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EXECUTIVE COMMITTEE
AGENDA
for the meeting to be held on 3 July 2014
in Room 501

Present: Paula Vennells (Chair), Martin Edwards, Mark Davies, Kevin Gilliland, Neil Hayward, Nick Kennett, Alwen Lyons, Martin George, Chris Aujard, David Ryan, Paul Bleasby (deputising for Lesley Sewell), Chris Day

Apologies: Lesley Sewell (dialling in for item 1)

In attendance: Angela Van-Den-Bogerd, Spencer Chapman, Natasha Wilson

Start time : 09.15
End: 14.30

Time	Item	ExCo Sponsor/Presenter
09.15 – 11.15	**Kelly report (pre Board) http://www.thekellyreview.co.uk/documents/168461-07-Kelly%20Review-FINAL%20REPORT-30APR14.pdf	Chris Aujard
11.15 – 11.30	BREAK	
11.30 – 12.15	Project Sparrow verbal update (including Business improvement process update)	Chris Aujard/Angela Van-Den-Bogerd
12.15 – 12.45	LUNCH	
12.45 – 13.15	Digital (to be held in Martin George's room)	Martin George/Spencer Chapman
13.15 – 13.35	Pensions update	Neil Hayward/Natasha Wilson
13.35 – 13.45	Noting papers for the Board: • Significant Litigation Report • Health and Safety Report • Cyber/Information Security Update • Colleague offers	Alwen Lyons
13.45 – 14.05	Actions Log	All
14.05 – 14.30	AOB • 3MC	All
14.30	CLOSE	

** Lesley Sewell will dial into the Kelly report section of the meeting and Paul Bleasby will deputise the rest of the meeting for Lesley.

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Failings in management and governance

Report of the independent review into the events leading to the Co-operative Bank's capital shortfall

Sir Christopher Kelly

30 April 2014

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TERMS OF REFERENCE

To investigate the robustness and timeliness of the Board's and the management's strategic decisions which ultimately led to the need to adopt a Capital Action Plan by the Co-operative Bank to address its £1.5 billion capital shortfall;

To look at the management structure and culture in which those decisions were taken; lines of accountability which governed those decisions; and the processes which led to them;

To identify lessons which can be learnt to strengthen the Co-operative Bank and the wider Co-operative Group, and the co-operative business model generally;

To review the financial accounting practices of the Bank, the representations made by management to the independent auditors regarding these practices and the role of the independent auditors in reporting to the Audit Committee of the Bank and giving an opinion on its financial statements;

To publish the findings of its review to members, colleagues and other key stakeholders.

LEGAL DISCLAIMER

The Report has been prepared by Sir Christopher Kelly as independent reviewer commissioned by the executive teams, together with the Boards, of the Co-operative Group Limited (the Group) and the Co-operative Bank plc (the Bank). It is published at their request. The Review's Terms of Reference are set out above.

The Report is not for the purpose of guiding or influencing the conduct or decisions of any person other than the Group and the Bank. Accordingly, it must not be relied upon for that purpose by any party.

Sir Christopher accepts no legal responsibility or liability for the contents of, or any omissions from, the Report or any actions taken or decisions made by any party as a consequence of the views, findings and lessons set forth in the Report.

The full terms of the disclaimer in respect of this Report are set out at Appendix G.

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1 INTRODUCTION TO THE REPORT

1.1 This report is the result of an independent review of the events which led to the capital shortfall announced by the Co-operative Bank in June 2013. It was commissioned jointly by the Co-operative Bank (the Bank) and the Co-operative Group (the Group). It describes what happened, identifies the root causes and draws the lessons. Except where I state otherwise, the period covered by this Review runs from the first quarter of 2007 to the announcement of the shortfall. My terms of reference are in the front of the Report.

1.2 I began my work at the end of August 2013. As far as I am aware, I was given full access to all relevant internal papers, where these could be identified. In addition, the Review team conducted over 130 interviews with current and former employees, with external Bank advisers and with others. I also had the advantage of seeing written evidence volunteered by a number of individuals and organisations in response to an invitation published in Co-operative News and circulated to staff in the Co-operative Banking Group and the Co-operative Group. I am grateful to all those who agreed to be interviewed or who provided information in other ways. To encourage them to be as open as possible, interviewees were told that I would not attribute any views to them by name in my report without their agreement. I understand, however, that the regulatory authorities have the power to request any information from me relevant to investigations they may be pursuing.

1.3 The only member, or former member, of the senior leadership teams of the Group or Bank who declined an invitation to meet me was the Reverend Paul Flowers, the former Chair of the Co-operative Banking Group.

1.4 In order to fulfil my commission I have thought it important to spell out in some detail exactly what happened in the period leading up to the announcement of the capital shortfall. This report therefore looks at the decision to merge the Co-operative Bank with the Britannia Building Society in 2009, the abortive attempt to replace the Banking Group's IT platform, the proposed acquisition of the Verde assets from Lloyds Banking Group and the attempt to bring the Bank closer to the Group under Project Unity. It also includes chapters dealing specifically with the Bank's management of its loan book, payment protection insurance, governance of the Bank and the Group, risk management, capital and accounting judgements. The final chapter identifies the lessons to be learnt.

1.5 I have been impressed during this review by the commitment and attachment shown by so many to the values and principles of the co-operative movement. That commitment makes more painful the failings in the Bank described in this report.

1.6 In the pages which follow I make a number of strong criticisms of the Bank's management and governance, and of its business practices over the last few years. My comments on governance should not be interpreted as a criticism of the co-operative model or of co-operative principles and values, for which I have a great deal of respect. It is the particular method of governance adopted by the Co-operative Group and Bank which in my view has manifestly failed, not the co-operative ideal in general. The current governance structure in the Co-operative Group, which dates only from 2001, is not the only way of putting co-operative principles into practice.

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Other reviews

1.7 A number of other reviews have been conducted or announced since I began my work. In particular, the Treasury Select Committee has been conducting an inquiry which has yet to report into the divestment of the 632 branches of Lloyds Banking Group known as 'Project Verde', including the Co-operative Group's failed bid for these assets. The Prudential Regulatory Authority (PRA), the Financial Conduct Authority (FCA) and the Chancellor of the Exchequer have each announced formal inquiries into events at the Bank. The Financial Reporting Council (FRC) is investigating the preparation, approval and audit of the Bank's financial statements up to the end of 2012; and the Co-operative Group has commissioned Lord Myners to lead a review of the Group's governance structures. The Bank has also undertaken its own internal reviews. I have been able to take into account the results of these internal reviews and the oral and written evidence to the Treasury Select Committee so far published. I have also had several discussions with Lord Myners and seen his interim report. But this review has been conducted independently of all other reviews. I hope that the work I have done will be of help to some of them.

Acknowledgements

1.8 In conducting this review I have been supported by a strong team, provided mainly by the Boston Consulting Group but also including an accountant seconded from Deloitte, and of legal advice from Herbert Smith Freehills. I am very grateful to all of them and to my executive assistant Louise Hollamby for their hard work and wise counsel. The views expressed in this report are, of course, my own.

A note on terminology

1.9 From 2002 until its recent separation from the Co-operative Group the Co-operative Bank was part of a wider grouping which included a general insurance business (CISGIL) and a life and pensions fund (CIS). Though legally separate, for all practical purposes these businesses shared a common Board. Initially the grouping was called Co-operative Financial Services (CFS). In September 2011 the name was changed to The Co-operative Banking Group (CBG). In this report I have largely used the name "Co-operative Banking Group (CBG)" or the "Bank" to avoid confusion.

1.10 The Bank's main regulator during most of the period was the Financial Services Authority (FSA). In April 2013 the FSA was replaced by two separate bodies – the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA), part of the Bank of England. References to the Regulator in this report should be interpreted as referring to the FSA and, after April 2013, to the PRA and/or FCA unless indicated otherwise.

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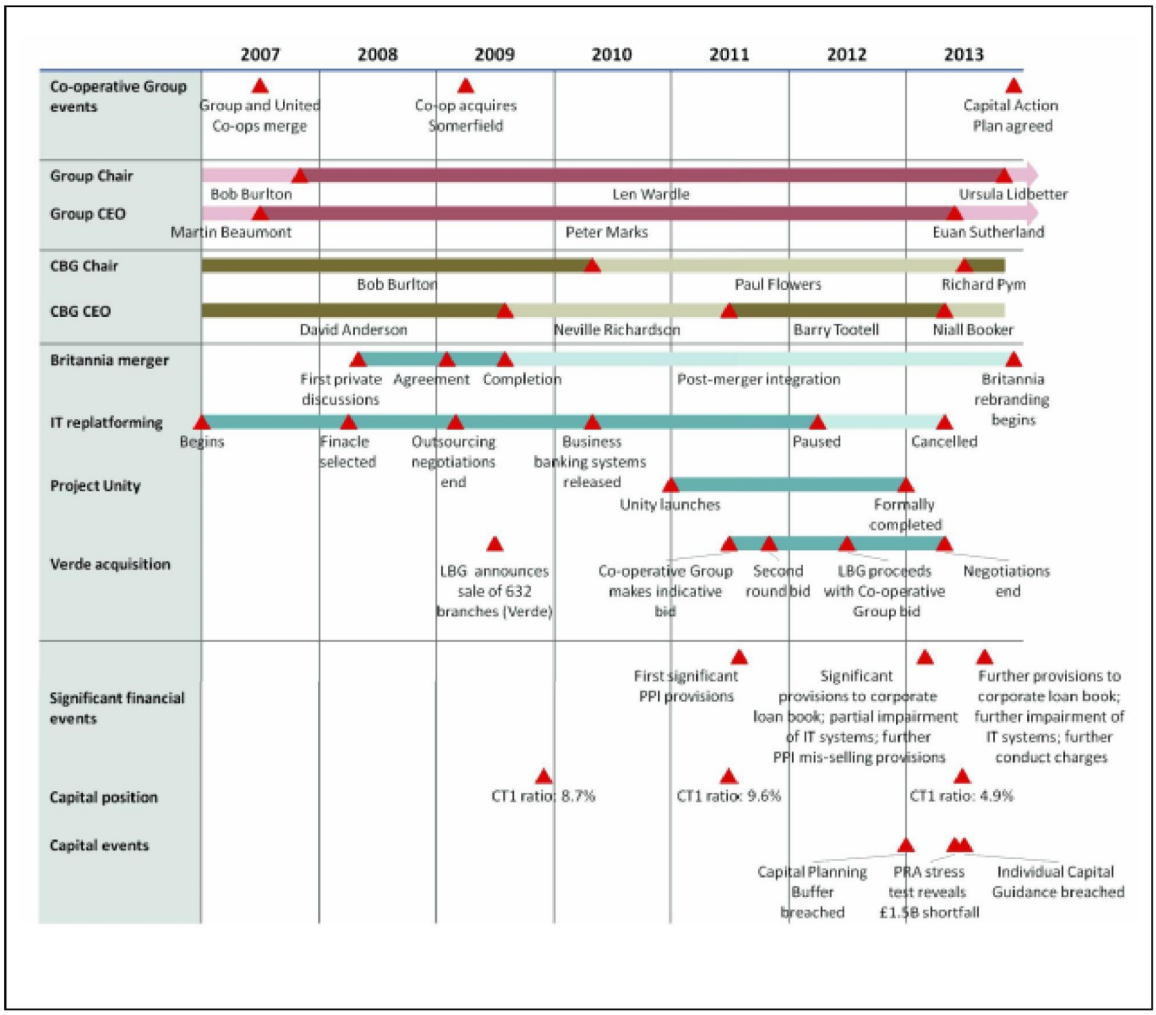
Exhibit 1: High-level timeline



Financial Times, 17 June 2013:

> *"With the restructuring of the Co-operative Bank, the bank wholly owned by the eponymous mutual, the cost of mismanagement at the lender has finally washed ashore...the bank needs £1.5bn to stay in business"*

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2 EXECUTIVE SUMMARY

2.1 This report tells a sorry story of failings on a number of levels. The Bank Executive failed to exercise sufficiently prudent and effective management of capital and risk. The Banking Group Board failed in its oversight of the Executive. The Group Board failed in its duties as shareholder to provide effective stewardship of an important member asset. Collectively, they failed to ensure that the Co-operative Bank consistently lived up to its ethical principles. In all these things they badly let down the Group's members.

2.2 The lessons set out in Chapter 14 are far from novel. It does no credit to those involved that they should need to be learnt again.

The root causes of the crisis

2.3 A number of factors contributed to the debacle of the capital shortfall and the subsequent restructuring:

i The economic environment.

ii Increasing capital requirements imposed on banks in general following the financial crisis, and on the Co-operative Bank in particular as a consequence of specific issues that it needed to address.

iii The merger with the Britannia Building Society in 2009.

iv Failure by the Bank after the merger to plan and manage capital adequately.

v Fundamental weaknesses in the governance and management of risk.

vi Material capability gaps, leading to a serious mismatch between aspirations and ability to deliver.

vii Past mis-selling of payment protection insurance (PPI).

viii A flawed culture.

ix A system of governance which led to serious failures of oversight.

2.4 Only the first of these, and to some extent the second, were outside the Co-operative Bank or Group's control.

The economic environment

2.5 Unlike a number of other financial institutions, before the merger the Co-operative Bank mostly obtained its funding from its own depositors. It was not therefore affected adversely when the wholesale markets dried up during the financial crisis. It regarded itself as having weathered the crisis well.

2.6 But like other banks and building societies it has been affected by the prolonged ensuing period of low interest rates, which has depressed net interest margins and profitability. Because of the mutual status of its parent, retained earnings were a particularly important potential source of additional capital.

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2.7 The economic climate also created difficulties for some of the Bank's customers, particularly those involved in commercial real estate. It depressed the value of the Bank's collateral and made it more difficult for its clients to refinance, limiting the Bank's ability to reduce its heavily concentrated exposure.

Regulatory demands for capital

2.8 The financial crisis prompted the Regulator to require all banks to increase the quantity and quality of their capital.

2.9 Between 2009, immediately after the Co-operative Bank's merger with Britannia, and January 2013 the Regulator increased the Bank's total capital requirement from £1.9 billion to £3.4 billion.[1] Most of the increase came towards the end of the period. The timing was particularly damaging. It coincided with a reduction in the Bank's capital resources caused by the recognition of significant impairments on its commercial real estate lending and against its failed IT replatforming project, as well as significant provisions required to remedy the mis-selling of PPI. It was the interaction between an increased requirement and a reduction in the capital available to meet it that led to the Bank's capital shortfall.

2.10 The Co-operative Bank was not singled out by the Regulator. All banks faced increased requirements. But the increase for the Bank was particularly large. That reflected the Bank's and the Regulator's concerns about the risk profile of the Bank, its poor risk management framework, its weak financial performance, its over-extended management and a number of other issues specific to the Bank. The Regulator had been making warning noises about most of these issues for some time. Had the Bank listened more carefully, and responded earlier or more vigorously, the increase in its capital requirement might have been less dramatic.

The merger with Britannia

2.11 The merger of the Co-operative Bank with the Britannia Building Society in August 2009 was a major source of the Bank's subsequent difficulties.

2.12 At the time, the Co-operative Bank was a small, full-service bank with a high cost/income ratio, which led to modest profits.

2.13 Britannia was the UK's second largest building society. It stood out from its peers in the extent to which it had expanded beyond conventional residential mortgages. Other lending, including a £3.7 billion corporate book composed largely of commercial real estate loans, accounted for as much as half of its lending (and a greater proportion of its regulatory capital). The Co-operative Bank wanted Britannia's personal customers and retail branches. In acquiring them, it also got saddled with a substantial volume of assets well outside its risk appetite in terms of type, loan-to-value or concentration risk.

2.14 Some of the attractions of the merger to the Group and Banking Group Boards are understandable. The Bank had long been concerned about its lack of scale and high cost base. The merger allowed it to increase its branch footprint at nil cost. It was also forecast to yield integration savings of £88 million a year – a material amount when the Bank's annual profits in

[1] These numbers are not strictly comparable because the latter also included a 'Capital Planning Buffer' – an amount of capital required to withstand a period of stress and which is available to use in such a situation – while the former did not. The Capital Planning Buffer is in addition to a firm's Individual Capital Guidance.

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the three years pre-merger had averaged only £67 million.[2] The business case indicated that the merged businesses would be adequately capitalised. The Regulator did not object.

2.15 But the merger took place against a background of deteriorating economic conditions and falling asset prices, particularly in commercial real estate. Britannia was not as financially strong as it had been. In its last seven months of independence most of its profits came from a one-off repurchase of some of its subordinated liabilities and debt securities.[3] The Regulator was sufficiently concerned about Britannia's position to have placed it on a watchlist. Britannia was not informed of this.[4] In July 2011 the Regulator told the Bank that it believed Britannia would not have survived without the merger.

2.16 The Banking Group Board was aware of some of the risks. But it believed that management had performed appropriate due diligence and stress-testing and had made a prudent allowance against future impairment of the more risky assets in the form of a Fair Value Adjustment. In practice, though the Board does not seem to have been aware of it at the time, the due diligence performed on what turned out to be the most risky part of the acquired assets – the corporate loan book and in particular the commercial real estate lending – had been cursory. The Fair Value Adjustment made to the value of the corporate loan book at acquisition proved woefully inadequate. An adjustment of £284 million might have looked like a substantial amount relative to a portfolio of only £3.7 billion. But impairments taken against the portfolio up to June 2013 have amounted to £802 million.

2.17 The impairment to the commercial real estate portfolio constitutes the largest single part of the Bank's subsequent capital shortfall even after allowing for the Fair Value Adjustments. The Chief Executive of Britannia, who became Chief Executive of the Bank, has told the Treasury Select Committee that the portfolio was in a reasonable condition at the point at which he left in mid-2011. In his view, it only deteriorated afterwards – partly because senior Bank executives were distracted by negotiations with Lloyds Banking Group.[5] It appears to be true that a set of factors particular to a number of the larger connections did affect the portfolio during 2012. But that is beside the point. The Bank would not have held a portfolio so far outside its pre-merger risk appetite had it not acquired it through merger.

2.18 The impact of the merger went wider than the impairments alone. Post-merger, a number of former Britannia executives occupied senior Bank positions. Under alternative management a number of things might have turned out differently. The Bank might, for example, have given greater attention to the option of proactively working out the commercial real estate portfolio had the Bank's Chief Executive been looking at the portfolio for the first time rather than having been Chief Executive of Britannia when the assets were accumulated. Very little attention seems to have been paid post-merger to the fact that the assets were outside the Bank's risk appetite. Nor did the post-merger management team do enough to address the Bank's pre-merger shortcomings.

2.19 The merger also considerably complicated the Bank's pre-existing and ambitious IT replatforming programme.

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[2] Profit before tax excluding significant items.

[3] Britannia's cessation accounts covered the seven months to 31 July 2009. Reported profit of £43.7 million was after a one-off profit on buying back its own subordinated debt (£57.9 million) and after costs relating to the merger (£26.9 million).

[4] It was not the FSA's policy at that time to advise all firms of their inclusion on a watchlist.

[5] Neville Richardson's written evidence to the Treasury Select Committee, August 2013; Neville Richardson's oral evidence to the Treasury Select Committee, 4 September 2013.

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Management of capital

2.20 Management of capital should be a priority for any bank.

2.21 In 2009 it ought to have been, and probably was, apparent to both Executive and Board of the Bank that:

i The Bank's ownership by a mutual meant that it could not access the equity markets. Its small scale meant that it would continue to have difficulty in generating additional capital internally through retained earnings, particularly in a low interest rate environment.

ii Its small capital base meant that it would be less resilient than some others to significant shocks, including self-inflicted ones such as the major impairment charges from its failed replatforming.

iii The Regulator would be imposing increased capital requirements and was likely to continue to do so.

2.22 In these circumstances it might have been expected that the Executive and Board would put particular emphasis on capital, and manage it prudently. One of their most serious failures is that they did not do so. Capital forecasting and planning were poor. The Banking Group did embark on the sale of its life insurance business, a poorly-performing asset. But a significant part of a number of other capital actions which were taken had the deliberate effect of pushing issues into the future – presumably in the hope that profitability would have improved by then. It is not clear that the Bank Board was as well informed as it might have been about the extent to which this was happening. The Executive appear consistently to have placed more emphasis on meeting budgets than on the prudent conservation of capital.

The risk framework

2.23 A second important priority for a bank is the management of risk. There were serious failures here too.

2.24 It is now standard practice for banks to establish three lines of defence to manage risk within a predetermined risk appetite.[6] The Bank had weaknesses in all three lines. It only belatedly started to address them in early 2012, after repeated warnings from the Regulator and after a change in Chief Executive and Chief Risk Officer. In the first line, the business banking relationship managers showed inadequate risk awareness. The second line, which is supposed to provide independent challenge to the business and unbiased reports to the Board, was poorly organised and insufficiently resourced. The quality and focus of the third line – Internal Audit – was also deficient.

2.25 It is difficult to assess whether better management of credit risk would have led to any material difference in the eventual capital shortfall. It ought to have led to more effective control of the heritage Co-operative Bank's lending and a more robust management of the inherited commercial real estate lending. But with markets as they were at the time it might simply have crystallised and brought forward greater losses than if the assets had been held to maturity. On the other hand, it is also possible that earlier recognition of the riskiness of its inherited portfolio would have forced the Bank to face up to the implications at an earlier stage, before its capital

[6] A front line interfacing with the customer or delivering support for that function; an independent second line under a chief risk officer monitoring and challenging the decisions of the first line; and a third line, internal audit, which provides independent assurance that appropriate procedures are in place and are being followed.

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requirement was increased so substantially. It might also have caused the Bank to think more carefully about some of the other things it was doing.

2.26 Better operational risk management might have mitigated difficulties with the Bank's IT replatforming – which contributed almost £300 million to the capital shortfall – and triggered far more careful consideration of the effect on business as usual of the prolonged negotiations with Lloyds Banking Group.

Capability

2.27 The Britannia merger did little to increase the capability of the Bank.

2.28 There were talented people in the merged Bank. But some of the senior team lacked appropriate experience. The incoming Chief Executive, Neville Richardson, had not worked in a bank before. The Chief Risk Officer was an actuary not a banker. The ex-Britannia executive given responsibility for the post-merger integration and the IT replatforming had managed the integration of the Bristol & West Building Society into Britannia some years previously. But he had not overseen a change programme of the complexity he now faced. Responsibility for strategy was given to the Director of Organisational Development, whose main role was HR.

2.29 Neville Richardson told the Treasury Select Committee that one of the reasons for the difficulties the Bank faced after he left in 2011 was that a number of mainly ex-Britannia senior people also left at about the same time.[7] It is true that there was some loss of continuity. Neville Richardson's own departure led to the promotion of the CFO to Chief Executive, a role which he found taxing. The CFO's role was then backfilled by one of his team who had only been in his previous position for a short time. But the departures as a whole did not lead to an obviously weaker team than before. A number of posts were filled by interim or permanent staff who, rather than representing a reduction in quality, began to address past deficiencies energetically.

2.30 Nor do I not think that the Bank was in a good position when Neville Richardson left. The evidence that it was not is overwhelming. The capital position only looked reasonable because problems had been pushed into the future. The risk management framework was poor. The IT replatforming project was floundering; and there was little sign of a coherent strategy towards the non-residential mortgage portfolios inherited from Britannia other than to wait for things to get better.

2.31 The Bank appeared to be largely unaware of the limitations on its own capability and what that meant for its capacity to deliver major programmes. A more self-aware Executive and Board might have reconsidered the replatforming programme once it had been complicated by the merger. They might also have refrained from pursuing the negotiations with Lloyds Banking Group about acquiring significant additional assets when both the replatforming programme and the integration of Britannia were far from complete.

2.32 Management stretch was a particularly acute issue for the Bank from 2011 onwards when it started the negotiations with Lloyds Banking Group and began Project Unity. The protracted negotiations over Verde were a major distraction for senior executives of the Bank. Without the distraction caused by Verde the emerging capital issue might have been better recognised and more effectively addressed at an earlier stage. Unity's stated objectives were largely unexceptional – to save costs by amalgamating various common services across the Co-operative Group and, in time, to increase cross-sales. But the project was clumsily implemented in a way that implied that the Group Chief Executive, who was perceived to be its main advocate, and the

[7] Neville Richardson's written evidence to the Treasury Select Committee, August 2013.

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Group Board did not fully understand the requirements of a regulated bank. Project Unity moved staff between Bank and Group and changed reporting lines, which undoubtedly led to some disruption to the Risk and Internal Audit functions at a crucial time.

2.33 Had management not been so distracted, they might have taken a different approach to the capital issues faced by the Bank. But the direct effect of Verde and Unity on the emerging capital shortfall was limited. The commercial real estate problems, the weak risk management framework, PPI mis-selling and the difficulties with the replatforming project were the most significant causes of the shortfall.

2.34 The CBG (and Group) Boards seemed either oblivious to these issues or, if they were aware, failed to take sufficiently timely action to mitigate them.

Payment protection insurance

2.35 The mis-selling of payment protection insurance (PPI) was largely a pre-merger issue, almost entirely related to the Co-operative Bank. Like other banks, the Bank had seen PPI as a highly profitable product to supplement low margins on its other business. Again like other banks, it had made no provision in its accounts for the possibility of compensation payments to its customers prior to May 2011.[8] By the first half of 2013, it had provided for expected mis-selling costs of £269 million - a disappointing outcome for an avowedly ethical bank. In its 2013 Annual Report and Accounts, the Bank reported a total conduct and legal risk charge for the year of £412 million, which included further provision for PPI as well as for other issues relating to mortgage products and compliance with the Consumer Credit Act.

