op Group and NBNK Board/Executive Directors and Audit partners.

9. The premise of the conversations was to help me obtain a better understanding of the main supervisory issues and the consequent decisions and actions taken by the FSA and subsequently the PRA. All of the conversations were recorded and written transcripts prepared so that I could retain an accurate account of the points made while drafting this report without having to take notes during the conversations or rely on my memory.

10. The recordings were destroyed after the transcripts were agreed with each of the individuals in question. However, in keeping with the BoE's records management policies, the transcripts have been retained by the BoE following the completion of the review in a highly secure part of its electronic records management system. Transcripts will only be accessed in extremely limited circumstances, such as where it is considered necessary for an enquiry or investigation of activities within the BoE of an exceptional nature; or providing evidence in relation to an external civil or criminal legal investigation or prosecution proceedings.

11. I initially contested the BoE's decision to retain the transcripts after the Review, formally invoking the escalation procedures of the Protocol in this regard. This was due to concern that it might hamper the frankness and quality of the conversations. Indeed, one individual that I met with has formally protested the retention of the transcript of their conversation to the BoE. However, in the end I am satisfied that the quality of the conversations was not undermined by the BoE's transcript retention policy. I am very grateful to everyone I met with for their willingness to speak frankly with me about events that in some cases were not the most pleasant parts of their professional careers.

The BoE/PRA provided excellent analytical support for the review

12. To ensure the veracity of the evidence within the report, I commissioned the PRA and BoE to prepare a series of work packages under my guidance to set out the historic facts and the subsequent developments in regulatory practice. This information has been incorporated in this report.

Representations Process

13. Further to the provisions set out in section E of the Review Protocol (see Appendix 3), we arranged a process whereby affected individuals could review relevant passages of the draft report before publication and alert us to any factual inaccuracies.

14. During this process, we received comments from 23 individuals and organisations, which were carefully considered. Having reviewed these comments, changes to the report were made where appropriate.

Cost of the review

15. The external cost to conduct the review and prepare this Report was £1.8m to 31 January 2019. Some additional costs will be incurred as the Review project concludes.

Appendix 3: Independent Review of the Co-operative Bank Protocol

PROTOCOL

For the conduct of the investigation into events at the Co-operative Bank PLC pursuant to the Direction from HM Treasury to the Prudential Regulation Authority on 12 June 2018 and amended on 25 July 2018

A. Introduction

1. Mark Zelmer (hereafter “you”) has been appointed by the PRA, Bank of England to carry out an independent investigation into events at the Co-operative Bank PLC between 2008 and 2013.

2. The scope of the investigation is set out in the Direction issued to the PRA on 6th March 2018 by Her Majesty’s Treasury (“HMT”) pursuant to Section 77 of the Financial Services Act 2012 (“the Direction”). The Direction therefore stands as the Terms of Reference for the investigation. It also reflects the statutory requirement that at the conclusion of the investigation the PRA must make a written report to HMT.

3. This Protocol sets out the procedures under which the investigation is to be carried out, reflecting the requirement for this investigation to be, and to be seen to be, independent.

B. Administrative Matters

4. You will be given specific individual contacts at the PRA, including the Senior Responsible Officer (‘SRO’) to whom the Prudential Regulation Committee has delegated responsibility for oversight of this investigation.

5. The SRO will be supported in his role by a Project Review Board which will provide advice to the SRO when he requests it but which will not have any delegated decision-making powers. Any interactions you have (or may have) with the Project Review Board will be at the discretion of, and through, the SRO.

6. To facilitate you in conducting the investigation, particularly in relation to requesting and obtaining relevant documents and information, a dedicated email inbox for communications relating to the investigation has been set up. You should send communications relating to the investigation to this inbox as this will ensure that they are logged and actioned efficiently.

7. The PRA will arrange for you to have access to office facilities within the Bank of England at Threadneedle Street.

C. Documents, other information and meeting

Documents: requests and production

8. You will send all requests for the production of relevant documents (to include, for the purposes of this Protocol, documents, information and communications in hard copy and in electronic form) to the email address referred to in paragraph 6 above. Such requests will set out the documents or class of documents requested for production.