Bank culture

2.36 The culture of the Bank contributed to the debacle in a number of ways.

2.37 I have already referred to risk management failings which allowed the pursuit of too many initiatives, given limited management capability. Other damaging aspects of Bank culture included:

i A willingness to accept poor performance.

ii Confused or diffused accountabilities in a number of important areas, including risk and change management.

iii A tendency not to welcome challenge.

iv A willingness to accept certain key assertions without subjecting them to proper scrutiny.

v A tendency to promote good news and to delay bad news.

vi Unwarranted optimism that an economic recovery would raise low levels of profitability and lift the value of property assets.

vii A Board and Executive which allowed themselves to be carried along by events, rather than stepping back at appropriate points and taking stock.

[8] That is, until after the judicial review of the FSA's guidance on the handling of PPI complaints found against the British Bankers' Association.

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viii A tendency towards being inward-looking, arguably not helped by being based outside London.

ix A failure to take seriously enough the warnings given by the Regulator or the (not always consistent) advice they received at different times from a series of professional advisers.

x A willingness to take opportunities to shift problems into the future when it would be more prudent to address them earlier.

xi Less than complete transparency.

Governance

2.38 I am conscious that member control by democratically elected representatives is a fundamental part of the co-operative ideal.

2.39 But there is more than one way to implement this principle. I have no doubt at all that the methods used over the last few years to appoint members to the Board of the Co-operative Group and its subsidiaries have led to serious failures in relation to oversight and governance of the Bank. The existing governance structure has badly let down the Co-operative Group's members.

2.40 In my view the Group Board contributed to what happened by:

i Failing to ensure that it had a clear perspective on the long-term place of the Banking Group within the Group's portfolio. At no time did it have a clear strategy for the Bank. The absence of a strategy has two paradoxical effects. It meant it had nothing against which to assess the merits of the Verde proposal put to them, which makes it difficult to see how it could reasonably even have begun the negotiations. But it also allowed itself to be too easily persuaded by the attractiveness of the transaction without giving adequate thought to the implications of Verde for the Group's structure, capital and exposure to risk.

ii Failing to exercise appropriate stewardship of one of the Group's major assets, particularly during a period of merger and financial crisis – an inevitable consequence of the limited relevant experience of the individual Board members.

iii Allowing the Group Chief Executive too much latitude in pursuing Project Unity in a way which suggests that neither he nor the Board can fully have appreciated the differences between a regulated bank and the trading businesses.

iv Appointing as Chair of the Banking Group an individual who manifestly did not have the appropriate experience. The Regulator did not object. But it was the Group Board's appointment, not the FSA's.

v Failing to appoint an experienced, permanent Banking Group CEO following the resignation of Neville Richardson in July 2011.

vi Failing to ensure that more non-executives on the CBG Board had relevant banking experience.

vii Allowing itself to be seduced by the prospects of an apparently bargain price for Verde without giving sufficient thought to its integration or the impact on business as usual; and then compounding that by failing to call a halt earlier.

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2.41 The CBG Board must be regarded as being at least as culpable as the Group Board since it had the more direct responsibility.

2.42 Unlike the Group Board, the CBG Board did include a small number of Independent Professional Non-Executive Directors (IPNEDs), some of whom had previous banking experience. But they were in a minority and must have been hampered by the size of the Board – 22 members immediately after the Britannia merger – and by the lack of banking experience of the Chair.

2.43 I have some sympathy for the position in which the IPNEDs found themselves, particularly those who were appointed in 2011, when the Board was restructured and the die was already largely cast. A number were clearly frustrated by what was going on.

2.44 But when failures of this magnitude occur boards must always accept accountability, if only for things they did not do. Looked at with the advantage of hindsight, I am surprised that a Board which did possess a small number of experienced and well-regarded individuals nevertheless failed to raise more concerns about the way the Bank was being managed; failed to insist that the shortcomings in the operation of the risk management framework were addressed; failed to require a much greater emphasis on capital; failed to hold the replatforming project sufficiently to account as cost escalated and timescales slipped; and failed to call a halt to the Verde negotiations, despite the doubts many of the Board members appear to have had about it, and even though one Deputy Chair told the Review he resigned over the issue and the other told the Review he tried to resign – though he was initially persuaded not to.

Concluding remark

2.45 The capital shortfall is rooted in a number of specific events. Poor commercial lending, a failed IT project, and mis-selling of PPI accounted for the bulk of it in numerical terms. But the severity of the problem was magnified by failures of management, lack of capability, a fallible culture and weak governance.

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3 BRITANNIA MERGER

Date	Key Event	
December 2006	x	Sir John Butterfill MP proposes legislation enabling a building society and a co-operative to merge
October 2007	x	Butterfill Act granted Royal Assent
May 2008	x	David Anderson (CEO of Co-operative Financial Services) initiates merger discussions with Neville Richardson (CEO of Britannia)
July 2008	x	CFS and Britannia Boards are informed of merger opportunity
August 2008	x	CFS and Britannia each start due diligence
December 2008	x	Due diligence reports submitted to CFS and Group Boards and Audit and Risk Committees
January 2009	x	CFS and Britannia sign the merger agreement
March 2009	x	Elements of Butterfill Act enabled by statutory instrument, allowing merger to proceed
April 2009	x	Britannia members approve the merger
July 2009	x	Britannia notifies the FSA that the merger will complete on 1 August
August 2009	x	Merger completed

3.1 The merger of the Co-operative Bank with Britannia Building Society in August 2009 was the source of many of the Bank's subsequent difficulties.

3.2 Six factors, knowable or avoidable at the time of merger, were particularly relevant to what happened later:

i The extent to which so many of Britannia's assets fell outside the Co-operative Bank's previous risk appetite, in particular Britannia's highly concentrated commercial real estate lending on which only cursory due diligence was performed and against which very substantial provisions had to be made some years later.

ii The approach adopted after the merger in respect of these high risk assets.

iii A deterioration in Britannia's financial position during the course of the merger discussions, which put pressure on the capital adequacy of the combined entity from the outset.

iv The assumptions underlying the unwind of the Fair Value Adjustment to some of Britannia's liabilities, which had the effect of pushing pressure on the Bank's capital into the future, just as demands were increasing for banks generally to hold more capital.

v The decisions taken about which staff should assume senior roles in the combined entity.

vi The additional complexity brought to the Bank's already complex IT replatforming programme.

The Co-operative Bank before the merger

3.3 At the time of the merger the Co-operative Bank was a small, full-service bank with a high cost/income ratio, leading to modest profits. It had a balance sheet of about £15 billion (Exhibit 2). It operated through 90 branches and served 500,000 retail customers. It had a substantial corporate lending business, an internet bank ('smile'), a small wholesale arm and it supplied clearing services to other financial institutions. As subsequent events proved, some of its retail sales practices were poor and its corporate lending policies and risk governance and control

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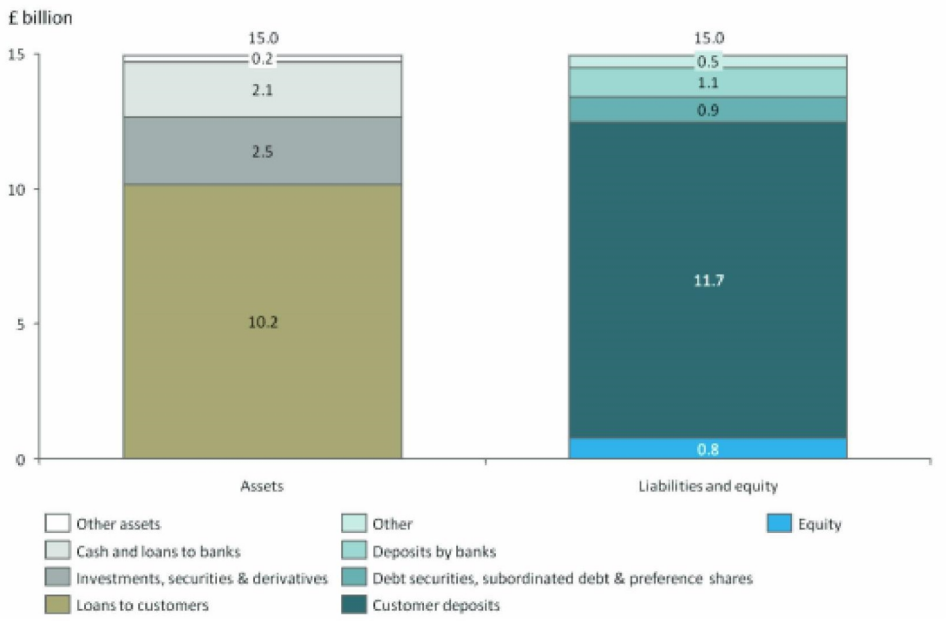
framework were not strong. It had a reasonable, but deteriorating, capital position. At the end of 2008 it had a Tier 1 capital ratio of 8.3 per cent and a Core Tier 1 ratio of 7.6 per cent.

Exhibit 2: Co-operative Bank balance sheet – January 2009



Note: Financial year ended 10 January 2009.
Source: Co-operative Bank 2009 Annual Report and Accounts, Kelly Review analysis.

3.4 The retail side of the Bank had assets of £5.7 billion. It offered a range of standard products, including current accounts, savings accounts, credit cards, personal loans and mortgages. The corporate side had assets of £4.2 billion and was a traditional relationship business with lending across a range of industry sectors.[9]

3.5 Before the merger became a possibility, the Co-operative Bank had intended to grow organically. Its main focus was on developing deeper relationships with existing customers and reducing its cost base. In 2008 it had just begun a large-scale replatforming programme to address its high cost (and increasingly high risk) IT systems.

3.6 The capability of the Bank's management was consistent with its small size and product offering. It was relatively inexperienced in executing mergers or major change programmes.

3.7 Since 2002, the Bank had been part of a wider grouping: Co-operative Financial Services (CFS). CFS also included a general insurance business (CISGIL) with £1.3 billion of assets and a £21.6 billion life and pensions fund (CIS). CIS was subsequently sold to Royal London. When the Group ceded a 70 per cent stake in the Bank in late 2013, CISGIL was kept as a wholly-owned part of the Co-operative Group. Neither CIS nor CISGIL is considered further in this report. But it is worth noting that for all practical purposes the three businesses had the same board, although technically they had separate boards for legal reasons. The insurance businesses were run as business units reporting initially to the head of the retail banking business and subsequently to

[9] Co-operative Bank Annual Reports and Accounts, 2009.

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the Bank CEO. In consequence, throughout the period under review, those running the Co-operative Bank at the most senior level had also to devote part of their time to issues relating to the insurance businesses.

Britannia Building Society before the merger

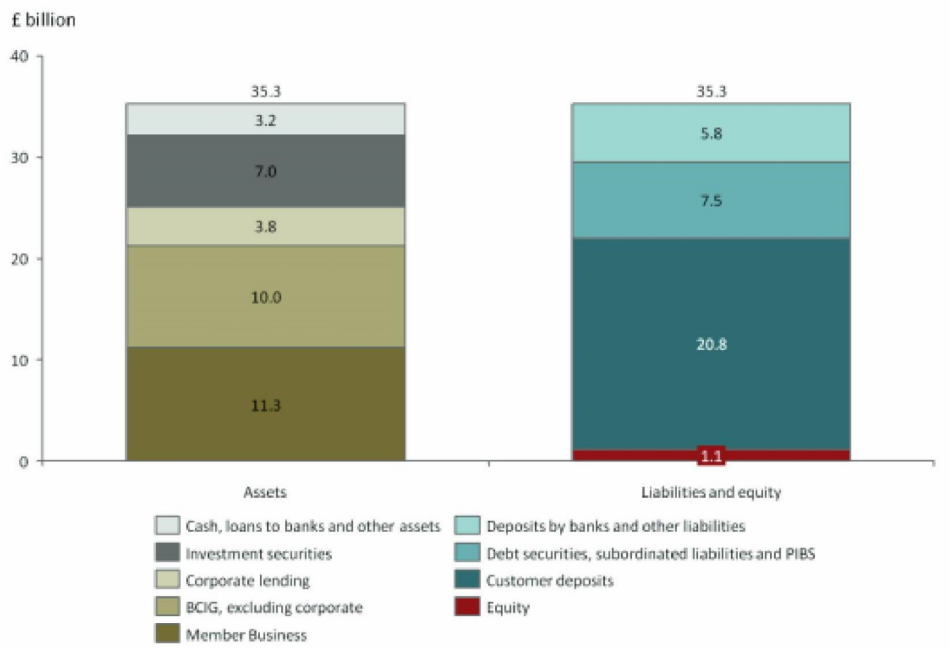
3.8 Britannia before the merger was the second largest building society in the UK. It had assets of about £35 billion, 254 branches and 2.8 million customers.[10] On most dimensions it was, therefore, substantially bigger than the Co-operative Bank.

3.9 Its balance sheet (Exhibit 3) comprised two main components - a low-risk Member Business and a higher-risk specialist business, Britannia Capital Investment Group (BCIG).

3.10 The Member Business accounted for roughly half of the lending and had low margins. It offered simple, competitively-priced mortgages and savings products. Its loans were high quality, with an average loan-to-value ratio at the end of 2008 of below 40 per cent.

3.11 The other half of the lending, BCIG, contributed 75 per cent of Britannia's profit before tax in the five years prior to merger.

Exhibit 3: Britannia balance sheet – June 2008



Note: Numbers do not sum due to rounding differences.
Source: KPMG Due Diligence Report, 25 March 2009; Kelly Review analysis.

3.12 All customers of the Member Business were eligible to receive an annual share of Britannia's profits, the Britannia Membership Reward (BMR).[11] Britannia's Board and Executive saw the BMR as central to Britannia's member proposition.

[10] Britannia Interim Report, 2008.

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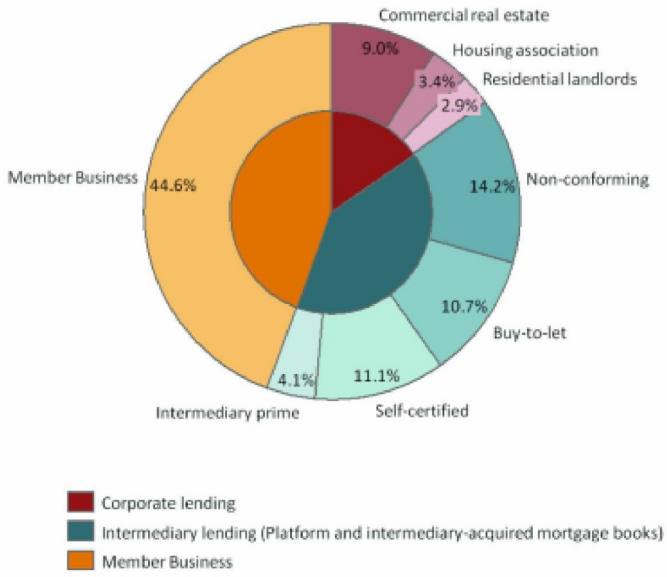
3.13 The bulk of the profits necessary to fund the BMR came from BCIG. BCIG invested in sub-prime assets, intermediary residential lending (including non-conforming, buy-to-let, and self-certified mortgages brought together in a vehicle called Platform), intermediary-purchased residential mortgage portfolios and commercial lending (Exhibit 4).

Exhibit 4: Britannia's lending mix - June 2008



Source: KPMG Due Diligence Report, 25 March 2009; Kelly Review analysis.

3.14 Other building societies had also moved into non-traditional forms of lending in the search for yield. Britannia was unusual in the extent to which it had done so. BCIG accounted for around half its loan book. It also constituted over 90 per cent of its risk-weighted assets.[12] No other large building society had as much exposure to sub-prime lending. Its overall impairment and arrears profile was one of the worst in the sector (Exhibit 5).[13] Several interviewees told the Review that Britannia would sometimes complete transactions which no other lender would take on.

3.15 Britannia's commercial lending was predominantly sourced through intermediaries.[14] It included a large (approximately £2.2 billion) portfolio of commercial real estate loans, £0.8 billion of low-risk, low-margin housing association loans, and £0.7 billion of loans to buy-to-let landlords.

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11 Britannia customers earned BMR points from their savings, ISA, mortgage, personal loan, credit card, general insurance, life protection and asset management products. Longstanding customers received a multiplier. The size of the reward paid to each customer depended on the number of points they accrued.

12 As at June 2008. KPMG: Project Vintage, final due diligence report, 25 May 2009.

13 KPMG due diligence report, 25 March 2009.

14 PwC: Project Ides - Commercial credit review, 29 April 2010.

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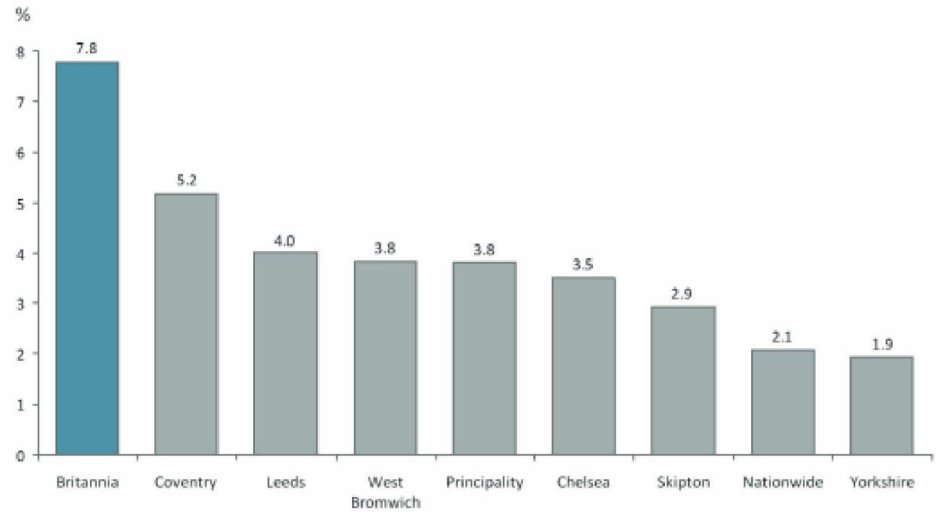
Exhibit 5: Arrears at building societies in 2007



Note: Includes all arrears (<3 months; >3 months; >12 months) and repossessions.
Source: KPMG Due Diligence Report, 25 March 2009.

3.16 The commercial portfolio was highly concentrated and included some large individual exposures. The total exposure of the top ten connections was in excess of £1.4 billion. The average size of the other connections was £10 million. The portfolio therefore involved a high counterparty and credit risk, particularly when set against Britannia's total Tier 1 and Tier 2 capital of £1.6 billion at the end of 2008.

3.17 Unlike most other building societies, and unlike the Co-operative Bank, Britannia relied heavily on wholesale markets for funding. In particular, it had issued a series of floating rate securitised instruments known as Leek Notes.[15]

3.18 In 2008, Britannia started to operate a separate company, Illius, which purchased re-possessed Platform-originated and residential landlord properties and managed them as investments with the intention to sell once real estate values had recovered. This arrangement was an unusual activity for a building society.

3.19 Britannia was relatively well-capitalised, with a Tier 1 capital ratio of 10 per cent at the end of 2008.[16] But its profits had fallen significantly during the financial crisis. In its last seven months of independence, after accounting for merger costs, it would have made a loss without a one-off gain from the repurchase of some of its subordinated liabilities and debt securities at below the issue price (Exhibit 6). Its business model, its risk appetite and its significant exposure to non-prime lending meant that the business was particularly vulnerable to the worsening economic environment. In recognition of this, it had started to scale back some of its BCIG activity in 2007.

[15] Named after the town in which Britannia's head office was located.
[16] Britannia Annual Report and Accounts, 2008.

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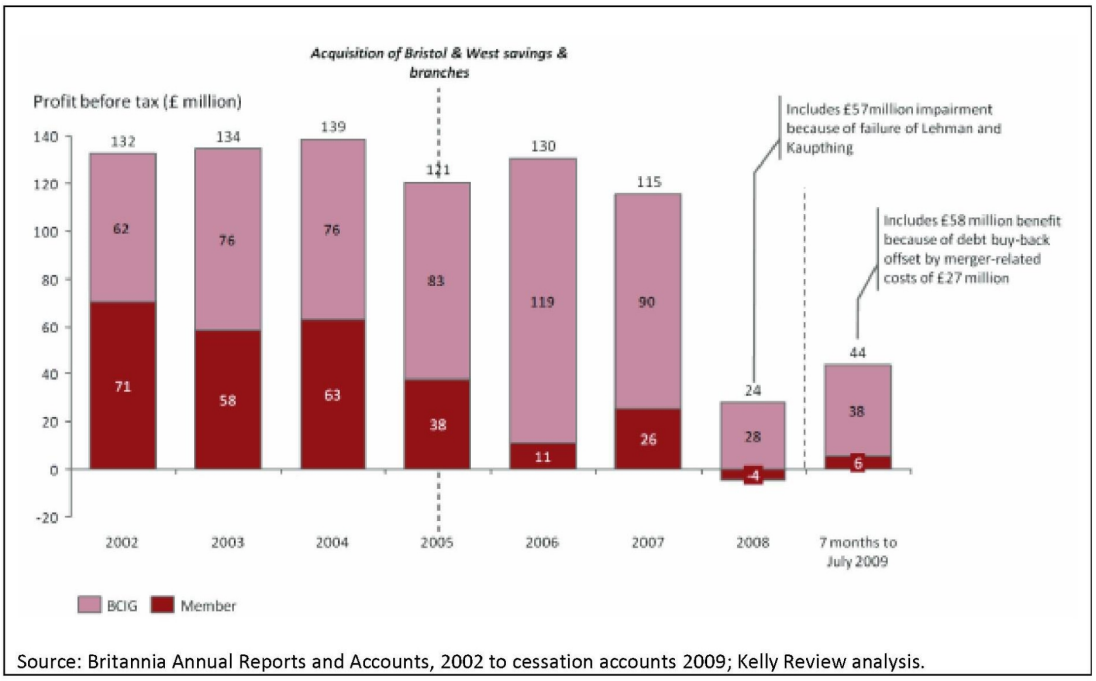
Exhibit 6: Britannia profit before tax 2002 to cessation accounts July 2009



Source: Britannia Annual Reports and Accounts, 2002 to cessation accounts 2009; Kelly Review analysis.

3.20 After remaining low and relatively stable for a number of years, Britannia's loan impairments increased substantially from £14 million in 2007 to £58 million in 2008 (Exhibit 7).

3.21 The FSA raised issues relating to the long-term sustainability of Britannia's high-risk model in an ARROW letter in early 2009.[17] It expressed concerns about Britannia's Illius business, which it deemed not core to the activities of a building society as well as being an imprudent use of funding and beyond the capabilities of the Britannia management. It subsequently transpired that the FSA had placed Britannia on a watchlist. Two years later, in July 2011, the Regulator told the Bank that *"Britannia would have failed had it not been for the Co-op"*.[18] But at the time the FSA apparently did not consider the merger to be a rescue.[19]

3.22 The Review found no evidence that either Britannia management or its Board was aware that the organisation was on a watchlist or thought it was in need of rescue.

[17] ARROW stands for Advanced, Risk-Responsive Operating Framework. The FSA used this framework to assess the risks faced by financial institutions it supervised.

[18] Andrew Bailey's written evidence to the Treasury Select Committee dated 13 January 2014, which included minutes of a meeting with the Co-operative Group CEO (Peter Marks), CFS Chair (Paul Flowers) and acting CEO (Barry Tootell) on 28 July 2011.

[19] Clive Adamson (Director of Supervision, Financial Conduct Authority, and former Director, Major Retail Groups Division, Financial Services Authority (2008-2011)) oral evidence given to the Treasury Select Committee, 7 January 2014.

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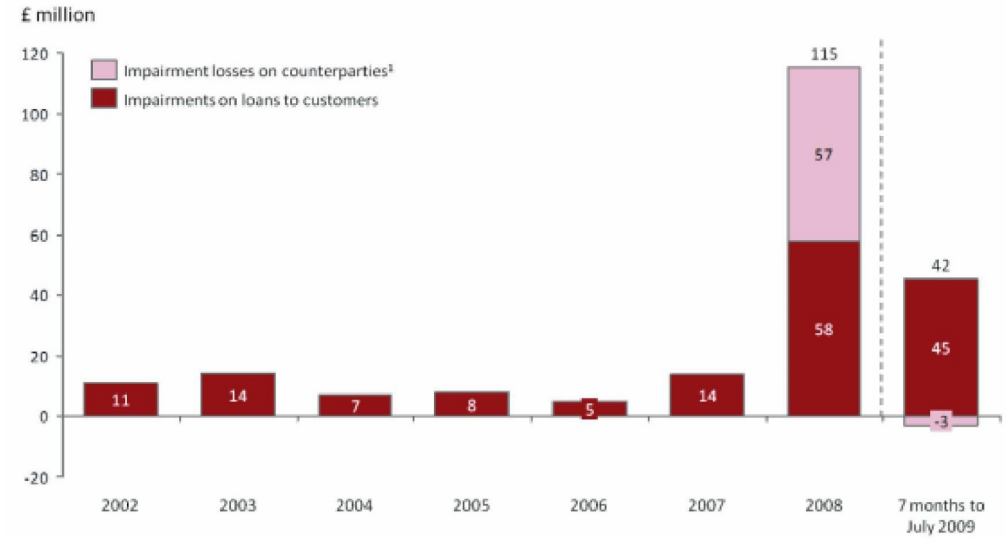
Exhibit 7: Britannia impairments 2002 to cessation accounts July 2009



1. Impairment losses on counterparties represent provisions to cover for losses arising from exposure to the Lehman and Kaupthing groups. £3 million write-back on these losses registered in cessation accounts.
Source: Britannia Annual Reports and Accounts, 2002 to cessation accounts 2009; Kelly Review analysis.

The external context

3.23 The first discussions about the possibility of a merger took place in May 2008.

3.24 The discussions took place against a background of turmoil in the financial markets. The financial crisis had become an economic crisis, with falling interest rates, rising unemployment, severe liquidity and solvency problems in the banking sector and – of particular significance in the light of the composition of Britannia's loan portfolio – substantial falls in the value of commercial real estate. Experience of previous economic downturns suggested that further deterioration in real estate prices would be likely. The Bank of England's October 2008 Financial Stability Report forecast slowing rental growth, tighter credit availability and falling prices, leading to an increase in covenant breaches and defaults. The FSA's Financial Risk Outlook, published in January 2009, stated that *"commercial property values have already fallen approximately 36 per cent since their peak in 2007 and further falls are expected...Given the high levels of financial gearing in this sector, this will increase the levels of write-offs by banks and other financial institutions, as in the early 1990s"*.[20]

3.25 A significant proportion of Britannia's commercial real estate lending had been originated between 2005 and 2007, at the height of the market. The extent to which the market was falling during the merger discussions is demonstrated by the fact that the average loan-to-value of new commercial lending written by Britannia during 2008 deteriorated from 77 per cent (using valuations at time of loan) to 103 per cent for the same lending by the end of the financial year.[21]

[20] FSA Financial Risk Outlook, 2009.
[21] Britannia Cessation Accounts, 2009.

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3.26 By the time the merger agreement was signed, a number of significant banks and building societies had either been rescued by the Government or been taken over by competitors (Exhibit 8).

Exhibit 8: Selected mergers, acquisitions and nationalisations in the UK bank and building society sector, 2008-2009

Announcement date	Organisation	Outcome
February 2008	Northern Rock	Nationalised
July 2008	Alliance & Leicester	Acquired by Santander
September 2008	HBOS	Acquired by Lloyds TSB
	Bradford & Bingley	Part-nationalised, part-acquired by Santander
	Cheshire Building Society	Acquired by Nationwide Building Society
	Derbyshire Building Society	Acquired by Nationwide Building Society
October 2008	Royal Bank of Scotland	Part-nationalised
	Lloyds TSB / HBOS	Part-nationalised
	Barnsley Building Society	Acquired by Yorkshire Building Society
November 2008	Scarborough Building Society	Acquired by Skipton Building Society
March 2009	Dunfermline Building Society	Part-nationalised, part-acquired by Nationwide

3.27 It was a surprising time for the Co-operative Bank to be contemplating a merger, particularly in the light of Britannia's risk profile. There is no evidence that the Board gave any serious consideration to the possibility of delay or walking away while it waited to see how the markets developed. At the very least, it might have been expected to ensure that great care was taken over due diligence, with a particular focus on commercial real estate.

The merger discussions

3.28 A merger between a co-operative and a mutual building society would have been impossible prior to the passage of the Building Societies (Funding) and Mutual Societies (Transfers) Act 2007, unless one of them demutualised first. The Act was the result of a Private Member's Bill sponsored by a Conservative MP, Sir John Butterfill. It had been the brainchild of Mutuo, an organisation set up in 2001 to promote mutuals and co-operatives, of which the Co-operative Group was a major supporter. The secondary legislation necessary to give the Act effect, and make the merger possible, was passed in 2009.

3.29 The Review was told that the possibility of a merger between the Co-operative Bank and Britannia was not on anyone's agenda prior to the Bill. The Co-operative Bank was conscious that it needed greater scale to compete effectively. But it had no clearly articulated strategy for increasing its size other than organic growth, which it recognised would be challenging. There was certainly no strong push to look for any other route.

3.30 Britannia had also concluded that in the long term its business was too small to compete effectively and that it needed to find a way to improve scale. Like the Bank, however, it was not actively looking for a merger partner. The Britannia Board was aware that business performance was under pressure given the economic environment, but did not appear to consider its survival to be threatened in any way.

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3.31 After the Butterfill Act received Royal Assent, the Bank Board asked its Chief Executive, David Anderson, to be open to merger opportunities that might arise. On the back of that brief, David Anderson approached Neville Richardson, CEO of Britannia, in May 2008. Ironically, Neville Richardson was said initially not to have been in favour of the Butterfill legislation. In July 2008, the two Chief Executives informed their Boards that they had been discussing the possibility of a merger and formal negotiations began. The merger agreement was signed in January 2009. Britannia members approved the merger in April 2009. It was completed in August 2009.

3.32 The attraction of the merger to the Co-operative Bank was the opportunity it gave to increase scale at what appeared to be nil cost, excluding the guarantee of continued payment of the Britannia Membership Reward for three years after the merger. Britannia brought with it a significant number of additional branches and a larger customer base into which to sell banking and insurance products, in particular current accounts. It would also strengthen the Co-operative Bank's mortgage capability. The Board looked briefly at other possible partners. But it concluded that no other building society offered comparable benefits. The Nationwide was too large. Coventry's branches were too geographically concentrated; and Skipton's business was too diversified.[22] I understand that Yorkshire was also considered, but discounted.

3.33 Britannia was particularly interested in the Co-operative Bank's current accounts and internet banking. It had decided that it was impractical to develop these capabilities independently. The fact that the Co-operative Group offered a membership reward was also attractive.

3.34 In contrast to what happened some years later in the negotiations with Lloyds Banking Group over the Verde assets, the Co-operative Group Board and Executive played a limited part in the Britannia transaction. Both were preoccupied at the time with the acquisition and subsequent integration of the Somerfield supermarket chain into the Group's Food business. But the Group was attracted by the prospect of increased scale for the Bank and by the addition of a large number of Britannia customers to its membership.[23]

3.35 The two Chief Executives agreed during their initial discussions that Neville Richardson would become the Chief Executive of the merged entity. When David Anderson delivered the proposal to his Board, it expressed some concerns. But it accepted his view that Neville Richardson's appointment was key to gaining the support of Britannia members for the deal. The Board interviewed him twice and subjected him to a series of psychometric tests. It considered no other candidates for the position.

3.36 It is not surprising that Neville Richardson was attracted to the role. He became the CEO of a substantially larger, broader financial institution, carrying with it greater responsibility and commensurate reward.[24]

3.37 It is not unusual in a merger for the role of chief executive of the merged entity to go to one of the incumbents. The mutual sector is no exception. The consequence in this case was that the greatly enlarged Bank appointed a CEO with no direct experience of running a bank, as opposed to a building society. He also brought with him a number of ex-Britannia executives, including the

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22 'CFS Merger Options on Strategic and Commercial Fit', 24 October 2008.

23 Once the merger was completed, Britannia members became members of the Co-operative Group, not the Bank. The Bank was a PLC and did not have members.

24 Neville Richardson's total compensation increased from £489,000 in 2008 (Britannia; £409,000 base salary; £52,000 in LTIP; £28,000 in benefits and pension) to £1,196,000 in 2010 (CBG; £664,000 base salary; £349,000 bonus; £162,000 in LTIP; £21,000 in benefits). Source: Britannia Annual Report 2008 and Co-operative Bank Annual Report 2010.

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new Director of Integration and Change to lead a complex integration and IT replatforming programme.

3.38 In view of some public speculation on this point, it is worth saying that I have found no evidence – either during interviews (with individuals including past and present board members, executives and regulators), or in documentation – of any pressure for the merger to take place from Government ministers, the Bank of England or the Regulator. The Butterfill Act, being a Private Members Bill, required the support of the Government to reach the statute book. But it received all-party support and was sponsored by an Opposition MP.

Due diligence and the merger agreement

3.39 Due diligence is an important part of any transaction. It serves to confirm all material facts in regards to a sale or purchase, reflecting the care a reasonable person should take before entering into an agreement. It typically includes commercial due diligence (which assesses the strategic fit between the two entities and the business's outlook) and financial due diligence (which reviews the quality of the financial accounts and is typically conducted with the assistance of advisers).

3.40 The Co-operative Bank's due diligence of Britannia included a review of the main risk areas in Britannia's business (as identified by the Co-operative Bank itself) and an examination of the business case for the combined entity under several different scenarios – a base case intended to reflect fairly neutral assumptions about areas such as interest rates and the course of the economy, and moderate and severe "stress" cases intended to show what might happen in more adverse circumstances.

3.41 The due diligence took place in two stages. This was not unusual. Phase 1 was conducted from August 2008 until the sale and purchase agreement was signed in mid-January 2009. Phase 2 was conducted between the signing of the merger agreement and merger completion in August 2009. Once the merger agreement was signed, the transaction could only be discontinued in certain specified circumstances. So the main purpose of Phase 2 ought to have been to determine the 'fair values' (see below) at which Britannia's assets and liabilities would be taken into the combined entity's balance sheet at the point of merger.

3.42 For the most part, the approach taken to the due diligence process was conventional. A Bank working team was set up under the Co-operative Bank CFO, Barry Tootell. The Bank and Group Audit Committees were jointly given the role of challenge. The Bank's Risk Committee looked in more detail at the risks.

3.43 A number of professional advisers were also engaged by the Bank. In particular:

i KPMG was asked in Phase 1 to look at the ten key risk areas in Britannia identified by the Co-operative Bank, review the transaction synergies, comment on the projected impact of the merger on capital, provide a high-level review of the Fair Value Adjustments proposed by Britannia and identify the key areas for follow up in Phase 2.

ii J.P. Morgan Cazenove was taken on as financial adviser to advise on negotiations and tactics for the transaction, advise on the valuation of Britannia, assist the Co-operative Bank and its advisers in determining the scope of appropriate due diligence, review the commercial due

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diligence conducted by the Co-operative Bank on Britannia in the context of evaluating the merger, co-ordinate the different advisers and assist with public announcements.[25]

3.44 KPMG's Phase 1 due diligence report was broadly neutral, though it did warn about Britannia's high risk profile and large exposure to sub-prime and specialist lending and arrears in its asset-backed securities. Its high-level analysis of Britannia's commercial loan portfolio identified no substantial arrears or impairment. At the time, Britannia executives described the commercial loan portfolio to KPMG as high quality. The Bank did not deem the risks identified by KPMG – and the way in which they were described – to be sufficiently material to stop the transaction going ahead.

3.45 The due diligence report recorded, however, that KPMG had not been given access to the Britannia premises. As a result, it was not able to look at individual loan files, as would have been necessary for a thorough due diligence on the corporate loan book. The Britannia and Bank management teams had agreed at the outset only to use information readily available. Britannia wanted to keep the proposed merger confidential until it was announced. KPMG could therefore only perform high level due diligence on the Britannia corporate book, based on whatever information was provided.

3.46 The Co-operative Bank's own Corporate Credit Risk team did have some access to Britannia's commercial book before the signing of the merger agreement. The Review has faced considerable difficulty in establishing how extensive this was in practice. There was no written report and the individuals concerned could remember little about it five years later. But it appears to have been limited. As far as it has been possible to ascertain, three members of a Co-operative Bank team including the Head of Banking Risk, Kevin Blake, reviewed about 30 of the largest commercial loans over a two-day period in early January 2009 (about two weeks before signing the sale and purchase agreement).[26] In the time available it cannot have looked at them in any great detail. Moreover, the high concentration risk which would have been apparent might have been expected to raise some important questions.

3.47 It is puzzling that no written report was requested or produced, particularly since one member of the team described the portfolio to the Review as containing *"the worst lending I have ever seen"*.

3.48 Kevin Blake provided a verbal update to the Bank's Risk Committee on 7 January. The minutes record that the work had not identified any *"holes"*, but noted that Britannia had a *"higher risk appetite and [that] processes [were] not as robust as those of [the Co-operative Bank]"*. It went on to say that *"nothing was found that was beyond addressing over time in terms of policies and processes"*.[27] Consequently, no further work was requested. There was little recorded discussion of Britannia's commercial loan portfolio either in the Risk and Audit Committees or in the Bank Board at any time prior to merger approval.

3.49 The cursory due diligence on Britannia's corporate lending portfolio is startling in view of how different that lending was to the Co-operative Bank's own business and that of comparable building societies. It is particularly surprising in respect of the commercial real estate lending, with its high concentration risk at a time of a deteriorating macroeconomic environment characterised by collapsing commercial real estate prices.

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[25] The full statement of services agreed between J.P. Morgan Cazenove and the Bank are set out in a letter sent by Tim Wise to John Reizenstein dated 19 January 2009, submitted to the Treasury Select Committee.

[26] Interviewees recall a fourth person being there, possibly from KPMG.

[27] Risk Management Committee minutes, 7 January 2009.

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3.50 Ironically, Britannia's approach was very different. As part of the limited scope of work that PwC was asked to conduct on behalf of Britannia, PwC identified, among a number of other matters, the Co-operative Bank's corporate lending book as a priority focus area for further due diligence. The Bank's corporate book was also reviewed by one of Britannia's non-executive directors who had previous commercial banking experience.

3.51 In January 2009, J.P. Morgan Cazenove advised the Co-operative Bank that it considered the transaction to be *"fair"* and described its commercial and strategic logic as *"compelling"*.[28] Stress testing under various scenarios suggested a comfortable Tier 1 capital ratio for the combined entity over the next three years.[29] The Bank Board minutes record J.P. Morgan Cazenove as telling the Board that the due diligence undertaken by KPMG *"exceeded that normally undertaken for listed companies"*.

3.52 It is not easy to understand how J.P. Morgan Cazenove came to this view about the due diligence. It seems that much of the evidence for the assertion came from assurances given by management, rather than any detailed review of the work itself. The fact that this Review was unable to trace any written report from management's due diligence on Britannia's corporate loan book makes it difficult to establish quite what information underpinned the discussions about it between J.P. Morgan Cazenove and Co-operative Bank management.

3.53 Similarly, the underlying assumptions for J.P. Morgan Cazenove's modelling as it related to the Britannia business came from Britannia's management. As with any financial model, the outputs are only as robust as the inputs. J.P. Morgan Cazenove was not asked to undertake any work to assess or challenge the assumptions underpinning management's projections.

3.54 In January 2009, the Regulator told the Co-operative Bank that the Tripartite Authorities (FSA, the Bank of England and HM Treasury) were *"content"* that the merger should go ahead.[30] The FSA had conducted its own stress testing in December 2008 and concluded that the projected capital position of the combined entity met its requirements, albeit by a small margin (4.3 per cent Core Tier 1 compared to the FSA's minimum requirement in stress conditions of 4 per cent).

3.55 In the light of the advice it had received, the Regulator's acquiescence, and its own Audit and Risk Management Committees' recommendation in favour, the CBG Board approved the merger on 13 January 2009. It concluded that the forecast income statement, capital and risk profile resulting from the merger were acceptable and that the business case was sufficiently attractive.[31] It believed that the Fair Value Adjustments gave sufficient protection against future losses.

3.56 The Group Board approved the merger the following day.[32] The Group Executive had recommended in favour, while noting that the transaction increased the Group's overall risk profile.

3.57 Restricted access to data in a Phase 1 due diligence exercise is not unusual. But it is usually followed up by more detailed analysis in Phase 2. Consistent with this, the KPMG report identified a number of areas which it felt should be addressed in more detail in the second phase, including

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[28] Tim Wise's oral evidence to the Treasury Select Committee, 3 December 2013.

[29] The high stress case was, however, based on the Bank of England's one in 25 years scenario. It did not therefore assume a prolonged low interest rate environment of the kind which actually occurred. It anticipated an improvement in base rate in the first quarter of 2011, which would likely have had the effect of increasing the Bank's net interest margins and profitability.

[30] Letter to the Co-operative Bank from the FSA (Clive Adamson), copied to Andrew Bailey (Bank of England) and Ed Whiting (HMT), 19 January 2009.

[31] CFS Board minutes, 13 January 2009.

[32] Group Board minutes, 14 January 2009.

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an analysis of Britannia's corporate loan book. It subsequently put forward a proposal to do the work. Instead, Bank management decided to conduct the Phase 2 corporate loan book due diligence in-house. As far as I have been able to ascertain, no further detailed examination of the corporate loan book was undertaken before the merger took effect.[33]

3.58 In sum, the due diligence performed on what turned out with hindsight to be the most critical part of the portfolio – the commercial real estate – can only be described as limited.

From approval to completion: January-August 2009

3.59 Once the merger agreement had been signed, it could only have been derailed by an adverse vote by Britannia members, by Regulator intervention or by a serious adverse event affecting the attractiveness of the deal. This last was defined in Material Adverse Change (MAC) clauses in the merger agreement. The Co-operative Bank's MAC clause gave it the option to walk away from the deal only if Britannia's capital headroom relative to its capital requirements fell below £100 million in the period before completion.

3.60 The Britannia members overwhelmingly approved the merger in April 2009. 86 per cent voted in favour.

3.61 The business case for the merger deteriorated substantially during the six months between approval and completion (Exhibit 9). An updated business case in July 2009 suggested that the combined entity would be loss-making for the first few years. The deterioration was in part driven by a change in macroeconomic forecasts that projected the base rate to remain lower for longer, and in part by a worsening in the assessment of the credit quality of the assets being acquired.

3.62 Britannia's capital position deteriorated to such an extent that in July 2009 it came within £55 million[34] of triggering the MAC clause. This was partly caused by something which might be regarded as close to a technicality. As already mentioned, in the month prior to merger, Britannia decided to buy back some of its subordinated liabilities and debt securities, generating a £57.9 million one-off gain.[35] The transaction enhanced the quality of Britannia's capital by replacing a significant amount of Tier 2 capital with a smaller amount of Tier 1 capital. It was an orthodox means of taking advantage of market conditions to generate a financial gain. But the profit could not be recognised in Tier 1 capital until it had been audited. So the transaction had the immediate impact of reducing Britannia's combined Tier 1 and Tier 2 capital by £99.5 million.

3.63 The buy-back was also a way of offsetting the fall in profitability of the underlying business. It had the effect of ensuring that a Britannia Membership Reward could be paid for 2009.

3.64 In July 2009, the FSA told Britannia that the buy-back demonstrated an insufficiently robust level of forward capital planning, but did not prevent it from going ahead.

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[33] KPMG did review the Fair Value Adjustments, including those to the corporate loan book, prior to completion of the merger, but this did not include any detailed due diligence on the portfolio.

[34] Email from Britannia Risk Capital Unit team to Co-operative Bank Banking Risk team, 18 August 2009, reported that the Britannia capital surplus was £155 million, compared to the £100 million minimum specified by the MAC clause.

[35] Britannia cessation accounts, 2009.

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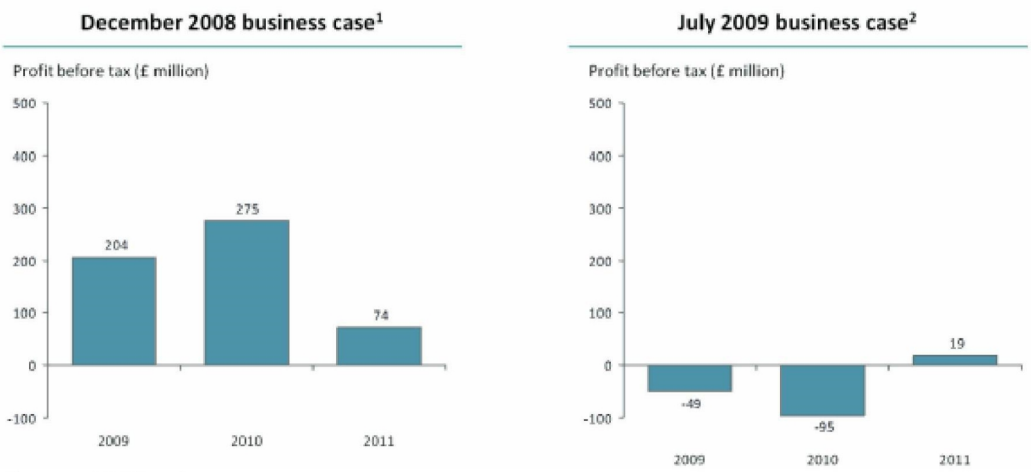
Exhibit 9: Forecast profit before tax for the combined entity, assuming consistent treatment of the Leek Notes



1. Shown to CBG Board.
2. Not shown to CBG Board.

Source: JP Morgan Cazenove, Project Vintage Board Paper, 20 January 2009; 'Vintage Update BT', 8 July 2009; Kelly Review analysis.

3.65 Bank management was informed of the transaction before it happened, but had no ability to influence the decision to pursue it.

3.66 The MAC clause was never actually triggered. So the Bank could not have called off the merger even if it had wanted to. But the deterioration in the capital position, illustrated by the near-triggering, should have been a major cause of concern to the Bank, particularly in the light of the economic climate and the expected tightening in regulatory requirements. At the very least it should have alerted the Bank to the need for very careful management of capital after the merger.

3.67 The Bank Board was not, however, given a chance to reflect on it because its attention was not drawn to either the deteriorating business case or the near-triggering of the MAC clause.[36] Details of the deteriorating business case (as shown in Exhibit 9) were at one point included in a draft Board report, but were removed before the paper was presented. At best, this was a major error of judgement.

3.68 The deterioration in the business case might also have been relevant to the view of the Regulator. Between December 2008 and July 2009 the capital position deteriorated on a like-for-like basis by approximately £205 million. The FSA did not re-run its stress testing prior to completion. Had it done so, it is possible that the business would have been judged at risk in stress conditions of falling below the minimum 4 per cent Core Tier 1 ratio.

3.69 A more thorough analysis of the commercial loan portfolio may not have led to a decision to abandon the merger. But it might have focused management's attention on the risks, resulting in closer scrutiny of the portfolio after the merger.

[36] There was a chart in Appendix 2 to a July 2009 CFS Board paper which would have shown that the capital position was forecast to deteriorate so that the MAC clause would be close to being triggered, but only if looked at closely.

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Fair Value Adjustments[37]

Exhibit 10: Fair Value Adjustments

Despite the transaction being described as a merger, for accounting purposes the Co-operative Bank was acquiring the Britannia business. As a result, Britannia's assets and liabilities were required to be adjusted at the point of acquisition to reflect their 'fair value'. Fair value is defined as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. Fair Value Adjustments broadly fall into two categories - changes to the value of an asset to account for lifetime expected credit losses ('credit Fair Value Adjustment') and changes to the value of both assets and liabilities as a result of interest rate fluctuations ('interest Fair Value Adjustment').

Credit Fair Value Adjustments reflect an expectation of not receiving full payment for an asset, for example because of a customer defaulting in the future. If the credit Fair Value Adjustment is accurately estimated at the point of acquisition, and if nothing else happens, future losses incurred on the assets would match the initial credit adjustment - thus having no overall impact on the income statement. Losses in excess of (or below) the credit Fair Value Adjustment would affect the income statement as incurred. If losses over the lifetime of the asset are lower than the credit Fair Value Adjustment, a gain is registered to the income statement.

Interest Fair Value Adjustments adjust the value of interest-bearing assets or liabilities according to the interest rate(s) and market conditions prevailing at the point the adjustments are made. The Bank was able to reduce the value of Britannia's Leek Note liabilities when it acquired them because they were trading in the market at a lower price than at the time the Notes were issued. But liabilities ultimately have to be repaid at par. So interest rate Fair Value Adjustments are subsequently "unwound" through the income statement over the expected life of the asset or liability in question. A day one decrease in the value of Leek Note liabilities led to a stream of charges to the income statement over the expected life of the Notes.

3.70 The final aspect of the merger which needs describing is that of Fair Value Adjustments made to the Britannia assets and liabilities following the completion of the merger. These adjustments were substantial (Exhibit 11). The value of assets was reduced by £1,782 million. The value of liabilities was reduced by £1,537 million, of which the Leek Notes contributed £1,259 million. The net impact of the adjustments was therefore £246 million.[38]

3.71 Two aspects of the Fair Value Adjustments should be highlighted.

3.72 First, the final adjustment to Britannia's corporate loan portfolio included a £284 million[39] credit-related adjustment to take into account the lifetime expected losses in the portfolio, of which £257 million was made against a specific pool of distressed loans. Hindsight suggests this to have been grossly inadequate: the impairments on the Britannia corporate portfolio had reached £802 million by June 2013.[40]

[37] Fair Value Accounting is a complex accounting requirement which is difficult to summarise in simple, non-technical terms. This report provides a brief description of the key points that are relevant to the Britannia story. The precise accounting requirements are governed by 'International Financial Reporting Standard 3: Business Combinations'.

[38] Numbers do not sum due to rounding differences.

[39] KPMG: Phase 2 Fair Value Adjustment report, July 2009.

[40] If the realised loss proves to be less than the amount provided for, some of the impairment would get written back.

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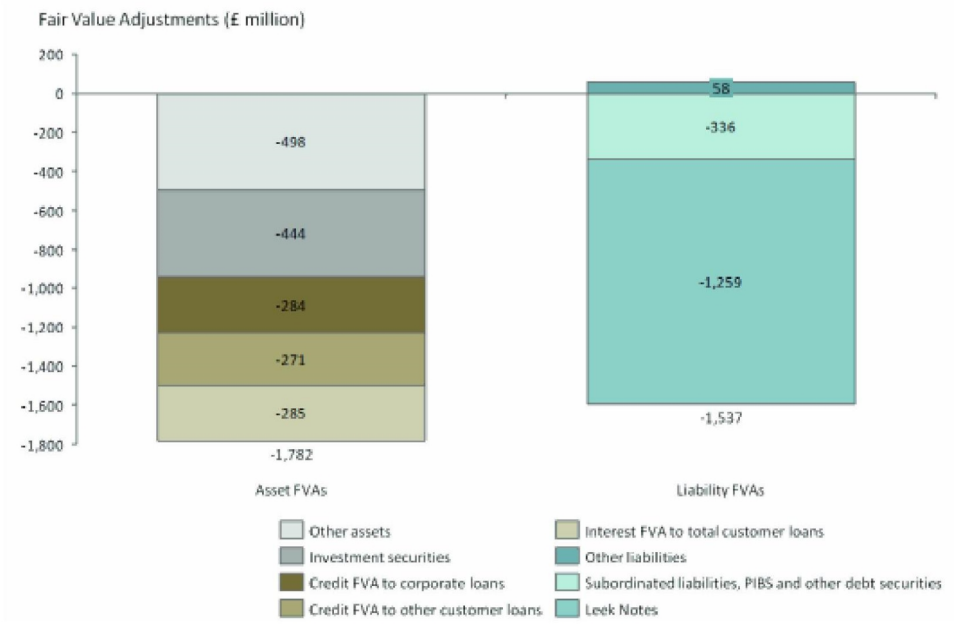
3.73 The credit Fair Value Adjustment to the commercial loan book was revised shortly before approval of the 31 December 2009 Annual Report and Accounts.[41] The extent of the work underlying the revision is again unclear. But, as before, it appears to have been limited. It was undertaken by a joint Britannia and Bank team, with KPMG performing its own assessment as part of the year-end audit. Management may well have considered the adjustment on which they alighted to be prudent. But there is some reason to believe that even in 2009 it might have been reasonable to have provided a somewhat larger number. The Review was told that the Corporate Credit Risk team argued that the adjustment should be higher, but was over-ruled. It is not clear by whom.