9. Provided that the documents requested for production are within the PRA’s power, custody or possession, they will be provided to you (either in hard copy or in electronic form) via a secure IT route as soon as possible. No such documents will be withheld from you.

10. Where documents are not within the PRA's power, custody or possession (for example, because they are held by the FCA or HMT) you should follow the procedure above and the PRA will contact the organisation holding the documents and request the documents on your behalf.

General information requests and general explanations

11. In the event that you require other information and/or explanations relating to the PRA's or FSA's activities, and falling within the scope of the Direction, you will send a request to the email address referred to in paragraph 6 above.

12. The PRA will respond as soon as possible to any such request.

13. In the event that you require other information and/or explanations relating to the activities of another organisation (for example, the FCA or HMT), falling within the scope of the Direction, you should follow the procedure above and the PRA will contact the relevant organisation to request its assistance and to obtain the relevant information and/or explanations for you.

Meetings with individuals

14. In the event that you wish to meet with any individual currently or formerly employed by the PRA, you will notify the PRA of the individuals whom you wish to meet (using the email address referred to in paragraph 6 above, attaching a letter from you to the individual for the PRA to pass on to the individual).

15. The PRA will endeavour to secure the attendance at a meeting of any identified individuals who are current or former employees of the PRA. It should be noted, however, that attendance by an individual at a meeting with you is voluntary.

16. In the event that you wish to meet with any other individual, currently or formerly employed by the FSA/FCA or HMT, you should follow the process above and the PRA will contact the FCA or HMT to request its assistance in contacting the relevant individuals and arranging the meetings.

17. Any meetings with individuals not within paragraphs 15 and 16 will be arranged by your team.

18. Meetings will be arranged at a mutually convenient time for yourself and the individual. You will provide to the PRA, no less than six working days in advance of the meeting (i) a broad outline of the topics you wish to cover during the meeting and (ii) a list of the principal documents you may wish to reference during the meeting (together the "meeting information"). The PRA will pass the meeting information to each individual no less than five working days in advance of the meeting between that individual and yourself. Meetings will be recorded by your professional services team and a transcript provided to the individual.[359]

19. To the extent possible you will endeavour to hold any meetings at a mutually convenient location for yourself and the individual with whom you are meeting. If you require it, the PRA will make available for any meeting a suitable room at its premises at Threadneedle Street or 20 Moorgate.

Third party assistance

20. You may contact third parties directly for assistance in relation to the investigation and the PRA will, to the extent that it is able to do so, facilitate such assistance.

---

[359] For the avoidance of doubt, the transcripts will not be made available to the PRA. The transcripts, however, will be retained by the Bank of England after the review has been completed in a secure electronic area, in accordance with the Bank of England's Records Management Policies and Standards.

Escalation

21. The PRA is committed to providing you with assistance to facilitate your conduct of the investigation. However, in the event that you consider that the PRA is not providing you with the co-operation or information that you reasonably require to fulfil your responsibilities, you may escalate matters to the Secretary of the Bank of England and thereafter, if necessary, to the Senior Responsible Officer at HMT.

D. Legal privilege and confidentiality

Privilege

22. It may be necessary for the PRA and/or FCA to provide you with information that is subject to the PRA or FCA's legal privilege. Neither the PRA nor the FCA will withhold documents from you on the grounds of legal privilege but, for the avoidance of doubt, the provision of such material to you does not constitute a more general waiver of legal privilege.

23. It may also be necessary for HMT to provide you with information that is subject to HMT's legal privilege. HMT will not withhold documents from you on the grounds of legal privilege but, for the avoidance of doubt, the provision of such material to you does not constitute a more general waiver of legal privilege.

24. You may refer to privileged documents in your report but the PRA (having consulted the FCA where the documents are subject to FCA privilege or HMT where the documents are subject to HMT privilege) will decide whether to redact parts of the material provided to persons as part of the representations process referred to in paragraphs 28 and 29 below or of the final report before its submission to HMT on the basis that this is necessary to protect and preserve privilege. If the PRA considers that redaction is necessary, it will include in the report to be submitted to HMT reasons for the redaction.