Exhibit 11: Final Fair Value Adjustments to Britannia's balance sheet



Source: Co-operative Bank Financial Statements 2009, 2010 and Co-operative Bank Finance; Kelly Review analysis.

3.74 The second issue is the interest Fair Value Adjustment to the Leek Notes. These securities were issued seriatim over a period of years. They have a typical contractual maturity of between twenty and twenty-five years. But they are structured so that the coupon increases five years after they are issued (referred to as 'step-up'). Regardless of the contractual maturity, instruments of this type are typically bought back ('called') at the point of step-up. Prior to merger, Britannia had always called Leek Notes at step-up – which was what the market expected to happen.

3.75 In line with the precedents and market convention, the Bank initially assumed in its merger business case that all the outstanding Leek Notes would be repaid as they reached their respective five year step-up points, rather than at maturity.

[41] The accounting rules allow a 12 month period during which the Fair Value Adjustments made on completion may be revised.

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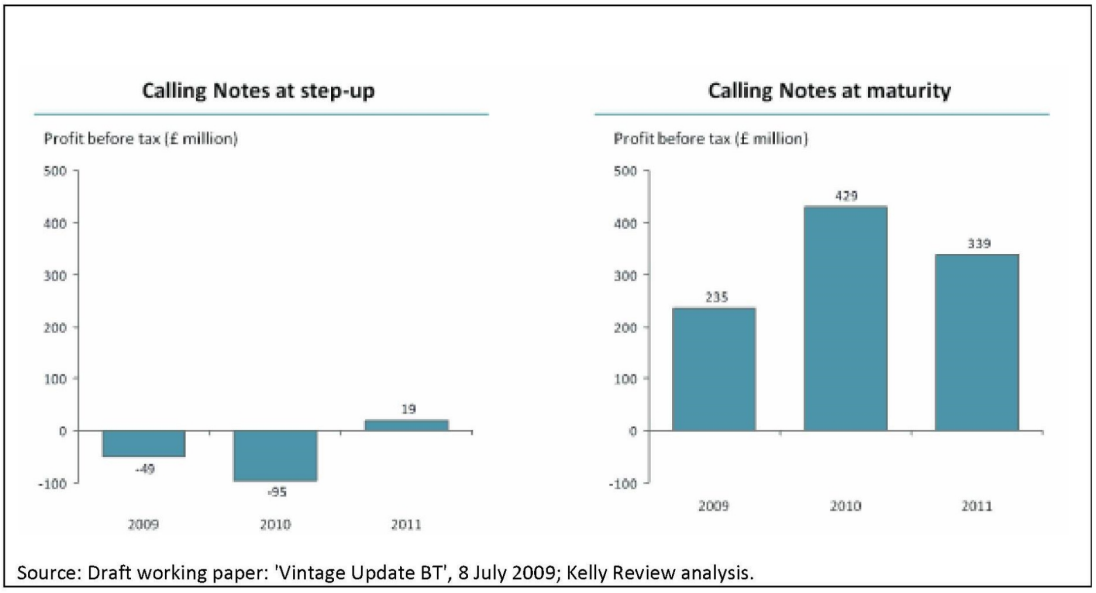
3.76 Following the deterioration in the business case, however, Bank management decided to change the assumption to one in which the Notes were expected to be repaid at the much later point of contractual maturity.[42] This change had the effect of deferring some of the charges to the income statement and improving the profitability and capital position in the near-term.

3.77 The change in assumption was an important judgement. But the CFO appears to have made a conscious decision not to draw it to the attention of the Bank Board at this point. The Review saw a draft Board paper, prepared in July 2009, which would have shown the business case impact under both a step-up and maturity assumption. This does not seem to have been presented to the Board. The work was based on a set of assumptions regarding the size of the Fair Value Adjustments which had yet to be finalised. However, it illustrates the dramatic impact which changing the Leek Note assumption had on the merger business case (Exhibit 12).

Exhibit 12: Forecast profit before tax under different Leek Note assumptions



Source: Draft working paper: 'Vintage Update BT', 8 July 2009; Kelly Review analysis.

3.78 In January 2009, the FSA had asked to be kept aware of all significant changes in Fair Value Adjustments. The Bank did not specifically inform the FSA of the change in assumption in the business plan. The CFO at the time justified this to the Review on the grounds that it was the expected unwind profile which changed, not the value of the adjustment itself.

3.79 The change in assumption was legitimate if management really did have the intention of not calling the Notes at step-up. But that would undoubtedly have sent a negative signal to the market about the firm's financial strength and risked constraining access to any future funding of this type. Indeed, in its Phase 1 due diligence report KPMG highlighted not calling the Leek Notes at step-up as a key risk. In practice, the next (relatively small) Note to reach step-up – Leek 14 – was called at that point in December 2009, contrary to the assumption made just a few months earlier. The history of subsequent Leek Notes is detailed in Chapter 11.

[42] Technically, each Leek Note is required to be repaid once the value of the mortgage assets within the securitisation reaches approximately 10 per cent of the original issuance, which will be before contractual maturity. However, for ease of explanation throughout this report, I refer to this requirement as 'maturity'.

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3.80 This episode is important for three reasons. The first is what it demonstrates about the approach of members of the Executive to informing the Bank Board of what might be thought to be important developments. The effect may have been to give the Board a false sense of security about the economics of the merger and the financial strength of the combined entity. Second, it shows a interesting attitude to dealings with the Regulator by some members of the Executive. Third, it is perhaps an early indication of the Executive team's tendency to push profit and capital problems into the future, presumably in the hope that an improving economic environment would increase profitability.

Was the merger a mistake?

3.81 The merger with Britannia lies at the heart of many of the Co-operative Bank's subsequent troubles.

3.82 As well as the direct effects, the indirect consequences of the merger are important. A narrow view of causality based solely on the performance of Britannia loans written pre-merger, such as that put forward in a submission to the Treasury Select Committee by several former Britannia Board members and officers, ignores the train of events and management action (and inaction) which can trace its roots to the merger.[43]

3.83 It is not difficult to understand why the Group and CBG Boards found the merger attractive given their desire for increased scale, the fact that it was presented as being at nil cost and the encouraging advice they were given by their own staff and by professional advisers.

3.84 It is less easy to understand why no consideration was given to delaying or cancelling the transaction in the light of the deteriorating economic situation; still less why no warning flags appeared to have been raised by the limited due diligence of the commercial real estate portfolio, despite the fact that commercial real estate prices were known to be collapsing.

3.85 It is fair to say that neither the absence of detailed due diligence of the commercial portfolio, nor the significance of its absence, was given prominence in any reporting to the Board; and the Board understandably took some assurance from J.P. Morgan Cazenove's reported remark about the quality of the due diligence that had been performed. But a more informed Board might have been expected to probe these issues more carefully.

3.86 It is impossible to know now what more detailed due diligence at the time might have thrown up. It is perhaps unlikely that it would have revealed sufficient difficulty with the portfolio to derail the deal. At the time the commercial real estate portfolio was showing minimal arrears or impairment[44] and there was considerable momentum behind the transaction. But it is possible that some of the characteristics of the commercial real estate lending, particularly its high concentration, might at least have given the Board pause for thought.

3.87 More detailed due diligence might also have caused the Bank to pay more attention to the subsequent management of both the commercial real estate lending and the rest of the BCIG portfolio. It is striking that, having identified how much of what they were taking on was outside their risk appetite, the CBG Board appears to have given little thought to what to do about it. It seems to have assumed implicitly that market circumstances at the time meant that there was little alternative to holding the assets to maturity.

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[43] Letter from former Board members and officers of Britannia Building Society to the Treasury Select Committee Project Verde Inquiry, 19 February 2014.

[44] KPMG: due diligence Report, 18 December 2008.

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3.88 Some interviewees suggested that a significant part of the very large provisions taken against the commercial real estate lending in 2012 and in the first part of 2013 resulted from a different interpretation of accounting conventions required by the Regulator and from events particular to some of the individual loans which only happened in 2012. But these claims are besides the point in this context. The Bank would not have held the portfolio in the first place but for the merger. In addition, the impact of events affecting individual loans in 2012 was more substantial than it might otherwise have been because of the portfolio's heavy concentration risk. It is possible that the management of the commercial real estate portfolio would have been given greater attention earlier had the Bank's post-merger Chief Executive been looking at the portfolio for the first time rather than having been Chief Executive of Britannia when the assets were accumulated.

3.89 Equally difficult to understand is the decision not explicitly to draw the Board's attention to either the deterioration of the business case for the merger or to the change of assumption about the unwind of the Fair Value Adjustments to the Leek Notes. It is hard to avoid the conclusion that both were major errors of judgement. Had the Board been more conscious of the fragility of the Bank's capital position, it might have paid more attention to it subsequently.

3.90 The merger not only had the direct consequences for the Co-operative Bank discussed in this chapter. It also greatly complicated the IT replatforming project; and it meant that the Bank's management were faced with the stretching task of trying to integrate the two organisations at the same time as navigating the enlarged institution through economically turbulent times.

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4 MANAGEMENT OF THE LOAN BOOK

Date	Key event	
August 2009	x	Merger with Britannia completed
Early 2012	x	Disaggregation of core and non-core loan book, with each reporting separately
March 2013	x	2012 Annual Report and Accounts include £427 million impairment to corporate loan book
August 2013	x	2013 Interim Accounts include additional £434 million impairment to corporate loan book

4.1 This chapter considers the management of the Bank's combined corporate loan book after the merger.

4.2 I have reached my conclusions on the basis of interviews with current and former Britannia and Bank executives, discussions with third parties, and a series of reports made at various times by employees and external advisers. The Review did not examine individual loan files.

4.3 It should be recorded that some interviewees had markedly contradictory perspectives to those recorded here. In September 2013, Neville Richardson told the Treasury Select Committee that *"the Co-op Bank had taken its eye off the ball of running the business"* after he left in July 2011. He suggested that this was one of the main reasons why the loan book had deteriorated markedly in 2012.[45] My view is that the Bank did not have its eye on the ball in the first place.

Britannia and Bank commercial loan portfolios compared

4.4 I have argued earlier that the approach the Bank took to due diligence at the time of merger meant that it did not seem fully to have appreciated the risks inherent in the composition of Britannia's corporate loan book when it made the decision to merge.

4.5 Britannia's corporate loan book in 2009 contained around £2.2 billion of commercial real estate loans, £0.8 billion of low risk but low margin housing association loans, and £0.7 billion of loans to landlords with portfolios of buy-to-let or multiple occupation properties.

4.6 Much of the commercial real estate lending was originated in the period immediately prior to the financial crisis, when prices were at their highest. Commercial real estate prices deteriorated dramatically in 2008 and 2009 (Exhibit 13).

4.7 Significantly, Britannia's corporate loan book was much more highly concentrated than the Bank's had been before the merger. The Bank's largest ten connections represented 11 per cent of their corporate book.[46] The equivalent figure for Britannia was 37 per cent. Britannia's individual connections were typically much larger than those of the Co-operative Bank.

4.8 Moreover, much of the heritage Britannia business had been originated through intermediaries, rather than directly through relationship managers as was the case for the Bank - suggesting that Britannia understood its customers less well than it would have done had its model been based on long-standing, broader-based relationships.

[45] Neville Richardson, in his written evidence to the Treasury Select Committee, also attributed the increase in impairments to changes in the Regulator's approach to provisioning. For discussion of this point see Chapter 11.

[46] Excluding loans to the Co-operative Group. Equivalent including the Co-operative Group was 13 per cent.

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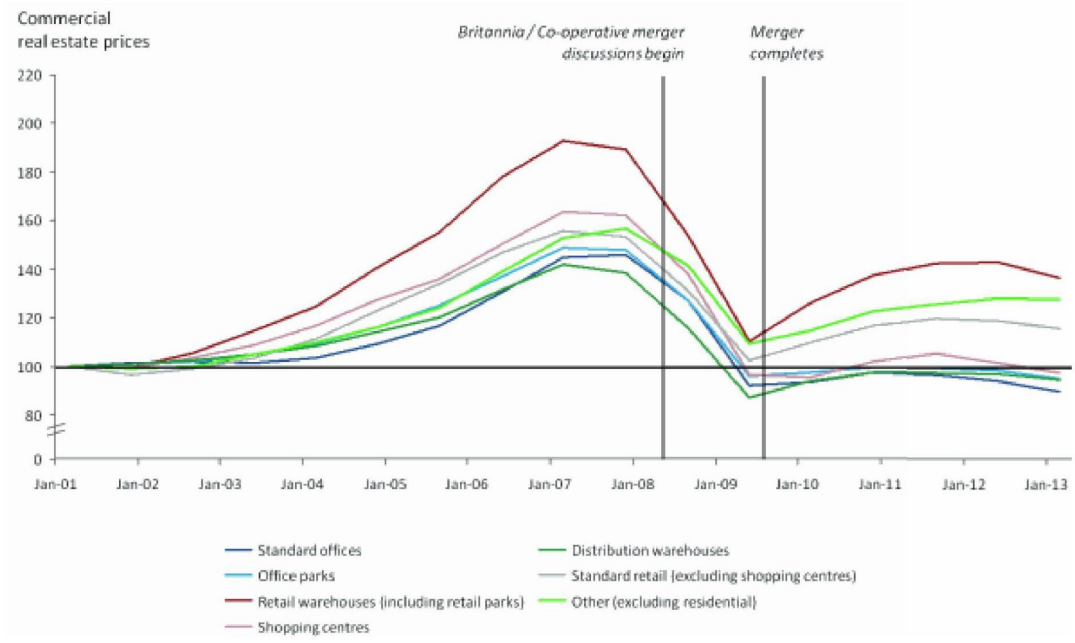
Exhibit 13: Regional commercial real estate prices, 2001 to 2013



Source: Regional IPD Index.

4.9 Britannia's lending criteria were also less conservative than the Co-operative Bank's. Its maximum loan-to-value at the point of origination was 85 per cent, compared with 70 per cent for the Co-operative Bank. Its minimum interest cover for interest-only loans was 105 per cent, compared with 150 per cent for the Co-operative Bank.[47]

4.10 It is also worth noting that a significant proportion of Britannia's commercial real estate and registered social landlord lending had been written at such low margins that for much of the post-merger period it has generated negative returns, even before impairments.[48] In addition, a number of interviewees told the Review that some of Britannia's loan documentation was incomplete, which led to difficulties when the Bank subsequently tried to take control of collateral.

4.11 The Bank's pre-merger loan portfolio had its own problems. But they were of a different order of magnitude to those of Britannia.

Post-merger strategy for managing the book

4.12 The Bank did not acquire Britannia for its corporate loans. Its interest lay in its branch network and retail customers. Since the Britannia corporate lending was mostly outside the Bank's previous risk appetite, logic might suggest that it should have wanted to dispose of much of it – particularly the concentrated commercial real estate lending – as soon as circumstances permitted.

[47] PwC: 'Project Ides: Commercial Credit Review', 29 April 2010.
[48] Paper presented to CBG Board, 'Corporate and Business Banking (CABB) Non Core Portfolio', 16 May 2012.

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4.13 At the very least, the Bank might have been expected to manage the portfolio separately from its other assets on the basis that relationship managers typically do not have the appropriate mindset or skills to look after unwanted exposures. The role of the relationship manager is to service the needs of the customers, not to handle the difficult negotiations involved when a bank wants to manage down its exposure or recover assets. It is partly for this reason that a number of other banks separated their books into core and non-core assets in the aftermath of the financial crisis. Instead, the Bank managed the combined book within Corporate Banking. This part of the Bank was led by Keith Alderson - the Business Leader for Corporate Banking until October 2010, and then Managing Director of Corporate and Business Banking until May 2013.

4.14 Surprisingly, the Board minutes for the period immediately after the merger record very little discussion of what to do about the inherited corporate portfolio and only a very high level consideration of risk mitigation. The Board was reassured that those large exposures which were experiencing difficulties were adequately covered by the Fair Value Adjustments and provisions already made, and that the rest of the book was of a high quality.

4.15 Market conditions in the period immediately post-merger are likely to have made it difficult for the Bank then to dispose of Britannia's corporate loan portfolio, even if it had wanted to. Prices were such that a sale would probably only have been achieved at a significant discount, which would have had a marked impact on the Bank's capital position. It is understandable that management should not have been keen to catalyse recognition of losses when they believed there to be a good chance that prices would recover, particularly since the vast majority of the loans were still being serviced.

4.16 But the Bank might have been expected to give some thought to disposing of part of this portfolio to reduce their risks, particularly as prices for commercial real estate began to improve during 2010 and 2011. Informal discussions may have taken place, but the Review has found no evidence of any serious consideration of the possibilities in any of the relevant documents. Instead the Bank, almost by default, allowed the loans to run on.

4.17 The Bank did eventually split the management of its loan book into core and non-core parts, but only at the start of 2012. The corporate assets in the non-core book at that point contained £3.3 billion of the Britannia heritage commercial real estate, landlord and social housing loans, and an additional £270 million of Co-operative Bank heritage loans. It was not until the first half of 2012, when most of the Fair Value Adjustments had been consumed and the Bank was becoming concerned about the possibility of further impairments, that the Bank looked seriously at the possibility of asset sales. It then began to approach advisers and potential acquirers.

History of impairments

4.18 Between 2009 and 2011 the Bank recognised total impairments to the corporate loan book of £324 million. £129 million of this was taken against heritage Co-operative Bank loans and new loans written post-merger by the combined organisation. The remaining £195 million was taken against heritage Britannia loans, of which £174 million was offset against the Fair Value Adjustment, and £21 million charged to the income statement.[49]

4.19 In the 2012 Annual Report and Accounts, impairments increased dramatically. The Bank then booked £427 million, of which £347 million related to the combined non-core book, which contained some heritage Co-operative Bank assets. In the 2013 Interim Accounts, the Bank

[49] Because the £257 million credit Fair Value Adjustment to the Britannia's corporate loan book was made specifically against a pool of distressed assets, impairments to loans outside that pool could not be offset by the Fair Value Adjustments.

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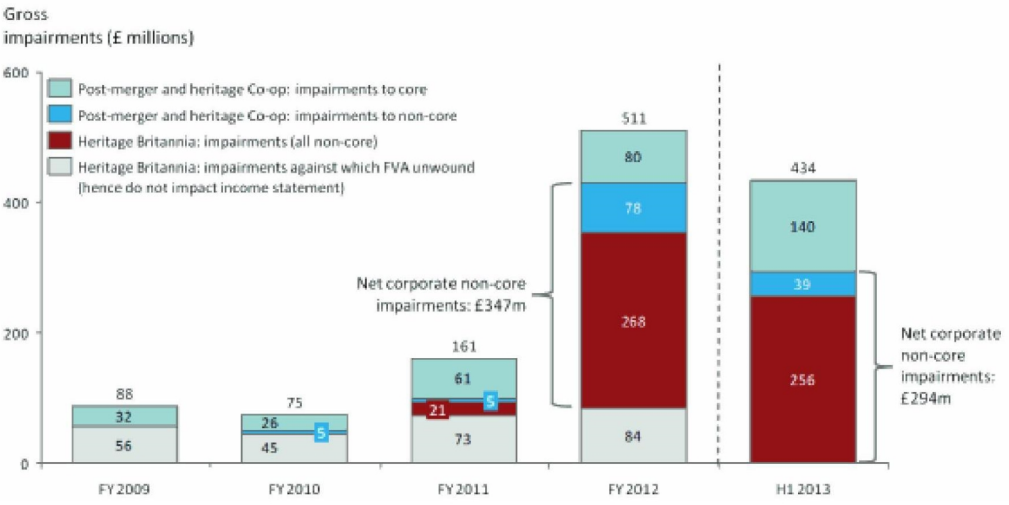
reported an additional £434 million of impairments, of which £294 million related to the combined non-core assets. £250 million of the additional impairment in the Interim Accounts reflected a decision to sell part of the portfolio (Exhibit 14).

Exhibit 14: Impairments to the corporate loan book, 2009 to H1 2013



Note: Does not include the £27 million Fair Value Adjustment to the non-distressed Britannia corporate assets which was unwound in the income statement separately. Numbers do not sum due to rounding differences.
Source: Co-operative Bank Finance, Kelly Review analysis.

Management of the corporate loan watchlist

4.20 Prior to merger, both organisations had watchlists for corporate loans that were either in distress or seemed likely to become distressed. Banks typically manage difficult exposures of this kind to minimise the probability of default, to maximise recovered value in case of default, to recover that value as quickly as possible or with some combination of the three in mind. In doing so a bank will tread a fine line. It must judge, for example, whether offering forbearance on a loan in financial distress will make it more likely that the customer will eventually return to financial health, or whether prompt foreclosure will maximise recovery.

4.21 In 2009, the combined bank set up a three-tier workout system to manage loans on the aggregated watchlist – a close care team (for connections with exposures greater than £0.5 million), an intensive care team (to turn around or restructure serious problem cases) and a corporate recoveries department (to recover assets from cases in administration).

4.22 The workout process was supervised by a Board Sub-Committee called the Exposures Committee (later disbanded and its remit passed to the Board Risk Committee and an executive Credit Approvals Committee). An executive-level Problematic Exposures Reporting Group (PERG), chaired by the Managing Director of Corporate and Business Banking, oversaw the management of the watchlist.

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4.23 In principle this approach was well-structured.[50] But a number of weaknesses prevented it from working well in practice.

4.24 First, the arrangements for putting connections onto the watchlist and managing them were relatively informal. There were criteria and procedures in place. But there was a lack of clear guidance on how to apply them.

4.25 Decisions on whether a loan should be moved on to the watchlist were taken by the relationship managers and underwriting team. Relationship managers had little incentive to put their clients forward, and the second line of defence failed to enforce a robust approach. In addition, when connections were put on the watchlist the rationale was often poorly documented. It was therefore sometimes not obvious to the relevant workout team why the connection should be treated as distressed, or how high a priority the case should be. PwC raised concerns about the documentation for putting accounts on the watchlist as early as 2010.[51] An Internal Audit report in 2013 reiterated this concern, and noted inconsistencies in the decisions made.

4.26 Second, in late 2009 the workout teams in total consisted of only ten full-time equivalent staff. There were over 350 connections on the watchlist or in default at this time, with a combined exposure of approximately £1.2 billion. When the teams were set up, the Function Leader of Corporate Business Support noted that further resource would be necessary if the watchlist was to grow. The Review heard that, despite an increase in the number of cases, resources were not increased accordingly.

4.27 Third, there were a number of large exposures in the heritage Britannia commercial real estate book which constituted a critical risk simply because of their size and asset type. These loans did not qualify for the watchlist at the point of merger because they were not showing any signs of distress. They therefore remained in the control of relationship managers. Of the heritage Britannia portfolio, less than a third (£1.1 billion) was on the watchlist in January 2010. It was not until the Bank formally split core assets from non-core assets in early 2012 that the business began to embed a systematic strategy for managing these loans separately. The then Managing Director of Corporate and Business Banking maintains that the Bank embarked on this course earlier. The documentary evidence seen by the Review suggests that the changes implemented in 2012 were considered to be very material.

4.28 Fourth, the split in responsibility for the watchlist between Corporate Banking and Risk seems to have created ambiguity as to which held responsibility for management of which connections. Consequently, it may have been difficult to ensure that the right connections received the right level of scrutiny.

4.29 Finally, and significantly, the minutes show that before mid-2012 the Bank Board as a whole engaged in only limited discussion of problem exposures, despite the fact that the corporate loan book posed such a risk. The Board received quarterly updates, which included information on large impairments and significant new business. But crucially the updates lacked important detail on the commercial real estate book such as the concentration risk or the capital it was consuming. An education session in March 2011 introduced the Board to some of these characteristics of the commercial real estate book. In May 2012, the Managing Director of Corporate and Business Banking brought to the Board's attention further details of the commercial real estate book, and the difficulties it was experiencing. Even at this point, there was

[50] Sufficient for KPMG, in its 2011 planning report to the Audit Committee, to have rated the control environment in corporate lending and credit at between 1 and 2 on a scale of 1 to 5 (where 1 is good). This conclusion was formed based on KPMG's previous audits.

[51] PwC: 'Project Ides: Commercial Credit Review', 29 April 2010.

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no significant recorded discussion of concentration risk. I find it very surprising that he, the CFO and the CEO did so little to communicate to the Board at an earlier stage the challenges posed by the loan book, and in particular the heritage Britannia commercial real estate.

4.30 A lot of detailed information on individual problem exposures had been provided to PERG and the Exposures Committee in the interim. But neither body had spent much time discussing the overall strategy for the portfolio.

Consequences of weaknesses in the workout structure

4.31 It is possible that more effective management of the watchlist and non-core portfolio might have resulted in lower losses from problem connections. A number of interviewees pointed to a range of process and collateral management issues, which they say combined to increase the impairments suffered by the Bank.

4.32 But there is a limit to what a bank can do to recover value from a poorly performing loan. The collapse in commercial real estate values between 2007 and 2009 meant that the underlying collateral for many of the problem connections no longer covered the full value of the loans. Recovery value in case of foreclosure was therefore constrained. Once the merger with Britannia had been completed, the probability is that there was relatively little that could be done to improve the eventual outcome.

4.33 It seems likely, therefore, that the impact of a better workout team would not have been significant. Even if the impairments might have been mitigated to some extent by closer management, the post-merger Bank was always going to incur impairments on a significant scale, and so would still have suffered from a substantial capital shortfall.

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Postscript: Optimum

4.34 In reviewing the assets the Bank acquired through the merger with Britannia, this chapter has focused largely on the £2.2 billion commercial real estate portfolio because of its significant contribution to the capital shortfall. There were, however, a number of much larger books within BCIG which merit some examination and which the Bank regarded before the merger as posing a much greater risk. At the point of merger, these portfolios had an aggregate book value of £9.4 billion, representing around 40 per cent of Britannia's assets and more than quadruple the value of the commercial real estate book. They also consumed the majority of Britannia's capital. They included assets originated through Britannia's 'Platform' (i.e. intermediary) business, such as sub-prime residential mortgages, buy-to-let loans and a small proportion of prime residential mortgages. They also included residential mortgage portfolios purchased by Britannia from other financial institutions.

4.35 Britannia did not manage these assets as a single portfolio. Shortly after the merger, the Bank combined them and called the portfolio Optimum. Because the Optimum assets were outside the Bank's risk appetite, it gave them to a separate team to manage. The assets were transferred into the non-core portfolio when core and non-core assets were split in early 2012. The book has been in run-off since the Bank first acquired it.

4.36 In contrast to the commercial real estate lending, the assets which went into Optimum were carefully looked at both in pre-merger agreement due diligence and subsequently for the purposes of calculating the Fair Value Adjustment. The Bank also engaged a third party to perform an independent review of the portfolios' performance. The thoroughness of the examination of these assets makes the limited nature of that performed on the commercial real estate lending the more surprising.

4.37 The Fair Value Adjustment made to the Optimum assets was £448 million, comprising £262 million for future credit losses and an interest Fair Value Adjustment of £186 million. Cumulative impairment charges on the book up to the 2013 Interim Accounts have amounted to around £210 million. Of this, only around £37 million has been charged to the income statement. Of the £262 million credit-related Fair Value Adjustment, £56 million[52] of protection for future impairment provisions within Optimum remained at interim 2013.

4.38 The comparatively low level of impairment within Optimum to date reflects the combination of a low base rate, which minimises arrears, and recovering residential house prices - which support the underlying value of the security. The portfolio is not, however, without future risk. A rise in base rate would generally be expected to improve the Bank's net interest margin; but a significant increase could raise impairments significantly, in particular on the large proportion of base rate tracker mortgage products. The prospectus for the Bank's Liability Management Exercise (LME) stated in November 2013 that *"if interest rates were to rise by 2.5 per cent, management estimate the impact on credit losses of Optimum resulting from such a rise in interest rates would be approximately £200 million (on a purely single stress basis)".* In the 2013 Annual Report and Accounts, around 35 per cent of the Optimum portfolio had a loan to value ratio of 90 per cent or above.[53] A sizeable fall in house prices could therefore also have a significant impact.

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[52] The remaining protection is lower than the net of the original credit Fair Value Adjustment and the amount utilised up to Interim 2013, primarily because of approximately £35 million of Optimum Fair Value Adjustment releases in 2010-2011. This presumably reflects a management belief that the lifetime losses incurred on these assets would be less than the original Fair Value Adjustment.

[53] Co-operative Bank Annual Report and Accounts 2013.

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4.39 The Bank did consider post-merger whether it would be possible to exit the portfolio. But the market price it would have achieved for most of the assets was significantly below their carrying value. Optimum is likely to cause a continuing drag on bank profitability for some time. The average net interest margin is low; and the reduction in credit available to some of Optimum's sub-prime customers in the aftermath of the financial crisis means that redemption levels have been significantly lower than anticipated at merger. It is likely that the portfolio will not shrink quickly. About £7 billion of the original £9.4 billion portfolio was still outstanding at end of 2013.[54] Some of the loans have a final maturity date as late as 2038.

4.40 The full extent of the impact of the Britannia assets acquired through the merger is not therefore measured solely by the impairments taken against commercial real estate lending. The Optimum portfolio is a capital-consuming, low margin book which may still pose material future risks to the Bank.

[54] Co-operative Bank Annual Report and Accounts 2013.

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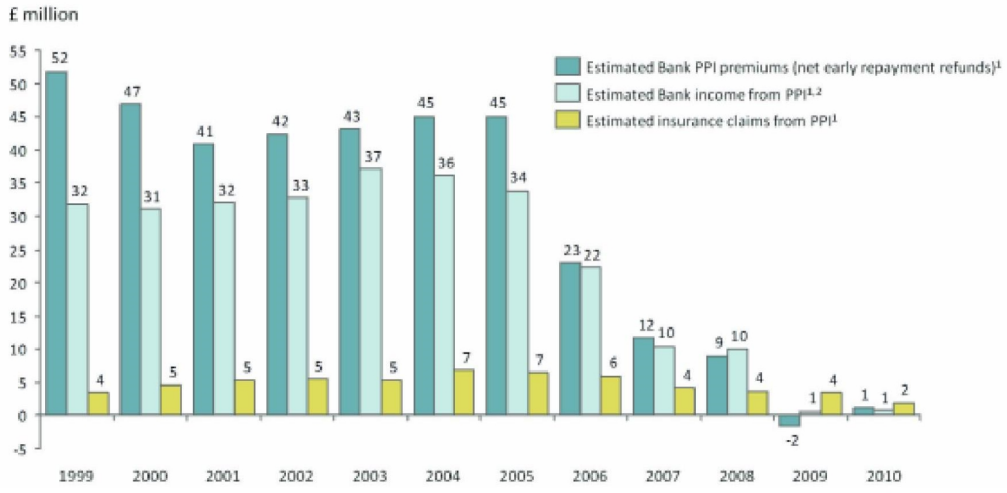
5 PAYMENT PROTECTION INSURANCE (PPI)

5.1 By the time of its 2013 Annual Report and Accounts the Bank had made provisions of £347 million in relation to compensating customers to whom it is judged to have mis-sold Payment Protection Insurance (PPI). Britannia did not engage in any large-scale selling of PPI. So this was neither a problem inherited from them nor a consequence of the merger. It was almost entirely a result of actions taken by the Co-operative Bank prior to the merger.

5.2 The Bank started selling PPI to its customers in the 1980s – a period when many other banks, and some building societies, were doing the same. It withdrew most products of this type in 2009.[55] PPI policies are meant to help with loan payments in the event of a reduction or loss of income. A policy is typically purchased at the point a customer arranges a personal loan, credit card or mortgage. It was a high-margin product with a very low claims rate. The Bank received a commission of between 50 and 70 percent from the insurer, plus a share in the insurer's profits. Between 1999 and 2005, estimated PPI income accounted for between six and eight per cent of the Bank's income (Exhibit 15).

5.3 The FSA assumed responsibility for the regulation of general insurance in 2005. In 2008, after a period of growing public concern about the possibility that many PPI policies had been mis-sold, it began a regulatory review. The industry recognised from the outset that the outcome of the review might require significant compensation payments from those institutions that had sold the product. The due diligence report undertaken for Britannia on the Co-operative Bank at the end of 2008 identified potential PPI compensation claims as a key future financial risk.[56]

Exhibit 15: Estimated Co-operative Bank PPI premiums, income and claims 1999 – 2010



1.Excludes Mortgage PPI, which accounts for less than 5 per cent of total PPI mis-selling provisions.
2.Income includes commission from the Bank PPI sales plus profit share with 3rd party insurer.
Note: Figures based on CBG estimates. Data prior to 1999 unavailable.
Source: CBG PPI Review team, Kelly Review analysis.

[55] The Bank stopped selling single premium loan PPI in January 2009, and monthly premium card and overdraft PPI in November 2009. It continued selling mortgage PPI in Co-operative Bank branches until May 2011 and in ex-Britannia branches until March 2012.

[56] PwC: "Project Red Wine: Phase 1 due diligence report", 14 November 2008.

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5.4 In September 2009, the FSA identified several industry-wide common failings in the way PPI had been sold. Typical shortcomings included placing undue pressure on customers to purchase, misleading customers about the necessity of buying it, not disclosing relevant information such as limitations to the cover provided, inadequate transparency about cost, and processing payments without the customer's explicit consent.[57] It set out new guidelines for providing customer redress in August 2010.[58] A judicial review, prompted by a British Bankers' Association's challenge to the guidelines, found in favour of the FSA in 2011.

5.5 In 2010 the Bank made an initial provision of £4 million for possible compensation payments. It increased the provision by £90 million in 2011, by a further £150 million in 2012, and another £103 million in 2013. Total provisions raised up to the end of 2013 are thus £347 million.[59] It is not alone in having had to revise upwards its initial estimates. Many other UK banks have had to do the same, having been surprised by the scale of claims made against them.

5.6 As far as it has been possible to ascertain, the scale of the provisions for PPI mis-selling made by the Bank relative to its customer base has so far been less than those made by some of the major high street banks, but much greater than provisions typically made by building societies. The final totals are not yet known. Claims are still being made and evaluated.

5.7 The Bank had an avowedly ethical policy. It is particularly disappointing that it pursued the high margins available from selling PPI, despite the fact that in many cases it manifestly failed to treat its customers fairly.

[57] FSA publication: 'Common Point of Sale Failings for PPI Sales'. http://www.fsa.gov.uk/pubs/other/trade_associations_ppi.pdf

[58] FSA Press Release: http://www.fsa.gov.uk/library/communication/pr/2010/132.shtml

[59] Co-operative Bank Annual Reports and Accounts 2010 to 2013.

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6 RISK GOVERNANCE AND CONTROL FRAMEWORK

Date	Key event
April 2010	x PwC delivers report of credit controls in commercial credit
May 2010	x FSA sends ARROW letter to CBG which includes concerns about risk appetite guidance and the role and remit of the CRO
April 2011	x FSA writes to the Bank highlighting its concerns with risk governance, asking the Bank to develop a new target operating model
Mid-2011	x Bank moves Banking Risk reporting line from CFO to CRO
July 2011	x Fiona Haywood appointed Head of Internal Audit
August 2011	x Bank moves responsibility for operational risk from Audit and Regulatory Compliance Committee to Risk Management Committee x Bank Internal Audit reporting line moves to Group
September 2011	x Deloitte delivers Risk Management Framework Design Review
October 2011	x FSA raises governance concerns, particularly about Internal Audit, culture and management stretch x Ernst & Young produces Internal Audit Quality Assessment Report
December 2011	x Deloitte delivers Operational Risk Management Review x Bank Internal Audit team transfers to Group
February 2012	x Merlyn Lowther is appointed Chair of Bank Risk Committee
March 2012	x Peter Shaw is appointed interim CRO
June 2012	x FSA reiterates its risk governance concerns
September 2012	x Exposures Committee disbands. Responsibilities transfer to Risk Committee and Credit Approvals Committee
October 2012	x Peter Harvey is appointed Chair of the Bank Audit Committee x David Rutherford appointed interim Head of Internal Audit
January 2013	x Grahame McGirr appointed CRO
February 2013	x Barry Pert appointed Operational Risk Director
May 2013	x Internal report and PwC report into collateral valuation errors

6.1 This chapter looks at the Bank's risk management framework applying to all areas of business. It considers multiple forms of risk, including credit risk, operational risk and liquidity risk. There were serious deficiencies – apparently dating from before the merger and not addressed early enough after it – in the way the Bank implemented the framework throughout most of the period under review.

6.2 Various advisers reviewed different aspects of the Bank's approach to risk governance and control at different times (Exhibit 17). Not all were wholly negative. The Regulator, however, consistently expressed concerns about shortcomings in the Bank's approach and showed increasing frustration as time went on. There was little sign of improvement until the arrival of a new (interim) Chief Risk Officer (CRO) in March 2012. By then the Regulator's patience appears to have been running out. Its concerns about the Bank's approach to risk management contributed significantly to the size of increase in the Bank's capital requirement imposed in January 2013. Substantial capital add-ons were required specifically for both operational risk and concentration risk.

6.3 It is worth noting that CBG's Risk Management Committee, and to a lesser extent its Audit and Regulatory Compliance Committee, spent a significant amount of time and attention during much of the period on CBG's life and general insurance businesses in addition to the Bank. This was

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particularly the case between 2010 and 2013, during prolonged negotiations with the Regulator and potential acquirers about the sale of the life business.

Three lines of defence

6.4 Successful risk governance in a bank requires a clear statement of risk appetite, translation of that into unambiguous guidance which is consistently and robustly implemented, a good understanding of risk on the part of those selling products, independent and influential challenge of the way the guidance is being followed, and post-event auditing of how well the processes are being operated.

6.5 Most banks today employ a three lines of defence model:

i *First line*. The business management and the day-to-day practices and controls within the customer-facing business. For example, when a relationship manager agrees a loan with a customer she or he should adhere to a set of policies and procedures designed to mitigate the risk being taken on.

ii *Second line*. A set of specialist control functions covering risk, regulatory compliance, legal issues and elements of finance and HR. These functions are responsible for the design, monitoring and policing of policies and procedures, for the training necessary to embed these policies and procedures in the business and for reporting to senior management and the board on risk issues. The second line's remit includes translating a bank's risk appetite into tangible guidance – for example, through Key Credit Criteria specifying aspects such as the maximum exposure allowable to any one client.

iii *Third line*. Internal audit provides independent assurance that appropriate procedures are in place and being followed.

6.6 In principle, the Bank adopted this model. It had developed an appropriate risk management framework, setting out the general principles and structures.[60] In reality, there were deficiencies in the way in which all three lines of defence were implemented.

6.7 Eventually the Bank began to implement significant changes to risk governance at the start of 2012, after Barry Tootell's appointment as acting CEO and when an interim Chief Risk Officer was appointed. The CBG Board sub-committees were re-organised in late 2012, with the Risk Management Committee taking some of the responsibilities from the dissolved Exposures Committee. At the same time, a new Head of Internal Audit was appointed. The Bank appointed a new CRO in early 2013.

6.8 The new management have taken positive steps towards reforming risk governance, including a reorganisation of reporting lines and some changes in personnel. Several interviewees told the Review that the Bank has been rebuilding the Risk Management function almost from scratch.

The first line of defence

6.9 Past and present employees told the Review that the heritage Co-operative Bank had a risk-averse culture.

6.10 This may, or may not, have been the case pre-merger. The Review has found that in the Bank post-merger:

[60] 'CFS Risk Management Framework Design', June 2011.

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i Risk awareness in the first line was generally low, and not supported by adequate training.[61]

ii Risk appetite statements were not always translated into effective policies and guidance.[62]

iii Where policies did exist they were sometimes inconsistent or incomplete. As late as 2013, the Credit Approvals Committee noted that Key Credit Criteria had not been defined for several of the commercial sectors in which the Bank operated.[63]

iv In areas where policies and procedures were in place, they were frequently ignored, with little apparent comeback either from the management of the front line or from the second line supposed to be policing them.

v Accountability was not always clear. For example, the FSA expressed concern in 2010 about the lack of clarity in the responsibility for operational risk in front-line managers.

vi Escalation procedures were frequently unclear and often informal. Informal methods have their place, particularly in small organisations. But they can be unreliable and lead to mistakes which a more formal approach would prevent.

6.11 Three examples of poor process in the first line in the corporate part of the Bank stand out. The first line of defence is the responsibility of the leadership of the relevant business unit, in these cases the Managing Director of Corporate and Business Banking, Keith Alderson.

i Breaches of the Key Credit Criteria were far from the exception. In 2012, for example, 46 per cent of new or increased corporate loans breached the relevant criteria. Only 33 per cent did not. It was impossible to assess the compliance or otherwise of the remaining 21 per cent because no relevant guidelines existed.[64]

The Key Credit Criteria were intended to be guidelines, not straitjackets. Policy was that they could be over-ridden in exceptional circumstances with the approval of the CEO, or for larger loans the Exposures Committee.[65] But such approval appears to have been given routinely, with little clarity about what constituted 'exceptional' circumstances. Approval of one loan of £64 million, well above the agreed limit of £25 million, was sanctioned in 2012, for example, on the grounds that it provided *"an opportunity to increase our support to a business which continues to perform well and with which we have developed a good relationship".*[66] It does not say much for the corporate Bank if it considered good performance and good relationships to constitute 'exceptional' circumstances.

I make no judgement on whether the Key Credit Criteria as set were appropriate to the Bank's circumstances at the time. The point is that if they accurately reflected the Bank's risk appetite they should have been followed in the vast majority of cases. If, on the other hand, they were set inappropriately, they should have been revised. Over-riding them systematically gave mixed messages and encouraged poor risk discipline in the first line.

ii Bank policy was to revalue the collateral for its commercial loans every two years, or every year for loans on the Bank's watchlist. Overrides were allowed under certain circumstances, for example while properties were being refurbished. But, as with the Key Credit Criteria, if a

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61 A point brought out in relation to operational risk, for example, in Deloitte's 2011 Risk Management Review.
62 As highlighted at different times both by the Regulator and by various external advisers.
63 Credit Approvals Committee minutes, 22 April 2013.
64 Email exchange between Credit Risk and CEO, 6 February 2013.
65 The Credit Approvals Committee from September 2012.
66 'KCC non-compliant summary', February 2013.

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policy of this kind is set appropriately it should normally be followed, particularly during a period when property values are changing rapidly. Even if borrowers are paying interest due, prudent lenders keep a close eye on the value of collateral against the possibility of borrowers coming under greater pressure should interest rates increase or a prolonged recession causes problems for tenants.

In practice, this area provides a further example of laxity in implementing agreed policies. A review of commercial credit policies by PwC in April 2010 noted a *"significant"* number of overrides by the management at the Co-operative Bank to the two-year revaluation rule, especially in the case of heritage Britannia loans.[67] An internal Bank review in May 2013 identified as many as 60 per cent of corporate loans as having errors in collateral valuation.[68] Not all of the errors were examples of revaluations being missed. In some cases revaluations had happened, but the wrong date had been entered on the file. In other cases, the collateral had been revalued by reference to a property index, but using the wrong index. The point is the same, whatever the nature of the error. On the face of it, the Bank had in place sensible risk management policies of a kind expected in a well-run bank. When subjected to examination, it turned out that compliance by the front line was at best sloppy. The second line either did not know what was happening, or if it did, did not respond effectively. The scale of the collateral revaluation overrides seemed to come as a surprise to the second line when it came to light.

The errors were not trivial. They could have had consequences for how some of the loans were managed and for the Bank's assessment of the risk it was carrying, including in the performing part of its commercial book.

iii Forbearance levels at the Bank were higher than in many other firms.[69] Benchmarking in this area is not an exact science. But the Bank of England reported that the median forbearance rate in UK commercial real estate lending in 2012 was 20 per cent by value.[70] In its contribution to the survey from which the Bank of England derived this figure, the Bank told the FSA that the forbearance rate in its own commercial real estate lending was 27 per cent in June 2011.[71] An internal paper, which seems to have used a different methodology, gave a figure of 29 per cent.[72] A number of interviewees told the Review that relationship managers systematically gave corporate customers the benefit of the doubt, trying to increase lending even when there were signs the customer was in financial difficulty. It was suggested that the heritage Co-operative Bank corporate relationship managers were ill-suited to managing the broker-sourced loans in the heritage Britannia book.

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67 PwC: 'Project Ides: Commercial Credit Review', 29 April 2010.

68 CABB lending policies memo, 14 May 2013.

69 In their correspondence with banks relating to a sector review of CRE lending, the FSA defined forbearance as occurring when "*a bank, for reasons relating to the actual or apparent financial stress of a borrower, grants a concession whether temporarily or permanently to that borrower... A concession may involve restructuring the contractual terms of a debt (such as a reduction in the interest rate or principal due, or an extension of the maturity date or any weakening of the security structure or adjustment/non enforcement of covenants) or payment in some form other than cash, such as an equity interest in the borrower*." See 'Forbearance Policies, Practices and Controls. Qualitative Return' paper submitted by CBG to the FSA in December 2011.

70 Bank of England quarterly bulletin, 'Commercial property and financial stability', 2013 Q1. http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2013/qb130105.pdf

71 'Forbearance Policies, Practices and Controls. Qualitative Return', paper submitted to the FSA, December 2011.

72 'Forbearance in the Commercial Real Estate (CRE) Portfolio', paper presented to the Exposures Committee, October 2011.

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The Bank prided itself on putting customers first. That sentiment is admirable. But where the approach pushes the Bank beyond its risk appetite, risk governance has failed.

The second line of defence

6.12 The three examples above were neither picked up nor as effectively dealt with as they should have been at the time by the management of the first line. They also evidence the weakness of the Bank's second line. In particular, they highlight the poor quality and incompleteness of the guidance the second line provided to the first line, its failure adequately to police the first line's compliance with agreed policies and its poor reporting on risk to the CBG Board and Executive. There were flaws both in the second line's organisation and in its capabilities.

Organisation

6.13 The organisation of the second line was unusual. Until mid-2011, the team dealing with credit risk – one of the most important risk areas for any bank – reported not to the Chief Risk Officer, as might be expected, but to the Chief Financial Officer.

6.14 This arrangement might have been regarded as sensible in light of the fact that the Chief Risk Officer was not a banker.[73] He was a qualified actuary who had previously worked in CBG's insurance businesses. If that was the reason, it raises the question of why it was thought acceptable to employ someone without banking experience as Chief Risk Officer of an enlarged banking group at a time of financial crisis, even if that group did include two insurance businesses.

6.15 The arrangement goes against generally recognised best practice in two respects.

6.16 First, the function of the second line of defence is to provide independent challenge to the first line and the rest of the business. A reporting line which blurs this distinction compromises the ability of the second line to do its job properly. The fact that the credit risk team reported to the CFO must have made it harder for the second line to challenge decisions signed off by the CFO, for example determining the extent to which provision was taken against non-performing loans.

6.17 There were a number of other cases of first and second line functions being mixed up. The FSA specifically expressed concern to the Bank about two examples. The first was asking retail credit teams both to create risk scorecards and to challenge them. The second was allowing both first and second line functions to report to the Head of Banking Risk.[74]

6.18 Second, it may not have been unknown elsewhere in the industry for credit and treasury risk to report (as it did in the Bank) to the CFO, while the CRO reported directly to the CEO on operational, conduct and other forms of risk. But this arrangement contravened the recommendation of the 2009 Walker Review that the CRO *"should participate in the risk management and oversight process at the highest level, covering all risks across the organisation, on an enterprise-wide basis".*[75] Unified reporting to a senior member of the Executive – whose sole responsibility was to oversee risk – increases the chances of an organisation effectively monitoring, reporting and addressing all risks. The indirect reporting line reduced the visibility of credit risk in the organisation.

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[73] Prior to merger, neither the Bank nor Britannia had a named CRO.

[74] First line functions identified by the FSA included corporate underwriting, credit limit authorisations and scorecard development. FSA Core Prudential Programme letter, 8 April 2011.

[75] Walker Review, p. 98. The FSA highlighted its concern about the lack of a single point of responsibility in the Bank for all risk areas in 2011.

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6.19 In mid-2011, following the appointment of Barry Tootell as CEO, responsibility for credit and treasury risk transferred to the CRO, thus meeting the Walker Review recommendation. But the CRO post was still at that time filled by an actuary. It was not until March 2012 that the Bank appointed a CRO with a substantial banking risk background. The impact of having someone in the role with knowledge of how things were done elsewhere was immediate.

Capability

6.20 There were further weaknesses in capability below the CRO. The Review was told that the Head of Banking Risk was more highly regarded within the business for his technical abilities than for the robustness of his challenges, given the circumstances in which he found himself at the Bank.

6.21 The number of employees in the second line seems to have been broadly consistent with what one would expect for a small diversified financial institution, although several interviewees referred to the Treasury Risk function as being under-resourced. More important than the quantity of staff, however, is the quality. Interviewees reported that the Risk function relied on a few good people, and that those people were stretched thinly.

6.22 The second line was also poorly supported by IT systems. The Bank lacked the quality of data warehousing and automated reporting that one would expect to find in a strong Risk function. The operational risk management system ('MEGA') was out of date, with the result that operational risk reporting was fragmented across multiple systems.[76] The Risk function is one of several examples of the business suffering from lack of investment while it waited for the Bank's IT replatforming programme to resolve its problems.

Management information

6.23 The Review has been told that the management information (MI) supplied by the Risk function was not fit for purpose, partly as a result of the flaws in the IT systems. The CRO's Risk Reports to the Board did not provide sufficient detail or quantitative analysis, and were not presented in a way that was easy to understand. They typically provided data with a two-month lag. In February 2012, the Bank Risk Committee's new Chair expressed serious concern that the MI lacked hard data, and the Committee noted that there was too much of the wrong kind of information. The FSA had earlier highlighted similar weaknesses in June 2010.[77] In 2011, Deloitte said much the same.[78] A number of interviewees, including CBG Board members, claimed they had concerns about the quality of risk MI. It is unclear why the Board put up with this for so long. Improvements only happened after the arrival of the new interim CRO in March 2012.

The third line of defence

6.24 The Bank's Internal Audit team was the subject of two external reviews during the period under examination.

6.25 The first, by Ernst & Young in 2011, was largely positive.[79] The review reported that Internal Audit was well-supported, highly-motivated and generally conformed to the International Standards for the Professional Practice of Internal Auditing (IIA), while highlighting room for improvement in a number of areas, for example regarding levels of quality assurance.

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[76] Operational risk report, May 2013.
[77] CFS Board minutes, 9 June 2010.
[78] Deloitte: 'Risk Management Framework Design Review', September 2011.
[79] Ernst & Young: Internal Audit Quality Assessment Report, 31 October 2011.

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6.26 The second review was commissioned following an ARROW letter from the Regulator in June 2012, in which it asked senior management to provide assurance on the effectiveness of the Internal Audit function. The Regulator judged the IIA standards to be insufficiently rigorous and argued that the function should instead be compared to that of its peers. This second review, conducted by a different firm in late 2012, was highly critical. It is also worth noting that one of the first acts of the new (interim) Head of Internal Audit appointed in October 2012 was to restructure the team completely, replacing the majority of its staff in early 2013.