Confidentiality

25. It may be necessary for the PRA to provide you with information that is deemed to be confidential within the meaning of Section 348 of the Financial Services and Markets Act 2000 ("FSMA").

26. You may refer to such confidential information in your report. If required it will be the responsibility of the contacts referred to in paragraph 4 above to seek, for the purposes of such references, the consent of the person from whom the information was obtained by the PRA and, if different, the consent of the person to whom it relates. If such consent is not obtained, you may nevertheless refer to such confidential information in your final report and the PRA will decide whether to suggest redactions when submitting the report to HMT on the basis of the restrictions in Section 348 of FSMA. If the PRA suggests such redactions, it will include in the report to be submitted to HMT reasons for suggesting them.

Naming personnel

27. Your final report will not name nor identify the position of any personnel (whether current or former PRA, FCA or HMT staff or former FSA staff) who were below the level of: in respect of HMT, Deputy Director; in the case of the PRA, FCA; and FSA, Director at the time of their actions.

E. Representations Process

28. Insofar as you intend in your report to criticise individuals, groups of individuals whose members are identifiable or organisations, including the PRA and FCA (both in in its own right and/or as the FSA's successor for actions pre-April 2013)), you will (i) identify those individuals,

groups or organisations (ii) provide them with a reasonable opportunity to make representations in relation to your proposed criticism and (iii) consider those representations before finalising your report.

29. The contacts referred to in paragraph 4 above will (i) assist you, if so requested, in deciding which individuals, groups or organisations should be given the opportunity to make representations and (ii) provide you with such administrative assistance as you may reasonably require for the purposes of conducting the representation process.

F. Governance and reporting

30. You will keep the SRO informed in relation to the logistical progress and costs of the investigation, but not in relation to matters of substance.

31. You should raise directly with SRO any matter which you consider to be so urgent or important that it needs to be disclosed to them.

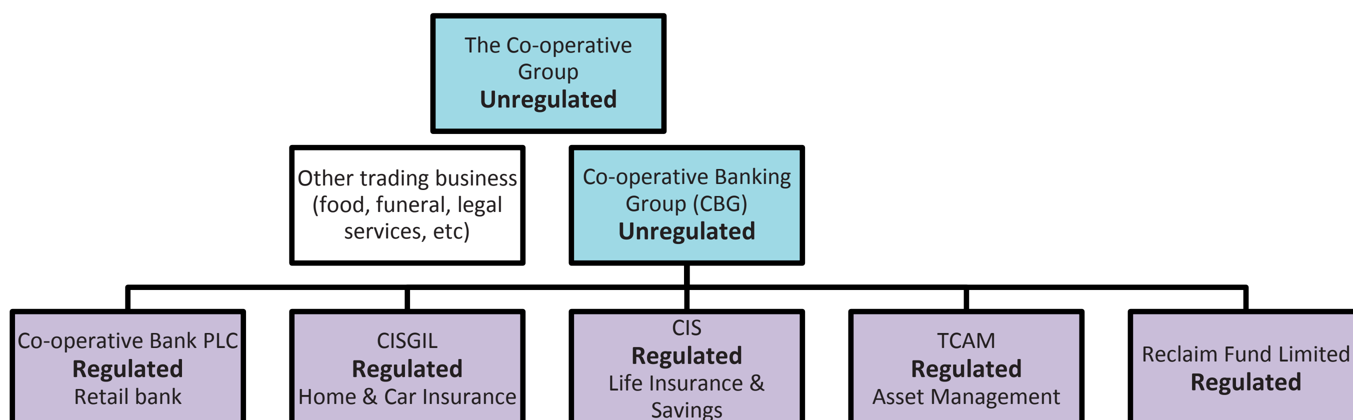
32. You will share a draft of your report with the SRO for information only. The SRO may at his discretion share, and discuss, the draft with the Project Review Board.