6.27 It is fair to say that the team had laboured under a number of handicaps.

6.28 According to the Regulator's Approved Persons regime, the Head of Internal Audit should have a reporting line to the governing body of the bank. The Regulator prefers that the Head of Internal Audit has a line into the Chair of the Audit Committee (who should be a non-executive director with no executive responsibilities), with a day-to-day reporting line to the CEO. The power over appointments and remuneration usually lies with the Chair of the Audit Committee. In CBG, until mid-2011, the Head of Internal Audit had a partial reporting line to the CRO – another example of confusion between lines of defence which must have affected their ability to criticise the second line. The team's independence was further compromised by the fact that the CRO reviewed all red and amber reports before sign-off, even if the final decision rested with the Head of Internal Audit.[80] It was not until reforms initiated in December 2012 by the new Head of Internal Audit that the Bank changed reporting lines so that the role reported directly to the Chair of the Audit Committee, with a secondary 'dotted' line to the CEO.

6.29 Second, the Internal Audit team was one of those most affected by changes in reporting lines resulting from Project Unity. The circumstances are described in detail in Chapter 8. In brief, in December 2011 the team transferred out of the Bank to be managed by the Head of Group Internal Audit. It transferred back to CBG just over a year later. While in the Group, most of the team could find itself at times diverted to other areas of the business. Being part of the Group team also meant that the Head of Bank Internal Audit found herself with a secondary reporting line to a non-Approved Person[81] – something which was not considered best practice and worried a number of those involved.

6.30 It is not evident that the Bank's management treated Internal Audit as a priority, or that the Internal Audit team exercised significant influence within the business. In contrast to what was said in the 2011 Ernst & Young report about the function having a high profile, several interviewees told the Review that it lacked access to senior management – especially after the implementation of Project Unity, the impact of which fell outside Ernst & Young's remit.

6.31 Nor did the CBG Audit Committee pay a great deal of attention to Internal Audit before late-2011. In that year, the FSA expressed concern that in the usual fifteen or sixteen pages of Audit Committee minutes typically only two to three were related to internal audit activity.[82] Until Peter Harvey joined the Committee in September 2011, the membership had possessed little banking experience.

6.32 A final judgement of the capability of the Internal Audit team ought to be based on the relevance and quality of the reports it produced. In that context it is unfortunate that it did not provide greater insight into some of the key risk areas of the business. In particular, it did not highlight any significant problems in commercial lending until March 2013, when it issued a highly critical report on the management of exposures. This report identified weaknesses in identifying and

[80] A practice criticised by the FSA in their Core Prudential Programme letter, 13 October 2011.
[81] Although the Bank's internal auditor still retained access to the Chair of the CBG Audit Committee.
[82] FSA: Core Prudential Programme letter, 13 October 2011.

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managing high-risk exposures, and determining the necessary provisions.[83] Some of the judgements in earlier reports which touched on the subject make for surprising reading in the light of subsequent events. In March 2010, a report stated that *"overall we found that the controls established over corporate exposures are suitably robust and materially address the key risks"*.[84] A June 2010 report stated that *"the controls ensure an effective governance system is in place to facilitate the future growth and profitability of the Real Estate & Public Sector division in line with risk appetite"*.[85]

Governance of the risk management framework

6.33 The Bank did not treat the risk management framework as a whole as seriously as I would have expected.

6.34 Until September 2012, there were three Board sub-committees with responsibility for different elements of risk governance:

i *Exposures Committee*, responsible for approving large loans, monitoring exposures and overseeing problematic connections.

ii *Risk Management Committee* (re-named the *Risk Committee* in September 2011), tasked with oversight of a number of risk areas such as credit, market and liquidity risk, and, from August 2011, operational risk.

iii *Audit and Regulatory Compliance Committee* (re-named the *Audit Committee* in August 2011), responsible for overseeing internal audit, external audit, regulatory compliance, financial reporting and, until August 2011, operational risk.

6.35 The Regulator expressed concerns about these arrangements in a series of communications beginning in 2011:

i It was unclear which committee had responsibility for conduct risk – not a trivial issue in the light of the provisions the Bank has had to make for the consequences of PPI mis-selling and, more recently, for other forms of conduct and legal risk.

ii Oversight of operational risk before mid-2011 was vested in the Audit and Regulatory Compliance Committee rather than the Risk Management Committee, which meant that neither committee had a view across CBG's entire risk spectrum.[86] The FSA could have added that both the Exposures Committee and the Risk Management Committee had responsibility for aspects of credit risk, which further exacerbated the difficulty of forming a single view of risk.

iii Non-executive directors on the Exposures Committee were performing roles which were in part the normal responsibility of the Executive.

iv The Board placed too much reliance on these committees rather than considering risk itself.

6.36 The last of these points might reflect the fact that risk issues, and in particular highly technical issues like the changes instigated by new Basel Accords, were a challenge for some of the democrats on the CBG Board, and possibly even for those IPNEDs with insurance, rather than

[83] Internal Audit report: 'Review of Corporate Exposures', 22 March 2013.
[84] Internal Audit report: 'Corporate Exposure Management', 22 March 2010.
[85] Internal Audit report: 'Real estate & Public Sector', 8 June 2010.
[86] Some common membership between committees did partially address this.

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banking, backgrounds. Only those few IPNEDs with banking experience had direct experience in bank risk management.[87]

6.37 The involvement of some of the IPNEDs in sanctioning large loans in the Exposures Committee provided some comfort to other members of the CBG Board. In reality, approval appears to have been something of a formality. The Review was unable to identify in the relevant minutes a single occasion after the merger on which either the Exposures Committee, or the executive-level Credit Approvals Committee which partially replaced it from September 2012, refused a loan application from the point of the Britannia merger until May 2013.[88] It is scarcely credible, given what we know about the Bank's risk management capability, that this was because earlier processes had been so efficient in weeding out weaker proposals that no refusals were appropriate.

6.38 In the light of the importance of concentration risk to the Britannia CRE portfolio and to the impairments charged to the corporate book in 2012 and 2013, it is worth noting that neither the Exposures Committee nor the Risk Committee are recorded as having paid much attention to the risk posed by the significant number of large counterparty exposures in the corporate loan book, although they did briefly discuss it on a number of occasions.

6.39 By the end of 2012, the FSA's patience with the Bank's lethargy in dealing with its concerns about the risk framework had clearly worn thin. In January 2013, the FSA increased the Bank's capital requirements significantly, at least in part due to concerns about its approach to risk.

Operational, liquidity and conduct risk

6.40 This chapter has focused on the operation of the Bank's risk framework in relation to credit risk. Other forms of risk management suffered from similar weaknesses.

Operational risk

6.41 Operational risk management has, until recently, been an under-developed discipline in many banks. Nor in the past did it receive much scrutiny from regulators. A greater focus on operational risk would however have helped the Bank deal with a number of the issues it faced. There was little challenge from the Bank's Risk function of either the replatforming programme, the integration of Britannia or Project Unity. In December 2010, Internal Audit noted that the total second line resource then charged with overseeing the entire Integration and Change directorate was approximately half of one full time equivalent member of staff. Dedicated operational risk resource was not assigned to oversee the Transformation Programme until the middle of 2011.

6.42 The business was aware of the risks associated with the replatforming and other projects. The Board discussed them regularly. But awareness does not seem to have been translated into adequate challenge or subsequent changes in the way the programmes were run. The CBG Board and its committees showed themselves insufficiently willing to challenge management assurances that adequate plans were in place.

6.43 The FSA noted in 2011 that the operational risk function paid a great deal of attention to catastrophe risk such as pandemics or terrorist attacks, but failed to provide sufficient assurance on the more prosaic elements of operational risk.

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[87] Before Merlyn Lowther and Anne Gunther joined the CBG Board in mid-2011, the only IPNEDs on the Board post-merger with banking (as opposed to building society or insurance) experience were Rodney Baker-Bates, Peter Harvey and Piers Williamson.

[88] The May 2013 example concerned a loan to a renewable energy company. The relationship manager had told the customer that the Bank was *"good to go"* despite final confirmation not having been received.

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6.44 The Bank collected a log of whistleblowing incidents with corresponding actions, and there were several instances in which whistleblowers identified operational risk breaches which the Bank acted to resolve (for example, in relation to employee and customer fraud, improper access to customer data and IT security breaches). But there was a lack of clarity about who was responsible for dealing with whistleblowing events and about how to register whistleblowing concerns.

Liquidity risk

Exhibit 16: Individual Liquidity Adequacy Assessment (ILAA) and Individual Liquidity Guidance (ILG)

Banks are required to ensure that they have sufficient liquid assets to meet expected withdrawals under various stress scenarios. The Bank produces its own assessment of the amount and type of necessary resources on the basis of internal information about the behaviour of customers and counterparties, and the nature of its balance sheet. This assessment is called the Individual Liquidity Adequacy Assessment (ILAA).

The Regulator takes the ILAA into account when determining the amount and type of liquid resources a bank requires through the Individual Liquidity Guidance (ILG) it sets. It also takes into account other factors, such as its assessment of a bank's risk controls and the behaviour of the market. As a result, there can be a discrepancy between a bank's view of its liquidity requirement and the ILG set by the Regulator, in which case the ILG prevails.

6.45 The Co-operative Bank has not generally faced liquidity problems. This does not, however, seem to have been due to the quality of its risk management. In early 2011, the FSA expressed a number of concerns about the robustness of its liquidity risk management and governance,[89] about the quality of its Individual Liquidity Adequacy Assessment and about the information the Board received in relation to some liquidity issues.[90] As a direct consequence, the FSA required the Bank to hold additional liquid assets on top of the amount required by its Individual Liquidity Guidance. Liquid assets attract low margins, which therefore reduce profitability.[91] In August 2011, the FSA also commissioned a Section 166 Skilled Persons Review of certain liquidity returns. The final report, submitted in January 2012, highlighted errors in the completion of the Bank's returns, reflecting the high level of manual adjustments required to complete them, issues relating to the division of responsibilities amongst the first line in completion of the returns and an overall lack of accountability and inadequate second line review.

6.46 The Bank's own assessments of its liquidity requirement, as expressed in its ILAA, were at times significantly different to the FSA's own assessment. Differences between internal and FSA assessments are not unusual. The judgements made are inevitably subjective. But the FSA's concerns about the preparation of the ILAA suggest that this difference was, at least partly, the result of weak liquidity risk management controls, rather than simply a difference in subjective judgement.

6.47 In April 2011, the Bank significantly overstated its liquidity position. The causes appear to have been a combination of poor forecasting, inadequate management information, a failure both to define and to take accountability, weak second line challenge and a fundamental disconnect in communication between the Finance and Treasury functions.

[89] Draft ILG Letter, 22 February 2011.
[90] FSA Core Prudential Programme letter, 8 April 2011.
[91] Draft ILG Letter, 22 February 2011.

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Conduct risk

6.48 The Bank's conduct of business philosophy did not always translate into positive customer outcomes.

6.49 In January 2013, the FSA fined the Bank £113,300 for the way in which it had handled PPI mis-selling complaints in early 2011. The fine related to the Bank's pausing of some complaints-handling during the judicial review of the FSA's policy statement, despite some guidance from the Regulator to the contrary. The Bank was not alone in being fined for its PPI compensation processes. But its ethical stance might be expected to have caused it to take particular care about treating its customers fairly.

6.50 In April 2014, the Bank announced further significant provisions in relation to a series of conduct or operational risk failings which occurred during the period covered by this Review. These provisions have served to deplete capital resources still further. The failings included technical breaches of the Consumer Credit Act resulting from inappropriate wording on customer correspondence, provisions for compensation relating to mortgage first payments, mis-selling interest rate swaps, and the management of mortgage arrears.[92] Given the findings of this Review the need for additional provisions did not come as a surprise.

Conclusion

6.51 Failings in risk management had severe consequences for the Bank, and ultimately underpinned much of the capital problem. A well-run risk management framework might arguably have prompted the Bank to apply greater scrutiny to the due diligence conducted on Britannia Building Society, improved the management of the commercial loan book, led to far more rigorous interrogation of the replatforming programme, and recognised the challenge of taking on Verde in the light of everything else with which the Bank was dealing.

[92] 'Co-operative Bank 2013 Reporting and Capital update', 24 March 2014. Financial Times, ' Co-op Bank review finds yet more skeletons', 24 March 2014. http://www.ft.com/cms/s/0/079af6c2-b35c-11e3-b09d-00144feabdc0.html#axzz2x48Z70rQ

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Exhibit 17: Adviser reports and regulatory correspondence relating to risk governance and control framework

2010

- A PwC review of credit controls in the corporate lending book concluded that adequate controls were in place. It noted the risk-focused culture, strength of governance, adequacy of staffing (subject to the intended action plan having been implemented), and appropriateness of risk policies. But it raised concerns about manual processing, the quality of Britannia loan documentation and the failure to refresh collateral values.[93]
- An FSA ARROW letter identified a number of risks to the Bank, including in relation to Treating Customers Fairly, the role and remit of the CRO, and the translation of risk appetite into effective guidance for the business.[94]

2011

- An FSA letter noted the Regulator's "disappointment at the pace of progress in addressing the weaknesses around [the Bank's] risk management and control framework", and reiterated its concerns raised in previous letters. It highlighted the risk "that the firm's philosophy may inadvertently lead management and the Board into believing that ethical or mutual translates into customer-focused without any reinforcement".[95]
- A Deloitte Risk Management Framework Design Review identified a number of actions the Bank needed to take in order to reach its risk management target operating model. These included clarifying responsibilities across the three lines of defence and between governing committees, increasing resources, ensuring consistency and completeness of documentation and improving management information.[96]
- Another FSA letter noted weaknesses in the Internal Audit function, which included a lack of technical capability, overly-optimistic grading of reports, and the Audit and Regulatory Compliance Committee's lack of attention to the function. It also commented on a culture which did not provide sufficient challenge, as well as on the risks posed by Project Unity.[97]
- An Ernst & Young review of Internal Audit reported that Internal Audit was well supported, highly motivated and focused on key issues, while highlighting some room to improve, for example regarding levels of quality assurance.[98]
- A Deloitte operational risk management review noted that the key building blocks for operational risk were in place, with room to build on these to satisfy regulatory expectations. It recommended improvements to documentation and definition of risk appetites, better application of control self assessment, with more challenge provided by the second line, and better quantitative modelling of operational risk.[99]

[93] PwC: 'Project Ides: Commercial Credit Review', 29 April 2010.
[94] FSA: Risk assessment letter, 10 May 2010.
[95] FSA: Risk assessment – Co-operative Banking Group, 1 June 2012.
[96] Deloitte: 'Risk Management Framework Design Review', September 2011.
[97] FSA: Core Prudential Programme, 13 October 2011.
[98] Ernst & Young: 'Internal Audit Quality Assessment Report', 31 October 2011.
[99] Deloitte: 'Operational Risk Management Review', December 2011.

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2012

- An FSA letter noted the Regulator's "disappointment at the pace of progress in addressing the weaknesses around [the Bank's] risk management and control framework", and reiterated its concerns raised in previous letters. It highlighted the risk "that the firm's philosophy may inadvertently lead management and the Board into believing that ethical or mutual translates into customer-focused without any reinforcement".[100]
- A critical external review of the Internal Audit function was issued, following an ARROW letter from the Regulator in June 2012, in which it asked senior management to provide assurance on the effectiveness of the function.

2013

- PwC reported several failings with regards to the valuation of commercial real estate loan collateral, including incorrect valuation amount, incorrect valuation date, and the use of inappropriate indices for estimating collateral value.[101]

[100] FSA: Risk assessment – Co-operative Banking Group, 1 June 2012.
[101] PwC: 'Project Phileas - Limited Scope Review: CRE, Hotels & Student accommodation loans', 23 May 2013.

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7 IT REPLATFORMING

Date	Key event
Mid-2006	x Bank starts investigating options for upgrading core banking system
2007	x Discussion with IBM about support for replatforming, including outsourcing of IT infrastructure and business processes (Project Olympus)
Q1 2007	x Bank issues Request for Information for core banking system provider
Mid-2007	x Bank determines high-level scope of 'Enterprise Platform' including core banking system, customer relationship management and business process systems
Q1 2008	x Bank issues Request for Proposal for Enterprise Platform solution. x Bank selects Finacle
Q3 2008	x Bank CIO departs
Q3 2008 – Q1 2009	x Bank reduces scope of, defers and then cancels Project Olympus
Mid-2009	x Britannia merger completes x New Director of Integration and Change x Bank selects Infosys to be Systems Integrator
Q4 2009	x New programme manager for replatforming, reporting into Director of Integration and Change
Mid-2010	x Bank delivers Release 1 (business internet banking)
Mid-2011	x Bank incorporates replatforming into wider Transformation Programme x New programme management
Q3 2011	x Infosys delivers Finacle v10.4.1
Q4 2011	x FSA conducts review of Transformation Programme
Q2 2012	x Director of Integration and Change is made redundant x Bank pauses replatforming programme
Q2 2013	x Bank cancels replatforming programme

7.1 As a full-service retail bank, also serving small and medium-sized enterprises, the Co-operative Bank of 2007 needed a technological platform disproportionately complex for its size.

7.2 It had originally built its core banking system in the 1970s, as had many other UK banks. An array of new components had been added over the subsequent decades as products evolved and new services were developed.

7.3 The age and complexity of the system, and the many interfaces between its components, meant that the Bank's technology platform was unstable, expensive to maintain, complex to adapt and ill-equipped to support its business requirements. There were particularly severe problems with the functionality of the online business banking platform.

7.4 These weaknesses resulted in high running costs. Upgrading to comply with new regulatory requirements ate up considerable resource, as had happened, for example, in 2007 to implement the UK Faster Payments scheme.

7.5 Operational risk was also significant. At the start of the financial crisis, limitations in capacity led to the Bank only narrowly avoiding serious difficulties in processing the large number of transactions resulting from its role as the clearing bank for Northern Rock.

7.6 The Bank had considered restructuring its IT systems in 1996 and again in 2001. On both occasions it had decided that the costs and difficulties were too great. It revisited the issue again

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in 2006-2007 when it was developing a new retail banking strategy. This time it concluded that the weaknesses in the legacy systems, and the need to support a more customer-centric approach, meant that it could no longer defer taking action.

7.7 In common with other deposit-taking institutions, from December 2010 the Regulator required the Bank to develop 'a single view' of all its customers, many of whom might hold a number of different products. The Bank's existing systems were organised in product silos so that simple requests applying to multiple products (like a change of address) took a significant amount of time to process. Interrogating information across different products required much manual intervention. Antiquated systems also made it difficult to market products in a targeted way and significantly increased the time and the cost involved in launching new products or making changes to existing ones.

7.8 A further factor was the Bank's consciousness that even if it decided not substantially to re-engineer its legacy systems, it would still have to incur significant cost in amending them to satisfy changing regulatory requirements.

Decision to replatform

7.9 Having decided that it had to take action, the Bank evaluated the different options. It had two broad choices if it was to continue to run its IT systems in-house. It could attempt to improve its existing systems (remediation). Or, much more ambitiously, it could replace its core banking system completely, and simultaneously upgrade a large number of other applications - business process management tools, data management systems, internet banking applications and so on. The Bank decided to pursue the ambitious option.

7.10 The Bank's problems with its legacy IT systems were not unique. The costs and risks associated with antiquated IT systems were - and still are - challenges for virtually the entire banking sector. Core banking system replacement is therefore often discussed. But it has rarely been pursued. It is recognised to be both complex and very risky, sometimes compared to "changing engines on an airliner at 30,000 feet."[102]

7.11 At the time the Bank decided on this option, no UK full-service bank had successfully replaced its core banking system. Nor, with a few limited exceptions, had major banks in Europe and North America. In the UK, Alliance & Leicester and Nationwide were in the early stages of replatforming projects. But Alliance & Leicester's programme was cancelled after its acquisition by Santander (which had developed its own in-house platform) in 2008. Nationwide only completed its programme in 2013. So what the Co-operative Bank was attempting to do was very ambitious. On the face of it, the Bank was an unlikely trail-blazer.

7.12 The Bank Executive recognised that the replatforming project was risky. But it was attracted by the idea of leapfrogging the competition and gaining an advantage, or better protecting its position, through improved customer relationship management and quicker delivery of new products.

Other change programmes

7.13 The Bank was pursuing a number of other change programmes in parallel to replatforming. Some were technology-related with elements of dependency on the replatforming, but run as distinct

[102] Forbes – 'Replacing Legacy Core Banking Systems -- SAP Has Limited Success', 18 December 2012. http://www.forbes.com/sites/tomgroenfeldt/2012/12/18/replacing-legacy-core-banking-systems-sap-has-limited-success/

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projects. They included, for example, projects to upgrade its card payments system and telephony. Others were entirely separate. The replatforming programme was amalgamated with many of these projects into a wider 'Transformation Programme' in mid-2011.

7.14 The different programmes were described using different terminology at different times. This report uses the phrase 'replatforming' to refer to the programme associated with the delivery of the banking platform, the applications directly associated with it and related activities such as migration of data from the legacy systems. The term is not intended to include other components of the broader Transformation Programme.

Core banking system vendor selection

7.15 In early 2007 the Bank issued a 'Request for Information' (RFI) to seven potential core banking system providers. The Bank favoured a package solution rather than a more expensive bespoke product. At this point, it expected to use separate providers for the related applications. Two core banking system providers were short-listed – SAP and Infosys.

7.16 By mid-2007, the Bank had changed its requirements. It now sought an Enterprise Platform solution (providing the core banking system and customer relationship management, data management and business process management applications) from a single provider. The Bank expected this to be simpler and cheaper to implement than if it used multiple suppliers for different applications - although it recognised that it would come at some cost to functionality. The change of requirements might have made it appropriate to reconsider the provider shortlist. The Bank did not do so.

7.17 In early 2008, the two shortlisted candidates were invited to a series of workshops to assess their suitability. Infosys emerged as preferred bidder. The process for the final selection of the solution provider appears to have been well-designed, well-managed and thorough, with support provided by both Deloitte and IBM.

7.18 The Infosys product was called Finacle. As with all packaged solutions (including the SAP product), Finacle required significant configuration to make it compliant with UK regulatory requirements and UK banking practice, as well as to meet the Bank's own specific needs. It had not previously been tested in UK banks, mainly being used hitherto by banks in developing economies. The Bank's management seems to have underestimated the amount of work reconfiguration would entail both for Infosys and for its own staff. The project would also require significant effort to migrate data from the legacy systems, to build interfaces with other bank applications, to train staff to use the new systems, and so on. Internal presentations and communication, including papers prepared for the Bank Board, described Finacle as a 'bank in a box'. This description may have given a misleading impression.

Departure of the CIO

7.19 The Bank CIO (Gerry Pennell) had been the driving force behind the decision to replatform. He left the organisation in late 2008 to join the London Organising Committee of the Olympic and Paralympic Games. With his departure, the organisation lost some of the capability and drive necessary to make the project a success.

Project Magellan / Olympus

7.20 At the same time as considering what to do with its core banking system, the Bank had been discussing the possibility of outsourcing certain business processes to IBM ('Project Magellan'). In

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late 2007, these discussions were expanded, under the rubric 'Project Olympus', to include two further components:

i Outsourcing the management of the Bank's IT infrastructure to IBM to reduce cost and acquire better disaster recovery and support facilities.

ii Engaging IBM to provide Systems Integration services and broader management support for the replacement of the core banking system.

7.21 The arrangement with IBM would have involved a degree of risk-sharing so that the Bank would not be solely liable for additional unexpected costs. In return, the Bank agreed to grant IBM a significant degree of control over project management. For example, contracts with the core banking system vendor were to be negotiated and signed by IBM, rather than directly with the Bank. IBM expected to be able to make savings in procurement and in the management of the infrastructure which would have helped to reduce the overall cost. Both they and Infosys would have had a substantial interest in the success of the programme. Implementing the first replatforming in a UK bank would have put them in a strong position to assist with similar programmes for other banks.

7.22 After Gerry Pennell's resignation, the Bank Executive progressively reduced the scope of Project Olympus. In late 2008, the Bank deferred the outsourcing of business processes and IT infrastructure. Possible explanations include:

i The Bank may have wished to avoid a significant number of redundancies.

ii Announcing a significant off-shoring programme might cause difficulties for the Britannia merger vote.

iii It was reasonable to wait until after the merger to evaluate the combined entity's outsourcing requirements.

7.23 In early 2009, the Bank reduced IBM's role further when it put the Systems Integration work out to tender. Infosys was selected. IBM was retained only for the Systems Integration on 'Release 1', which was to deliver the new platform for business internet banking. The Bank moved responsibility for the delivery of the programme, including management of external providers, in-house.

Britannia merger

7.24 The merger with Britannia increased the scope of the replatforming programme, and hence its risks. That might have been expected to have prompted a rethink. Instead, the new Director of Integration and Change and the new Bank CEO confirmed the importance of continuing with the programme. The Review found no record of any discussion of alternatives.

7.25 Received wisdom in bank mergers is that the safest approach is to migrate one business onto the platform of the other. It is a brave organisation which attempts to migrate both merging entities onto a brand new platform.

7.26 That is, however, exactly what the management and Board of the merged organisation intended to do. They decided that Britannia and Bank customers would both be migrated onto the new platform once it was completed. The platform would, for the first time, make it possible to offer current accounts in Britannia branches. Britannia's mortgages would remain separate. These were already well supported by a relatively new Britannia system.

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7.27 Even if the dual migration risk is ignored, continuing the replatforming programme while simultaneously attempting to integrate the two entities was itself very risky. Both would require a significant amount of senior management attention. It was almost inevitable that one, if not both, projects would be compromised. KPMG highlighted some of the risks in a quality assurance review in June 2009,[103] citing the impact of ending the Olympus programme, uncertainty over the programme's scope, the challenges associated with prioritisation between integrating Britannia and replatforming, and the limited availability of relevant capabilities within the Bank. The Bank was not deterred.