33. To the extent that you consider it necessary for the PRA to address issues relating to factual accuracy, or confidential information pursuant to section 348 of FSMA, you may share the relevant sections of your draft report with the contacts referred to at paragraph 4 above. These contacts will, with your specific and express permission, be entitled to share these sections with appropriate individuals at the PRA for the purposes of assisting you and finalising the draft report.

G. Publication

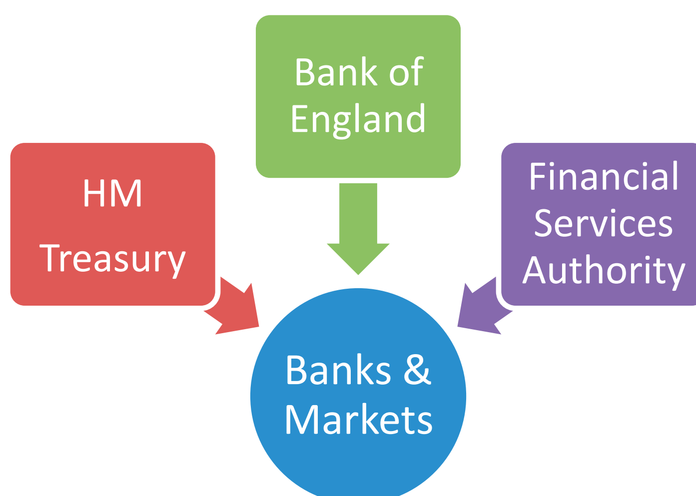
34. The PRA will arrange for your final report to be submitted to HMT which will consider whether to publish it in full or whether part(s) of it should be withheld from publication (in accordance with section 82 of the Financial Services Act 2012).

Appendix 4: The Co-operative Group structure chart[360]



[360] FSA Records, 2013.

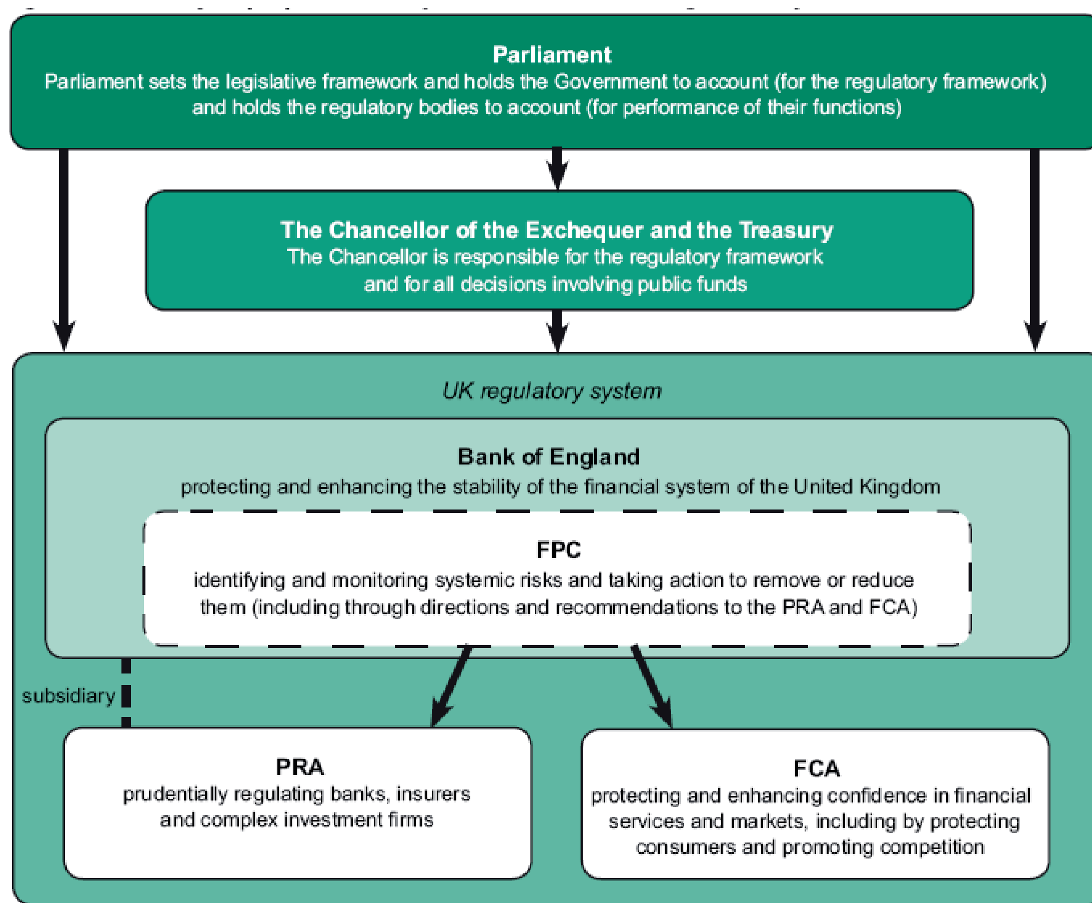
Appendix 5: Tripartite Regulation - up to 1 April 2013