Management of the programme after the merger

7.28 The litany of deficiencies in the way the replatforming programme was implemented after the completion of the merger makes sorry reading. A number of individuals made attempts to improve things at different stages, including a major re-organisation in mid-2011. But it is difficult to avoid concluding that in many important respects the programme was set up and implemented in a way which was almost bound to lead to failure.

7.29 First, it enjoyed neither stable executive sponsorship nor consistent day-to-day programme leadership. Between 2007 and 2012 three different executives were responsible for the programme. There was similar turnover below sponsor level in responsibility for programme delivery.

7.30 Second, after the departure of Gerry Pennell, the Bank lacked the capability necessary to implement such a complex and high risk programme. Former Britannia Executives and Non-Executive Directors drew comfort from the successful integration of part of the Bristol & West business into Britannia in 2005. That had, however, been a much simpler transaction, involving the migration of only savings and investment products and fewer than 100 branches.

7.31 The Bank did seek some support from external advisers. It retained Pelicam, a project management consultancy, as a quality assurance adviser in 2010 and 2011. Pelicam's remit was, however, limited to providing insight into the progress of the project rather than broader advice. Teams from Deloitte and KPMG also provided support on an intermittent basis, though their advice was not always heeded. Importantly, once the Bank decided not to progress with Project Olympus, it lost the opportunity to use IBM's expertise. The Bank's external technical support was provided by its suppliers – Infosys (providers of Finacle) and Steria (providers of development and delivery services for the Bank's legacy systems).

7.32 Third, communication and co-ordination between different parts of the business involved in the replatforming was weak. Successful execution of the programme depended on effective management of three interdependent elements:

i The team working with Infosys responsible for the design and implementation of the Finacle IT platform.

ii The Bank's IT department responsible for business as usual and for developing parts of the physical infrastructure on which the new platform would run.

iii The collection of additional technology change programmes, like the development of an accounting hub, which were separate from the new platform, but had some mutual dependencies.

[103] KPMG: 'CFS EP Programme, Programme Assessment', 1 June 2009.

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7.33 Key members of the programme leadership across these different parts of the business did not enjoy functioning working relationships. An internal review in late 2011 identified significant programme management dysfunctionality and unconstructive working relationships. Several interviewees told this Review of personal animosity between the various team leaders required to work together. A consequence was that at various times there was inadequate clarity about who bore responsibility for which deliverables. Some attributed this to differences between the heritage Co-operative and Britannia cultures.

7.34 Fourth, the Bank appears initially to have done too little to limit complexity. The programme team failed to push back hard enough against the business demand for amendments to the Finacle product. It gathered 18,000 requirements. It is not unreasonable for such a programme to surface a large number of requirements, but the Review was told that excessive demand for customisation increased the amount of work to make Finacle ready for use and compromised the benefits of an 'out of the box' solution. Even the collection and documentation of the requirements involved a considerable amount of work.

7.35 A large number of the requirements appear to have been non-essential, driven primarily by the preference for replicating what existed before. The example consistently quoted to the Review was that the business asked for information to be displayed on a single screen, rather than over multiple screens (the Finacle package default position), largely because this was the way the legacy systems operated.

7.36 In 2010, the programme team managed to reduce the number of requirements to below 11,000, many of which could be justified in terms of compliance with UK regulation and standard banking practice. But the improved discipline did not persist. A draft report produced in late 2011 indicated that the number of requirements had by then grown back to 17,000.

7.37 Fifth, as the work progressed, the scheduling and sequencing of releases changed frequently. Between 2007 and 2012 there were at least five different roadmaps. The programme plan oscillated between delivering several product-specific releases and delivering everything in a single 'big bang'. The team also switched from 'Co-operative first' to 'Britannia first'. In 2011, further changes were triggered when the programme team decided to prioritise launching current account functionality in Britannia branches before the replatforming was completed. A degree of flexibility is clearly desirable in any programme. But it is difficult to avoid the conclusion that this amount of change was disruptive and confusing and must have contributed to the escalation in costs.

7.38 Sixth, a number of interviewees identified a lack of 'left to right' plans and a disregard for the importance of detailed work scheduling. A KPMG Quality Assurance review in 2011 pointed out that a lack of detailed planning made it difficult to measure progress.[104] A draft internal report in 2011 compared unfavourably the failure to develop day-by-day, granular work-plans with those in place for similar programmes in other organisations. The lack of detail appears to have been a contributing factor to the friction between the business-as-usual and change leadership teams.

7.39 Finally, the programme's expected costs consistently escalated (Exhibit 18). Expected costs end-to-end were initially estimated in 2008 pre-merger to be £184 million. The cancellation of Project Olympus in 2009 led to expected costs rising to £250-£260 million, as a result of including the cost of infrastructure previously planned to be outsourced. In the first half of 2010, after completion of the Britannia merger, the new programme director revised expected costs to £460 million. In late 2011, the FSA raised concerns about the quality of even this estimate.

[104] KPMG: 'CFS Transformation Programme Review', September 2011.

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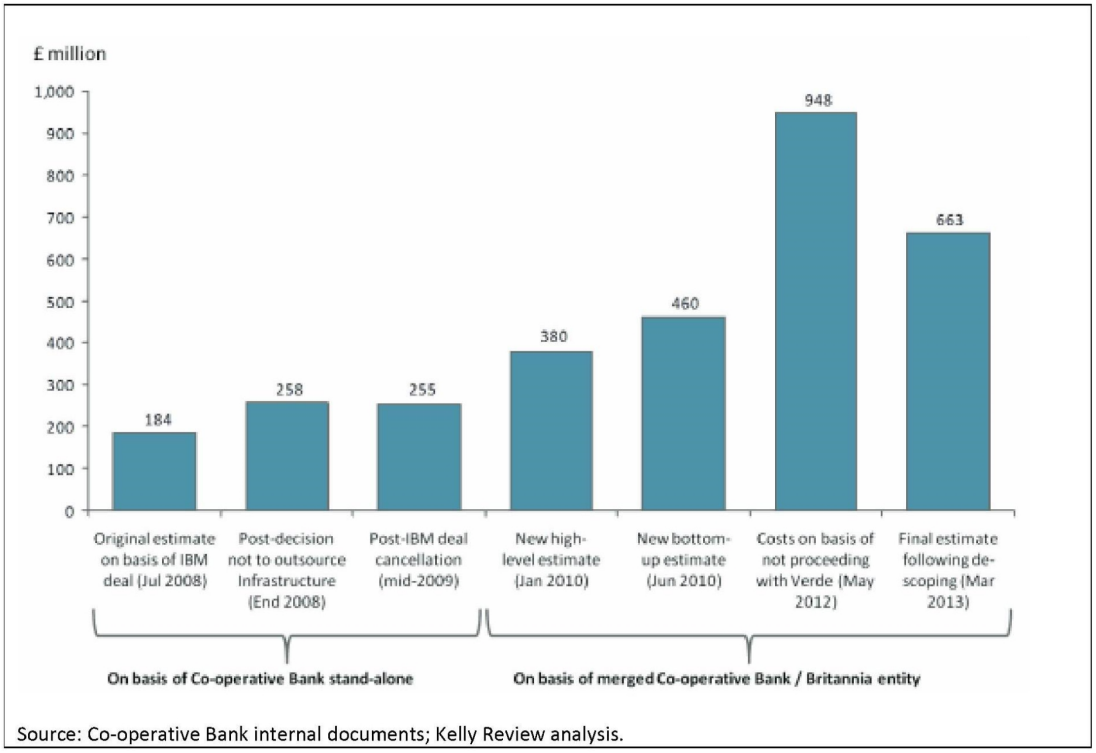
7.40 When the Bank worked with Lloyds Banking Group on the Verde acquisition, the due diligence team identified material replatforming costs that had been significantly underestimated or even omitted. These errors included costs relating to customer data migration, infrastructure, and staff training – the need for which cannot have come as a surprise. The result was that the cost of proceeding with the replatforming, even without Verde, increased to approximately £950 million - of which £349 million had already been spent.[105] Subsequent re-planning, based on reducing the scope, brought expected costs down to £663 million. But the CBG Board cancelled the programme soon afterwards.

Exhibit 18: Lifetime expected replatforming costs from 2008 to 2013



Source: Co-operative Bank internal documents; Kelly Review analysis.

7.41 Part of the cost escalation appears to have been due to an inefficient organisational structure. Interviewees described *"managers managing managers, managing managers"*. It is not clear how many people were actually contracted to the programme, partly because of its incorporation into the larger Transformation Programme in mid-2011. But in late 2011 it seems to have employed at least 800.

7.42 The business case for the replatforming depended on the costs being justified by the benefits it would bring. The 2011 KPMG Quality Assurance Review identified a failure to develop the benefits case in detail, and a lack of consistency about the benefits case across the programme – a concern later echoed by the FSA.

[105] The internal paper 'Plan B and B- Comparison', May 2012, gives an expected cost of £614 million (beyond what had already been spent) to complete the programme on the basis of not proceeding with the Verde acquisition. The Review saw a draft report 'Plan B revised options', dated July 2012, which gives a revised figure of £599 million to complete. To be conservative the Review has adopted the latter figure. Co-operative Bank Finance provided the Review with total replatforming actual expenditure data by year.

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External assurance

7.43 There were a significant number of external reviews of the programme over the period during which it was being implemented. The terms of reference for these reviews were sometimes broad, sometimes quite narrow. From the beginning they identified concerns.

7.44 The list includes:

i A programme assurance review conducted by Deloitte for the leader of the replatforming programme in mid-2008. This review identified concerns over clarity of scope, the definition of the target operating model, the development of implementation plans, the organisation of the project management office, allocation of accountabilities and supplier management.[106]

ii A KPMG Programme Assessment delivered to the Bank Audit and Regulatory Compliance Committee in mid-2009 expressed concerns around scope, roadmap design, change management capabilities, supplier management, and prioritisation between replatforming and Britannia integration.[107]

iii A quality assurance assessment report presented by Formicio to the Bank Executive Committee in April 2010 noted weaknesses in the delivery plan, lack of change experience, poor coordination and collaboration between both internal and external partners, and failure to control escalation of requirements.[108]

iv An RC Business Consulting report to the COO (Tim Franklin) and Director of Integration and Change (Phil Lee) in April 2010 suggested that the programme lacked appropriate capabilities, showed poor co-ordination between the different internal and external parties, and suffered from weak management of external suppliers.[109]

v Regular quality assurance reports provided by Pelicam throughout 2010 and 2011 indicated that progress was being made, but also expressed concerns relating to definition of scope, programme governance and organisation, dependency management, business case development, and alignment with supplier plans.[110]

vi A further programme review by KPMG in September 2011. This review was commissioned by the Co-operative Group CEO (Peter Marks) in the light of concerns about progress. The report reiterated many of the observations KPMG had made in 2009, noting weaknesses in implementation planning, definition of scope, project structure, capabilities, the benefits case and risk management.[111]

vii The FSA also conducted a review in late 2011. Its overall conclusion was that it did not observe that the governance and control framework was as effective as it would expect for a programme of this scale and strategic importance. More detailed concerns included budgeting, the benefits case, reporting, governance, contingency planning, the role of

[106] Deloitte, 'Enterprise Platform - Programme Assurance Review', 13 June 2008.
[107] KPMG: 'CFS EP Programme, Programme Assessment', 1 June 2009.
[108] Formicio: 'Briefing on Quality Assurance Assessment of the Banking Transformation Programme bTp', 28 April 2010.
[109] RC Business Consulting, 'Briefing on Quality Assurance Assessment of the Banking Transformation Programme bTp', 22 April 2010.
[110] Pelicam: Co-operative Financial Services Banking Transformation Programme Pelicam Project Reviews, 2010-11.
[111] KPMG: 'CFS Transformation Programme Review', September 2011.

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Internal Audit and external assurance, resourcing, source code and post-implementation support.[112]

7.45 It is not unusual for quality assurance reviews to point out difficulties. The scale and consistency of the concerns raised about the Bank's replatforming programme between 2008 and 2011 is striking.

Board oversight of the programme

7.46 The importance of the replatforming programme to the Bank's future strategy, its high risks and the size and unpredictability of its likely costs in relation to the Bank's profitability and capital might all have been expected to cause the Bank's Executive and Board to pay it particular attention.

7.47 There was a significant level of reporting on progress to both Board and Executive. From 2010 onwards, the programme reported to a Banking Transformation Programme ('bTp') Board Sub-Committee,[113] intended to provide closer oversight of the programme.

7.48 However, reporting suffered from two important weaknesses.

7.49 First, although the programme provided the Board Sub-Committee with high-level cost and benefit estimates, the figures were neither analysed in sufficient detail nor with sufficient consistency to give it insight into the key drivers of cost escalation.

7.50 Second, reports on progress did highlight some of the difficulties the programme was experiencing. In the light of the assurance reviews it would have been difficult to do anything else. In 2009 and 2010, for example, the Board discussed the causes of delays to Release 1 (the business internet banking system replacement). But the overall message consistently given to the Board and its Sub-Committee until the programme was paused in early 2012 was that it was making satisfactory progress, given its complexities, despite the unavoidable delays and hiccups inherent in any large change programme. Programme managers appear to have succumbed to the general Bank tendency to communicate matters in a favourable light wherever possible.

7.51 It is unreasonable to expect non-executive Board members to audit information provided to them in detail. But it is their responsibility to question it. It is difficult to avoid the conclusion that both Board and Executive failed to interrogate the programme sufficiently closely and paid inadequate attention to its obvious difficulties until it was too late. Former members of the bTp Sub-Committee, who should have been better placed than other directors to understand the programme, described being surprised that it failed. They should not have been.

Pause and cancellation

7.52 In spring 2012, the Bank paused the replatforming programme.

7.53 The Bank had been considering the potential acquisition of Verde since late 2011. Until early 2012 it had assumed that Verde customers would be transferred onto the Bank's systems if the transaction proceeded. But the expected cost of doing so escalated dramatically as due diligence progressed. At one stage, that escalation seemed to have killed the deal entirely.

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[112] FSA: Review of Transformation Programme, 11 January 2012.

[113] This was renamed the 'Transformation Committee' in mid-2011, at which point its remit expanded to cover the whole Transformation Programme, rather than only the replatforming.

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7.54 After some reconsideration, the Bank adopted a new approach called 'Plan C', under which both Bank and Verde customers would be hosted on the Lloyds platform. The implication was that the replatforming programme was likely to prove unnecessary. The Bank tried to pause the programme in a way that would allow it to re-start it at a later date if either the deal with Lloyds, or the option of moving to the Lloyds platform, did not materialise.

7.55 In practice, restarting IT programmes of this kind, once paused for any significant time, can be very difficult because teams and knowledge disperse. But that soon became irrelevant. The new Group CIO (Andy Haywood) was already forming the view that the programme would take more time and money to complete than was justified. In 2013, after the Verde negotiations had finally ended, the CBG Board decided, on the recommendation of the CIO, to cancel the replatforming programme entirely and remediate the legacy systems instead.

7.56 The decision to cancel was driven by several factors:

i A new, simple product strategy adopted by the Bank in 2013 assumed low growth and reduced complexity, with the result that the benefits anticipated from the programme no longer exceeded the expected future costs.

ii The Bank wanted to shift focus towards improving online and mobile banking channels - for which it thought Finacle was not a good fit.

iii The programme remained very risky. Even after the work already done, success was far from guaranteed.

7.57 Several interviewees, predominantly those distant from its day-to-day running, told the Review that if the replatforming programme had not been paused during the Verde negotiations it could have been concluded successfully.

7.58 Interviewees generally recognised in retrospect the various difficulties with the replatforming project which the Review identifies. A minority told the Review that the programme improved dramatically after the reorganisation in mid-2011, and that successful implementation was from then on a reasonable expectation. A version of the Finacle product, albeit not fully tested, had been delivered in late 2011, although this remained a long way from being put onto the Bank's IT infrastructure or having customer data migrated onto it. The Review was told that one element of the implementation programme, intended to deliver elements of Finacle's customer relationship management and till functionality, was six weeks away from testing at the point the programme was paused (although this left a great deal to be done). According to this account, the programme was stopped prematurely.

7.59 This is a misconception. Even in the early stages of the Verde negotiations, the new IT management were already considering whether to cancel the programme. The weight of evidence supports a conclusion that the programme was not set up to succeed. It was beset by destabilising changes to leadership, a lack of appropriate capability, poor co-ordination, over-complexity, underdeveloped plans in continual flux, and poor budgeting. It is not easy to believe that the programme was in a position to deliver successfully, with or without the impact of the Verde negotiations.

Consequences

7.60 The failure of the replatforming programme, combined with the manner in which it was accounted for, caused a near £300 million addition to the Bank's capital shortfall (see Chapter 11). After the programme was paused, the Bank recorded an impairment of £150 million in the

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2012 Annual Report and Accounts related to the intangible asset which the programme had built up. A further £148.4 million was impaired in the 2013 interim results when the programme was cancelled altogether.

7.61 The full amount was not recorded earlier because the Executive had not yet taken the decision to cancel, and thought that it would still be possible to resurrect the programme if the Verde deal did not go ahead. The Bank took the view that at the end of 2012 the work-in-progress still had residual value.

7.62 The total impairment charge is less than the full cost of the programme up to the point of cancellation (£349 million) because one part of the programme – Release 1, which replaced the business internet banking system and Financial Director products serving the Bank's corporate clients – was successfully delivered. Some other concurrent IT projects were also delivered successfully.[114]

7.63 The financial impact was not the only negative consequence. Other important activities were put on hold in anticipation of delivery of the new platform. The Britannia and Bank IT systems remained unintegrated even four years after the merger because the Bank expected to migrate both brands onto the new platform. The legacy systems were kept running throughout the programme and some remediation was also undertaken. But there is now a significant amount of remedial work to catch up on years of underinvestment.

Was replatforming the wrong decision?

7.64 There can be little dispute that action was necessary in 2007 to improve the Co-operative Bank's antiquated and creaking IT systems. The business internet banking system was in particular need of improvement.

7.65 Choosing to replace the core banking system was not necessarily irrational at the time the original decision was taken - before the additional complications introduced by the Britannia merger - provided the right conditions were in place. As originally conceived there would have been a lot of support from, and some risk-sharing with, IBM.

7.66 But the choice was always a brave one. The cost of implementing Finacle would have been much the same if a larger bank had been attempting it. But the Co-operative Bank's small size meant that a costly failure was bound to have a disproportionate effect on its profitability and capital.

7.67 In making its choice the Bank appears to have underestimated what could be achieved through the alternative route of remediation. A number of interviewees gave the impression that they thought the existing systems were in such a dire state that there was in practice little realistic alternative to replatforming. The subsequent history of the legacy systems suggests differently. Despite limited investment during those years, they were more resilient than some believed, could still be updated as necessary to meet changing regulatory requirements and were still capable of being improved to some extent better to meet the needs of the business – though this does not mean that they could be made future proof.

7.68 At the same time as the Bank was underestimating the possibility of alternatives, it was over-estimating its capability to deliver such a complex programme. The gap between ambition and capability became even more pronounced when the CIO who had championed the programme left, when the relationship with IBM was discontinued and when the implementation was complicated by the Britannia merger.

[114] Including the 'Big Card' Project, which replaced the operating platform for card transactions.

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7.69 If the programme was ever to have had a chance of succeeding it would have had to have been robustly managed by people with the right capabilities and experience using the best possible project management discipline. It would also have had to be subject to searching challenge and scrutiny at Board, Executive and programme management levels. The Bank did not provide any of these things to the extent necessary to ensure success.

7.70 In part, project management failures are illustrative of pre-existing weaknesses. The fact that the Bank neither had the requisite levels of discipline before the programme began, nor built it during the programme, played an important part in setting the programme up to fail. No-one should be surprised that costs escalated and the project proved unsucessful.

7.71 The episode is important not just for the contribution it made to the difficulties that led to the recapitalisation plan. The false belief, unchallenged until as late as 2012, that there was no alternative to replatforming illustrates important aspects of the Bank's culture visible elsewhere. Specifically, organisations with an inward-looking culture can be susceptible to myth building, wishful thinking and group-think. This can be particularly damaging in an organisation which does not welcome challenge and accepts mediocrity.

7.72 It is critical for an organisation to understand the extent to which it is capable of managing large-scale change programmes. It is important to be realistic about the scale of projects undertaken, and the burden this places on the organisation. It is necessary to understand what good looks like, using best practices and experience from outside. It is essential to heed warnings and act upon them.

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Postscript: post-merger integration

7.73 The delays to, and eventual failure of, the replatforming programme had serious consequences for the post-merger integration of Britannia and the Co-operative Bank.

7.74 Once the merger was completed, the Bank began a programme to integrate the two businesses and realise a forecast £88 million of synergies a year by 2012-2013. Substantial parts of the integration effort, primarily relating to systems, product features and service offering, were dependent on delivery of the replatforming programme. As this programme got delayed - and ultimately failed - so the integration programme stalled.

7.75 The integration programme was led by a steering group, chaired by the Director of Integration and Change, Phil Lee. It included managers from the business areas involved in delivering the integration,[115] and the CBG Board was given regular progress updates – albeit at a relatively high level.

7.76 A quality assurance assessment shortly after completion of the merger suggested that the Bank should conduct regular independent programme reviews. The Bank did not take up this idea.

7.77 The post-merger integration team soon concluded that neither heritage platform provided what the combined Bank needed. But the Bank expected its replatforming programme to deliver full retail banking functionality in the second half of 2011. It decided that Britannia and Bank customers would both be migrated on to the new platform at that point. No systems would be integrated before then.

7.78 The Review found no evidence that the new Bank management considered any other interim options. Such options would be likely to have added both cost and complexity. But the decision that was taken created a critical dependency on the replatforming project with no fallback should that programme take longer than expected or fail to deliver. In consequence, the true potential of the merger to generate synergies has still not been realised.

7.79 Many of the heritage banking systems were still largely run separately from each other four years after the merger. For example, financial reporting was on two separate systems with a different reporting calendar. So the creation of aggregate financial figures requires a complex, manual process of reconciliation.

7.80 A post-investment review of the Britannia merger in December 2012 highlighted the dependency on the replatforming programme as a key barrier to branch and brand consolidation. Full rebranding of the Britannia network only started in September 2013, finally enabled by the IT "workarounds" that had replaced the full replatforming and which give the appearance (but not the reality) of integrated systems to customers and staff. Full integration of IT systems still needs to be completed, at a cost estimated to be several hundred million pounds.

7.81 Some elements of the integration programme were not dependent on replatforming. Management, head office, human resources, customer operations and customer contact centres were integrated over the course of 2010 and 2011. The new Bank achieved its headline cost synergy targets in both 2009 and 2010.

7.82 Cultural integration appears to have been less effective. The Review was told repeatedly that "red" (i.e. Britannia) versus "blue" (i.e. Co-operative) thinking remains to this day.

[115] Membership included representatives from Integration, IT, Retail, Finance, Organisational Development, Culture, Risk and the Integration Management Office.

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7.83 Because of the IT constraints, it took until mid-2011 for the Bank to provide in-branch current account servicing in Britannia branches. Even then, in-branch functionality was limited to a subset of standard transactions including withdrawals, deposits and changes to personal details. It is possibly partly for that reason that sales of Bank current accounts to former Britannia members have been disappointing. By December 2012, only about 100,000 of the 2.6 million Britannia customers had opened Co-operative current accounts in Britannia branches, mostly as secondary accounts.

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8 PROJECT UNITY

Date	Key event
September 2010	x Group Board decides that CBG CEO should report directly to Group CEO (effective 2 January 2011)
October 2010	x Group Chair presents reporting line changes to CBG Board
November 2010	x Group Chair presents new Group management structure to Group and CBG Boards x Group Chair formally announces Project Unity to Co-operative Group senior management
January 2011	x Project Unity launches
January-March 2011	x Phase 1: Group defines new target operating model
April-June 2011	x Phase 2: work streams established
July 2011	x Phase 3: Group assigns objectives to work streams and work streams begin work x Neville Richardson announces his intention to resign
2011	x CBG transfers Governance, Internal Audit, Communications, Procurement and elements of Risk to Group
2012	x Risk fully returns to CBG x CBG transfers Brand and Customer Insight, Legal, and elements of HR, Estates and Finance to Group
December 2012	x Phase 3 ends x Programme moves to business as usual
January 2013	x Internal Audit returns to CBG

8.1 Management stretch was an issue for the Bank throughout the period covered by this Review. It was particularly acute from 2011 onwards. In that year, the Bank was both negotiating with Lloyds Banking Group over Verde and engaged in Project Unity.

8.2 Project Unity was formally launched in January 2011. It reflected a long-held view that the Group was not making the most effective use of its group structure and common brand. It had two major objectives:

i Make cost savings by bringing some functions together across the Group to remove duplication, lower procurement costs by negotiating contracts centrally and reduce the number of administrative locations.

ii Increase revenue by cross-selling more products between different Group businesses.

8.3 The objectives were not unreasonable. But the project was clumsily implemented in a way which paid insufficient attention to the differences between the Group's trading businesses and a bank operating in a regulated environment.

8.4 The Group initially expected that by the end of 2012 the project would generate cumulative cost savings of £50 million and revenue gains of £40 million. By 2015, the project forecast combined cost and revenue benefits of between £190 million and £450 million a year.

8.5 Its influence on the difficulties faced by the Bank was twofold:

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i It distracted Bank senior management and some of their teams. They faced the prospect of redundancy or changed reporting lines and job descriptions at a time when they were dealing with a challenging economic environment, the integration of Britannia and a complex IT replatforming.

ii It led to the departure of the CBG Chief Executive and, in whole or in part, to those of a number of other senior staff.

Project genesis and structure

8.6 The project was a Group initiative. It had been discussed to some extent before the Britannia merger. But Len Wardle, the Group Chair, and Peter Marks, the Group CEO, first presented the new management structure formally to the Group Board on 5 November 2010. Several interviewees told the Review that the project was presented as a *fait accompli* - agreement having been reached beforehand between these two and the CBG chair, Paul Flowers. The Group Board gave its approval. The minutes do not record much discussion of the changes involved or of their implications. Peter Marks told the Review that this was because the Board was fully supportive of the project and wanted to get on with it. The CBG Board were presented with a paper on Project Unity on 10 November 2010, apparently with little or no say on the changes proposed, despite the important implications for the Bank.