In 1997, the Chancellor of the Exchequer set up the system for sharing responsibility for financial regulation, known as the Tripartite. It consisted of the Bank of England, the FSA and HMT. Under that system, the BoE was given responsibility for financial stability, the FSA for regulating financial institutions (however this did not legally come into force until 2001) and HMT for legislation.[361]

[361] For more information, see FSA, *"Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority"*, accessible at http://www.fsa.gov.uk/pubs/mou/fsa_hmt_boe.pdf

Appendix 6: The Regulatory system - as at 1 April 2013[362]



[362] House of Commons Treasury Committee, Twenty-Sixth Report, *"Conduct of Business Regulation in the United Kingdom"*, 10 January 2012, Figure 1, accessible at https://publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/1574/157403.htm. Since 2017, the PRA is no longer a subsidiary of the Bank of England.

Glossary of main terms, other acronyms and abbreviations

Term	Definition
Acquisitions Directive	Directive 2007/44/EC of the European Parliament and of the Council of 5 September 2007 amending Council Directive 92/49/EEC and Directives 2002/83/EC, 2004/39/EC, 2005/68/EC and 2006/48/EC as regards procedural rules and evaluation criteria for the prudential assessment of acquisitions and increase of holdings in the financial sector
Arrears	Balance of Arrears >=1.50% of the Balance Outstanding
Asset Protection Scheme	A measure by HMT launched in early 2009 to support banks during the financial crisis by protecting them against losses on loans, mortgages and other financial assets
Asset Quality Review	This is a Supervisory tool to assess the credit risk associated with a particular asset within a bank
Bank Insolvency Procedure	The Bank (or Building Society) Insolvency Procedure differs from an ordinary corporate insolvency procedure because it prioritises either quick pay out of deposits protected by the Financial Services Compensation Scheme (FSCS) or a transfer of protected deposits to another firm using FSCS funds (Banking Act 2009).
Base Rate	The interest rate set by the Bank of England for lending to other banks, used as the benchmark for interest rates generally
BCD	Banking Consolidation Directive, 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions.
Basel III	Third of the Basel Accords - international regulatory framework for banks published by Basel Committee on Banking Supervision in June 2011 (Capital) and January 2013 (Liquidity). Effective as of 1 January 2014
BoE	Bank of England
Britannia	Britannia Building Society
BRRD	Bank Recovery and Resolution Directive. Legislation that implemented a common EU-wide recovery and resolution framework. Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council Text
BTP	Banking Transformation Programme. This was the wider Co-op Banking Group transformation programme of which the IT Re-platforming programme was part.
Butterfill Act	The Building Societies (Funding) and Mutual Societies (Transfers) Act 2007 (sometimes referred to as the Butterfill Act) is an Act of the Parliament of the United Kingdom. The Act gives building societies new powers to merge with subsidiaries of mutuals (including banks).
Category 1 firm	The PRA divides all deposit takers into five categories of impact. A Category 1 firm is the most significant whose size, interconnectedness, complexity and business type give them the capacity to cause very significant disruption to the UK financial system by failing or by carrying on their business in an unsafe manner
CBG	The Co-operative Banking Group Limited. Un-regulated Parent company of The Co-operative Bank, CIS and CISGIL. Known as Cooperative Financial Services prior to September 2011.
CEO	Chief Executive Officer
CFS	Co-operative Financial Services, the group name prior to September 2011

CFSMS	Co-operative Financial Services Management Services
CIS	Co-operative Insurance Society Limited
CISGIL	CIS General Insurance Limited
The Co-op Bank	The Co-operative Bank plc (see structure chart in Appendix 4)
CPB	Capital Planning Buffer, an amount of capital resources separate to the Individual Capital Guidance that a bank is required to hold that takes account of potential future adverse circumstances
CRD IV	Capital Requirements Directive IV
CRE	Commercial Real Estate
CRR	Capital Requirements Regulation. Regulation (EU) No.575/2013 of the European Parliament and of the Council of 26 June 2012 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.
Executive Committee/ EXCO	FSA Executive Committee, the most senior FSA management decision-making forum, below the Board
FCA	Financial Conduct Authority – the UK conduct regulator from 1 April 2013
FPC	Financial Policy Committee. Formally established in 2013 as a Bank of England Committee to identify, monitor, and take action against risks that threaten the resilience of the UK financial system as a whole. Subject to that, the FPC also supports the Government's economic policy, including its objectives for growth and employment
FSA	Financial Services Authority – the main UK financial services regulator up to March 2013
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act 2000
FVA	Fair Value Adjustment. See Chapter 3, Box 3 for further detail.
GDP	Gross Domestic Product
HMT	Her Majesty's Treasury
HMT Direction	The HMT Direction is the Direction that was given to the Bank of England from HMT to commission this Review. See Appendix 1 for the Direction wording.
IAS 39	International Accounting Standard which sets out the principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. Largely replaced by IFRS 9 after 1 January 2018.
ICAAP	Internal Capital Adequacy Assessment Process, referred to in the report as 'the bank's capital plan'.
ICG	Individual Capital Guidance, the amount and quality of capital that the regulator thinks a bank should hold at all times. It is the sum of Pillar 1 requirements and Pillar 2A requirements
IFRS 9	International Financial Reporting Standard 9 – introduced for banks on 1 January 2018
Internal Twin Peaks	The one year period before the FSA's responsibilities legally split between PRA and FCA when the FSA was run as two distinct business units
IRB	Internal Rating Based approach, the use by banks of their own risk parameters for the purpose of calculating regulatory capital
Kelly Review	An independent review into the events leading to the near final collapse of The Co-operative Bank – April 2014 led by Sir Christopher Kelly
Leek Notes	A series of floating rate loan notes secured by mortgages assets which were issued by Britannia prior to the merger with CBG
Legal Cutover	The date when the FSA's statutory responsibility for prudential supervision transferred from the FSA to the newly-formed PRA – 1 April 2013
Lloyds	Lloyds Banking Group
MAC clause	Material Adverse Change clause - Clause in a merger agreement that allows a

	party to walk away if certain conditions are met. In the context of the Britannia merger, it gave the bank the option to walk away from the deal if Britannia's capital headroom relative to its capital requirements fell below £100 million prior to the merger being completed
MREL	Minimum Requirement for own funds and Eligible Liabilities, the requirement for "bail-in" capital implemented under BRRD
MRGD	Major Retail Groups Division, the supervisory area of the FSA responsible for oversight of larger UK banks and building societies, including the Co-op Bank and Britannia
Myners Review	An independent review of the Group's governance led by Lord Myners.
NBNK	NBNK Investments plc was a UK-based financial investment company formed by Lord Levene. They were an additional bidder in Project Verde
Open Banking	The requirement upon banks to allow third party providers to access bank account data, introduced in 2018 to promote competition in banking. https://www.openbanking.org.uk/customers/what-is-open-banking/
Periodic Summary Meeting	An annual internal stocktake meeting held by the PRA to review a firm. It is a cornerstone of the PRA's supervisory process.
PIBS	Permanent Interest Bearing Shares, a capital instrument used by building societies
Platform	Platform Home Loans was a business line at the Britannia, undertaking specialised, broker-introduced mortgages
PPI	Payment Protection Insurance
PRA	Prudential Regulation Authority – the UK prudential regulator from 1 April 2013. Initially established as a subsidiary of the Bank and with a Board of directors, in 2017 the PRA was reorganised to become a functional unit of the Bank accountable to a statutory Prudential Regulation Committee (replacing the Board)
Project Broom	A stress test undertaken of the major UK deposit takers in 2009
Project Jupiter	The sale of the Co-op Life Insurance business to Royal London
Project Lotus	The second attempt to restructure the Leek Notes
Project Unity	Project to bring the various Group businesses closer together, thereby generating cost savings and new sources of revenue
Provision	A liability of uncertain timing or amount, which arises due to a present obligation as a result of a past event and will result in an outflow of economic benefits
Prudential Regulation Committee	A committee of the Bank of England, which makes the Prudential Regulation Authority's most important decisions.
Quantitative Easing	The introduction of new money into the money supply by a central bank (BoE)
Refinancing Risk	The risk that a borrower would not be able to obtain replacement finance at the maturity of a loan
Review Period	The prudential supervision of the Co-op Bank by the FSA (subsequently the PRA) from 1 May 2008 to 22 November 2013
Section 166 / S166	A 'Section 166' review is a supervisory tool found in Section 166 of the Financial Services and Markets Act 2000 (FSMA), which empowers the FCA and/ or PRA to themselves appoint or, more commonly, direct that a regulated firm or member of its group appoint, a 'skilled person' to report to it on a particular matter, with the firm bearing the cost
SM&CR	Senior Managers and Certification Regime, a new regime to strengthen accountability in banks and insurers that came into force in February 2016, implementing the recommendations of the 2014 report of the Parliamentary

	Commission on Banking Standards
Solvency II	Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance.
Structural Reform	Structural Reform, also known as ring-fencing, separates banks' retail banking activities from their wholesale and investment banking activities. See Independent Commission on Banking final report, page 9. http://webarchive.nationalarchives.gov.uk/20131003105424/https:/hmt-sanctions.s3.amazonaws.com/ICB%20final%20report/ICB%2520Final%2520Report%5b1%5d.pdf
Supervisory Enhance - ment Programme	This Programme was introduced as a result of the Northern Rock Internal Audit Report. The FSA enhanced and strengthen its supervisory model. Details published in March 2008: http://www.fsa.gov.uk/pubs/other/enhancement.pdf
TCF	Treating Customers Fairly, an FSA initiative to improve outcomes for retail customers
Threshold Conditions	Set out in legislation, the Threshold Conditions are the minimum requirements that firms must meet to become and remain authorised. The requirements at the time were set out in the FSA Handbook: http://www.fsa.gov.uk/pubs/hb-releases/rel37/rel37cond.pdf
Tripartite	In 1997, the Chancellor of the Exchequer set up the system for sharing responsibility for financial regulation, known as the Tripartite. It consisted of the BoE, FSA and HMT. Under that system, the BoE was given responsibility for financial stability, the FSA for regulating financial institutions and HMT for legislation. The regulatory system changed on 1 April 2013.
TSC	Treasury Select Committee
Verde	This was the plan by Lloyds Banking Group to divest of 632 branches, otherwise known as 'Project Verde'
Watchlist	The Watchlist is a list of firms maintained by the FSA, and subsequently the PRA, of those firms the regulator is most concerned about from the perspective of meeting its statutory objectives. The Watchlist helps the regulator’s management to monitor progress made on mitigating risks in these firms

Mark Zelmer Biography

Mr. Zelmer has over 30 years' experience in financial services regulation and policy. He is a former Deputy Superintendent of the Office of Superintendent of Financial Institutions, Canada, and previously a senior official at the Bank of Canada. He has also worked for the International Monetary Fund and has served as a representative on the Basel Committee on Banking Supervision and the Financial Stability Board's Standing Committee on Supervisory and Regulatory Cooperation.