8.7 The Group established a fairly standard project management structure. It appointed a project director and set up a project board under the Group CEO to monitor progress and provide direction. The project board comprised key Group and Bank executives, including the Bank CEO. It reported monthly to both Group and Bank Boards.

8.8 The project focused on CBG. The Group's other businesses were already largely integrated into the Group structure. Group expected that major opportunities for new revenues would come from selling CBG products to the Food business' 17 million customers.[116] In practice the project made little progress on revenue gains, possibly because CBG does not appear to have embraced this element.[117] Most attention was paid to cost savings.

8.9 Project Unity imposed three principal changes on the Bank – revised reporting lines, the transfer of some back office functions to Group and a related reduction in head count.

Changes in reporting lines

8.10 Before Project Unity, CBG had been largely left to run itself. The Bank CEO reported directly to the CBG Board, not to the Group CEO. Nor did he sit on the Group Executive Committee. When the Co-operative Wholesale Society merged with United Co-operatives in 2007 to form the Co-operative Group it was recorded[118] that the CEO of the Trading Group and the CEO of the Bank were to enjoy *"parallel and equal status"*. According to the merger agreement, neither was to be viewed as *"first among equals"*, although a number of interviewees told us that, in practice, people did view Peter Marks as such. Bank senior executives reported to the Bank CEO, not to anyone at Group.

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[116] The Bank at that time had around 8 million customers, The Co-operative Financial Services Financial Statements 2010; The Co-operative Group Annual Report & Accounts 2010.

[117] Some attempt was, however, made by the Group's legal and funeral businesses to cross-sell legal services and funeral plans.

[118] Memorandum of Agreement for Co-operative Wholesale Society and United Co-operatives merger, February 2007.

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8.11 Project Unity changed that. In future the Bank CEO would sit on the Group Executive Committee and report to the Group CEO. Other senior Bank executives, including the Chief Financial Officer, the Chief Information Officer, and the Organisational Development Director would report to their equivalents in the Group, as well as continuing to report to the Bank CEO.

8.12 The reporting line changes were not self-evidently necessary to achieve Project Unity's objectives. They were, however, highly symbolic. They led many to believe that the project was essentially a vehicle to allow the Group Chief Executive to assert control over the Bank. The fact that Project Unity was driven mostly by Peter Marks did little to dispel this view. Other banks owned by retailers have not found it necessary to consolidate reporting lines so completely to achieve similar objectives of generating revenue synergies.

8.13 Some of the changed reporting line changes ran the risk of inconsistency with the Approved Persons regime for banks.

8.14 An Approved Person is an individual who has been approved by the Regulator(s) to perform a controlled function within a bank. Approval should only be granted where the individual is fit and proper to perform the relevant controlled function. Being an Approved Person brings with it certain responsibilities, notably a duty to comply with 'Statements of Principle' and a code of conduct set by the Regulator(s). The definition of a particular Approved Person role includes the appropriate reporting lines for that role. It is not necessarily inconsistent with the regime for an Approved Person to have a reporting line to someone who is not an Approved Person, but generally this would not be regarded as best practice.

8.15 CBG Board minutes record in October 2010 that the Chair (Paul Flowers) had briefed the FSA about the proposed reporting lines and that *"they had not expressed any concerns"*.[119] The Regulator has told the Review that its records show that this discussion was about putting bank branches in supermarkets. There was no reference to changes in management or functional reporting lines apart from notifying the Regulator that there would be two Deputy CEOs of the Group – of which one would be the CEO of the Bank. When in April 2011 the Co-operative Group presented the FSA with a paper detailing the potential implications of Unity, the Regulator queried the impact on Approved Person roles. The Group CEO and the CBG Chair reassured the Regulator that the reporting line changes would not be significant, and that CBG Executives would only have a 'dotted' reporting line to Group Executives – which is not what internal documents imply and raises the question of what was the purpose of the change in reporting lines in the first place.

8.16 An interesting insight into the Group Board's approach to the Regulator was provided in 2012. In that year the FSA introduced new regulations relating to the control and oversight that all banks must exercise over activity that supports their business. An update presented to the Group Board by Peter Marks in October 2012 stated that *"the FSA is pulling CBG in a direction which conflicts with the Group Board objectives for Unity, which we cannot allow"*.[120]

8.17 In practice, some of the changes in reporting line did have little or no direct impact, as the FSA had been told. Some Group Executives told the Review that they had little interest in taking on the additional responsibility and did little to understand Bank matters. So they continued to operate much as they had before.

[119] Private minutes of CFS Board, 13 October 2010.
[120] 'Unity Programme Update' presented to Co-operative Group Board, 17 October 2012.

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8.18 In other cases the effect was more serious. The Bank Chief Executive was deeply discomfited and the Bank Organisational Development Director took the view that she had effectively been made redundant.

Transfer of functions

8.19 The project required a significant number of functions within CBG to transfer staff to common functions in the Group. Internal Audit, Internal Communications, Procurement, Legal Services and Brand and Customer Insight transferred in full. In HR, Risk, Estates, Finance, and IT and Change, some staff and the functions they performed also transferred from Bank to Group. The objective was to transfer activity which might be more efficiently or effectively provided as a shared service while retaining key functional areas. Thus, for example, 100 HR staff (a third of their total) dealing with things like payroll, employment relations, leadership development and HR policy, were moved to Group while resourcing, regulatory and business training and HR advice stayed with the Bank. The Bank Organisational Development Director, an Approved Person, felt most keenly the loss of responsibility for the strategic elements of her role, including Leadership Development and the formulation of HR policy.

8.20 Seeking benefits from establishing shared services in areas like procurement was not outlandish. Some of the transfers were self-evidently sensible. Areas like payroll or IT data centres are effectively commodity services which the Bank might otherwise have considered outsourcing.

8.21 But many functional areas within a bank require knowledge and technical skills specific to banking and distinct from those needed by the same functions serving food stores, undertakers or pharmacies. Either the individuals performing these functions for the Bank were kept as separate teams within the new structure, which largely negated the purpose of moving them; or there would be a dilution in the level of expertise available since those same individuals would now need to divide their time between Group and Bank matters.

8.22 Three areas in particular demonstrate a lack of clear thinking and foresight about the moves.

8.23 First, the Unity team initially intended to *"define and deliver a Group RIsk and Control Framework which is supported by a single, integrated risk framework"* for the Group,[121] with the Bank Chief Risk Officer at the time becoming the Chief Risk Officer for the Group. In retrospect, this appears a strange decision. Risk management in a bank is very different to that in a food, pharmacy or funeral business. The FSA was already becoming increasingly concerned about the quality and robustness of the Bank's Risk function. When informed of this change, it questioned whether the Bank Chief Risk Officer would be able to commit enough time to the Bank, in addition to his new responsibilities for Group risk. The Bank told the FSA that the Chief Risk Officer would spend 98 per cent of his time on Bank matters, which makes one wonder what the point of the change could have been.

8.24 After some reconsideration, the plan to transfer the Risk function to the Group was cancelled. Barry Tootell told the Review this was at his instigation. Some of the staff had already moved over and had to come back.

8.25 Second, it is difficult to understand the logic of transferring the Bank's Internal Audit team and why the CRO and Bank Audit Committee did not object (if they did, there is no record of it). As with Risk, the skills and expertise required to provide internal audit services in a bank are very different from those needed for internal audit in a retail business.

[121] 'Unity Programme Handbook', August 2011.

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8.26 The entire Internal Audit team transferred to Group in December 2011 and then transferred back to the Bank just over a year later, in January 2013. All but two of those that had gone across returned. It would be surprising if the team's ability to support the Bank had not deteriorated to some extent over the intervening period. The Review was told that while located at Group the quality and frequency of the team's engagement with senior Bank executives dropped off markedly. A few had remained focused on Bank matters, but others had divided their time between the Bank and the Group's other businesses.

8.27 Third, Unity left the Bank without its own General Counsel, which proved to be challenging during its Liability Management Exercise.

Redundancies

8.28 A significant part of the savings attributed to Project Unity came from redundancies. The majority were in the Bank. Between September 2011 and December 2013, 821 Bank employees were made redundant under Project Unity – approximately 8 per cent of its pre-Unity work force. The majority were in middle management grades. A subsequent second wave of Bank restructuring resulted in around 263 further redundancies. These savings were known inside the Group as "Unity 2". In reality they owed nothing to the project.

8.29 In addition to Neville Richardson, senior Bank staff who left in this period were the Organisational Development Director, the Operations Director, and the Director of Integration and Change. It is possible that factors other than Project Unity were behind the redundancies of the last two. Both had been removed from membership of the CBG Board when it was reduced in size in June 2011. The Review was told that they regarded this as a loss of status, even though both continued to attend Board meetings. The Director of Integration and Change was in charge of the IT replatforming programme. By the time he left the programme was clearly in difficulty. It had been paused while the discussions with Lloyds Banking Group were continuing.

8.30 All four senior directors who left had come from Britannia.

Termination of the project

8.31 Project Unity began to lose momentum in spring 2012 as management became distracted by other issues. It was formally stopped in December 2012. The project board and office stood down and regular reporting ceased. The last Unity project update to the Group Board in December 2012 reported that *"excellent progress"* was being made *"with planned costs, benefits and timescales being achieved"*.[122]

8.32 In reality, the project team still rated the overall status of the project at that stage as amber, defined as *"compromised, risk of failure."* The project team also rated three of the five component work streams as amber. It assessed one as red – *"seriously compromised, likely to fail"*. Status scores had actually deteriorated during 2012 compared with the previous year. The total benefits claimed by the end of 2012 were in excess of those forecast (£125 million as compared with £90 million), but little progress had been made on the anticipated cross-selling. The project team calculated revenue benefits by then as being only £1.5 million. The originally projected annual combined cost and revenue benefits of £190 million to £450 million by 2015 seem wildly optimistic.

8.33 It is a little difficult to see that as excellent progress, particularly bearing in mind that the project had also contributed to the departure of the Bank Chief Executive.

[122] 'Unity Programme Update' presented to Co-operative Group Board, 12 December 2012.

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The impact of Project Unity

8.34 Whatever the merits of its stated objectives, aspects of Project Unity were poorly thought through by the Group. The choice of functions to transfer to Group and the subsequent reversal of some of them in whole or in part suggest poor planning. Staff movements between the Bank and Group undoubtedly led to some disruption to the Risk and Internal Audit functions at a crucial time. The failure of the project to deliver significant revenue benefits suggests that the project team were not given enough authority, or enough backing, to make the necessary changes happen. Both the Bank and the Food business were preoccupied with other things at the time. But that should have been taken into account at the beginning and might have been a reason for delay, as Neville Richardson argued at the time.

8.35 The reporting line changes, which caused so much angst, do not appear to have been strictly necessary to achieve the stated objectives. They were either largely meaningless – as the FSA was in effect told and as they appear to have been in some cases – or risked offending against best practice in relation to the Approved Persons regime.

8.36 It is difficult to understand why the members of the CBG Board, particularly those with financial services experience, did not challenge this aspect of the project more robustly. If the Board did have major concerns, it failed to make them sufficiently well heard.

8.37 The project did deliver cost savings at a time when profitability was low and the Bank continued to be concerned about its high cost base - though in the first couple of years they were offset by some substantial redundancy costs.

8.38 On the other hand, the project led in whole or in part to the departure of the Chief Executive and a number of other senior staff, and distracted the Bank Executive at a time when it might have better been focused on other things.

8.39 Neville Richardson cited as his reasons for leaving both the reduction in autonomy as the result of changed reporting lines and his concern about management stretch.

8.40 A number of CBG Board directors told the Review that he had given no indication to the Board as a whole that he was prepared to resign over the issue. In his exit interview with the FSA (as disclosed to the Treasury Select Committee), he said that he had always intended to retire around the age of 55.[123] His resignation at the age of 54 was consistent with that.

8.41 Neville Richardson's departure, and that of his colleagues, inevitably meant some loss of continuity. But he had presided over Britannia when it had acquired the troublesome commercial real estate assets. Moreover, in two years running the Bank he had done little to deal with the Bank's developing capital problems, its inadequate risk management framework or the escalating costs of its IT replatforming project.

8.42 The impact of his departure was not perhaps so much that he left as that he was replaced by Barry Tootell, hitherto the Bank's CFO. The knock-on effect was that the Financial Controller, James Mack, was in turn promoted to acting CFO. The limited extent of James Mack's experience at this point must make it unlikely that he would have been appointed to this role under other circumstances.

[123] Neville Richardson's FSA Exit Interview, 23 September 2011; submitted to Treasury Select Committee on 13 January 2014.

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8.43 The project loomed large in the minds of a number of senior staff at the time. Its impact on the Bank's capital difficulties was, however, probably fairly limited compared to underlying issues of capability or problems with the commercial real estate portfolio. It is more important as further illustration of shortcomings in governance and an uncomfortable relationship between Bank and Group. It also shows an organisational tendency to take on new projects before other change efforts were properly bedded down and a willingness to countenance management distraction when other issues ought to have been given priority.

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9 VERDE

Date	Event
February 2011	x Credit Suisse brings deal to Group
July 2011	x Group makes indicative bid of £1.75 billion
November 2011	x Group makes second round bid of £600 million initial consideration
December 2011	x Lloyds Banking Group names Co-operative Group as preferred bidder; grants exclusivity form January -April 2012
March 2012	x Bank re-estimates IT costs which makes deal infeasible
April 2012	x Bank creates new business plan (Plan C, use of Lloyds Banking Group platform)
July 2012	x Heads of Terms: £350 million initial consideration
H2 2012	x Business case deteriorates
Q4 2012 – Q1 2013	x Bank develops Plan D to improve business case
April 2013	x Group withdraws

9.1 This chapter considers the prolonged negotiations between the Co-operative Group and Lloyds Banking Group relating to the potential acquisition of the so-called Verde assets.

9.2 Lloyds Banking Group was created in 2009 when Lloyds TSB took over HBOS. As a condition of State Aid, the European Commission required the newly-formed Group to divest a substantial part of its business in the shape of a viable retail bank known as Verde. Verde included 632 branches in England, Scotland and Wales, a full suite of retail banking products, around 5 million retail customers and a portfolio of approximately 0.1 million small business customers. Its total assets when discussions with the Co-operative Group began were of the order of £53 billion. That figure reduced as time went on and its scope was reduced.

9.3 Lloyds Banking Group's preferred option was for a trade buyer, rather than a public offering (IPO). But the number of potential purchasers was limited. Most of the handful of financial institutions initially expressing interest withdrew fairly quickly.

9.4 Credit Suisse first suggested the possibility of a deal to the Co-operative Group in February 2011. It came at a difficult time for the Bank. The integration of Britannia was far from complete. The capital outlook was challenging. The IT replatforming programme was struggling. The Bank had started to plan Project Unity. The sale of the life and savings business was in progress; and the economic environment remained unfavourable with base rates forecast to remain low. The Bank had not been seeking another large acquisition before the Verde opportunity arose.

9.5 But the deal had attractions. Even after the Britannia merger, the Bank still considered itself to be sub-scale. The acquisition of Verde would - on paper - make it a credible challenger bank, with over six per cent market share in UK current accounts, approximately ten per cent of the UK's total branch network, stronger penetration of major urban areas and a greater branch presence in Scotland. The additional scale could help drive a lower cost/income ratio and spread the cost of the new IT platform. At a later meeting of the Group Board, the Bank CEO described the deal as delivering *"approximately 15 years' worth of organic growth"* in one transaction.[124]

9.6 Whether the deal made strategic sense from the Group's perspective is another question. It is not obvious that it would have been sensible for the Group materially to increase its presence in the

[124] Co-operative Group Board minutes, 16 July 2012.

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banking industry. That would have meant substantial increases in its exposure both to risks which it little understood and to demands for increased capital.

Early stages through to Heads of Terms

9.7 Credit Suisse initially brought the deal to the Co-operative Group CEO, Peter Marks. He became a strong advocate and remained so until the end. He had a history of building scale through acquisitions. In previous roles as a chief executive he had merged Yorkshire Co-operatives with United Co-operatives and then United Co-operatives with the Co-operative Group. As Chief Executive of the Co-operative Group he had championed the acquisition of the Somerfield supermarket chain. He made it clear to the Group Board from the start that the Group as Bank shareholder and supplier of capital needed to be in the lead on this transaction.

9.8 Peter Marks was convinced that the risks of remaining sub-scale by not doing the deal were as high as the risks of pursuing it. His relative lack of banking expertise,[125] and his commitment to finding a way of making the transaction succeed, made a dangerous combination.

9.9 There is surprisingly little contemporary written evidence of what the CBG Board and CEO thought about the potential deal at this early stage. The Bank CEO, Neville Richardson, subsequently told the FSA in his exit interview that he was in favour of the deal in principle, but had concerns on the timing given the Bank's commitments to other projects.[126] In August 2013, he told the Treasury Select Committee that he had believed there to be merit in carrying out a *"fuller assessment of Verde"*, but that it would be too risky to continue with the deal at the same time as the replatforming, Unity, the sale of the life and savings business, and business as usual.[127]

9.10 Following initial work by a Group team, the Group Board agreed unanimously in July 2011 to submit an indicative offer of £1.75 billion. Peter Marks reportedly described the bid to the Group Board as a "*punt*" (though he denies using this word). One interviewee told the Review that the Board was not expecting anything to come of it. Only one other institution, NBNK Investments, submitted a formal bid.

9.11 The FSA expressed doubts about the Co-operative's bid from the outset. In June 2011, before the bid was made, Andrew Bailey, then Director of UK Banks and Building Societies at the FSA, wrote to Neville Richardson raising a number of areas of concern - capital, funding, integration, governance and risk management. A month later, he told the CBG Board at a strategy day that it was not clear to the FSA that the acquisition of Verde was within CBG's grasp. He presented a personal opinion that CFS would be better off targeting an alliance with a player such as Rabobank if it was serious about pursuing such a major acquisition. These interventions do not appear to have been interpreted as the warnings they were undoubtedly intended to be.

9.12 The transaction was discussed at a joint Bank and Group board meeting in October 2011. Interviewees told the Review that initially it received little support from most of those present. At a late point, the Chair invited the investment banking advisers to comment. Interviewees recall them presenting an inspiring vision of what the Bank could become, and reminding the directors that any second round bid would still be non-binding. Their intervention was decisive. The two

[125] Though he had sat on the CBG Board since 2009.
[126] Neville Richardson exit interview with FSA, 20 September 2011; submitted to Treasury Select Committee by Andrew Bailey, 13 January 2014.
[127] Written evidence submitted by Neville Richardson to the Treasury Select Committee, August 2013.

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Boards agreed to investigate further, concluding that it would be *"premature to cease considering [the deal] at this stage"*.[128]

9.13 None of the Group Board members at the time had any banking experience other than that which a few had acquired by also sitting on the CBG Board. They were therefore heavily reliant on the views of the Group and Bank executives, the CBG Board, and the external advisers. I find it surprising that the Bank executives and those IPNEDs on the CBG Board who did have relevant experience allowed the tone of the debate to shift so dramatically.

9.14 One month later, the Group Board approved a second round bid. Sixteen directors voted in favour and three against.[129] The bid involved an initial payment of £600 million, plus a deferred amount linked to subsequent performance. Verde's total assets at this point were £37 billion, significantly lower than at the point of the indicative bid. In December 2011, Lloyds Banking Group gave the Co-operative Group exclusive negotiating rights.

9.15 The FSA remained worried. In December 2011, Andrew Bailey wrote to the CBG Chair reiterating his concerns about capital, liquidity management, integration and governance. A subsequent FSA letter in January 2012 described the work that CBG would need to complete in order to satisfy the Regulator's concerns, which remained consistent with issues it had raised previously. The work required included actions to address policy and legal implications (including those relating to funding by the Group), capital, liquidity and asset and liability management, integration, management stretch, risk management and conduct.

9.16 Later in the same month, the Regulator raised further concerns about the Bank's risk management framework. It told CBG to make significant progress in three areas: business as usual; its capacity to perform appropriate due diligence on Verde and manage transaction and implementation risks; and its ability after the transaction to ensure that its risk management was scalable to the new entity.

9.17 The Regulator did not ask for the transaction to be stopped. But it made clear that it required a great deal of work to be done before it could approve a Sale and Purchase Agreement.

9.18 The funding of the transaction, particularly the funding from the Co-operative Group, was also an issue. The Banking Group could not fully fund the transaction itself. It required a capital injection from its parent by means of a hybrid debt instrument. In early 2012, the FSA informed the Bank that it was likely that on completion of the transaction, or shortly after completion, the Co-operative Group Limited would be a Financial Holding Company (FHC). This classification would mean that the Bank could not treat the funds injected by the Group as regulatory capital, and would have made the deal impossible. It may also have caused problems with the Group's banking syndicate, casting doubt on its ability to raise the funds in the first place. By the time the Verde bid was abandoned, the FSA was still considering whether the creation of a legally enforceable ring-fence of the Banking Group would mean that the Group would not be an FHC.[130]

9.19 Other important issues continued to emerge. In April 2012, Andy Haywood, the new Group CIO, commissioned a recalculation of the cost of the replatforming programme and the additional IT-

[128] Minutes of the joint meeting of the Group and CBG Boards, 19 October 2011.
[129] At the time of the vote the Board comprised nineteen Non-Executive Directors.
[130] Similar consequences would have arisen if the Group had been regarded as a Mixed Financial Holding Company (MFHC). In 2012, the Group met the default test to be an MFHC (irrespective of the Verde bid). This default test is based on balance sheet size. Under European law it can, however, be replaced by an income test. The Group applied for the income test to be used instead of the balance sheet test. In June 2012, the FSA granted this application on the basis that balance sheet size was not the most appropriate test for the Group.

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related implementation cost of the Verde transaction. The plan at this stage, known as 'Plan A', was to complete the replatforming project and then to migrate Verde on to the new platform. The new estimate suggested that the final cost of completing the replatforming and Verde migration would be £1.8 billion, a massive increase on the previous estimate of £0.8 billion for both. The increase made the deal economically impossible. The effect was to stall the negotiations. For a time, the Group withdrew.

9.20 Shortly thereafter the deal was back on. The banks adopted an alternative IT solution ('Plan C').[131] This plan involved migrating heritage Co-operative Bank and heritage Britannia customers on to Lloyds Banking Group's IT platform. Plan C was expected to be much cheaper and lower risk than completing the replatforming programme and then migrating Verde's 5 million customers on to that.

9.21 Plan C had significant consequences. It would make the work completed so far on the replatforming project redundant. That would trigger a substantial write-off. It also introduced significant risk in relying on a competitor for something fundamental to the operation of a bank. It became known within the Bank as "Living with Lloyds". The CBG Risk Committee did not regard it as a deal-breaker. It did, however, ask that an exit strategy be developed.

9.22 Since the original information memorandum, Lloyds Banking Group had reduced the scope and value of the Verde assets, including removing Intelligent Finance and part of Cheltenham & Gloucester. These changes took out high loan-to-value mortgage loans and low interest rate mortgage accounts (primarily lifetime trackers), thus improving the overall quality of the Verde book as well as reducing its size. Overall, Lloyds Banking Group reduced Verde's assets to around £25 billion. Lloyds Banking Group accepted a reduced initial down-payment of £350 million – with further earn-out subject to the combined entity meeting certain performance thresholds – and agreed to underwrite the debt required by the Co-operative Group to fund the initial consideration.

9.23 The combination of Plan C and the adjustment to the terms of the transaction restored momentum. Heads of Terms were signed in July 2012.

9.24 The CBG Board supported signing Heads of Terms. But it was notable that both Deputy Chairs (David Davies and Rodney Baker-Bates), who had been appointed to their roles because they had the financial services background that the CBG Board Chair (Paul Flowers) notably did not have, voted against. In doing so, they cited a number of concerns, including the macroeconomic environment, the Bank's capital position and management capability, increasing regulation of the retail banking sector, and conduct and cultural risks.[132] The rest of the CBG Board, including the other IPNEDs, voted to proceed.

9.25 Verde now became the Bank's sole strategy. It was expected to bring both a solution to the Bank's IT difficulties and new management, including a new CEO (Paul Pester). The Bank made no serious contingency plans against the possibility of the transaction not going ahead.

9.26 The FSA continued to raise concerns. In June 2012, it had placed the Bank on its Watchlist. In July 2012, it announced that it would not intervene to stop Heads of Terms being signed. But it made clear that, prior to the Group signing a Sale and Purchase Agreement, it would need to see further work to improve the Bank's governance framework, address management stretch, ensure the financial stability of the Bank and demonstrate the long-term viability of using Lloyds' IT

[131] 'Plan B' was to withdraw from the deal.

[132] CBG Board minutes, 11 July 2012. According to evidence given by Andrew Bailey to the Treasury Select Committee they expressed their reservations less strongly in their exit interviews with the FSA.

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platform. There is no record of any plans produced by the Bank to show the FSA how it was going to do this.

From Heads of Terms to withdrawal

9.27 The signing of Heads of Terms was a major milestone. There still, however, remained a lot of work to be done. One major issue was how the Bank could be indemnified against existing conduct risk in the Verde portfolio – a far from trivial issue in the light of the provisions Lloyds Banking Group had, for example, made in respect of PPI mis-selling. Lloyds Banking Group had agreed an unlimited indemnity in principle at Heads of Terms. But turning that into a concrete agreement had still to be done. It is not clear that a workable solution was ever reached.

9.28 In the period following the signing of Heads of Terms, the Bank's business deteriorated substantially. Its own projections forecast that it would continue to be unprofitable until 2017 because of the expectation that base rates would stay low for a long time, worsening corporate impairments, and further PPI provisioning. The FSA warned in November 2012 that it was likely to impose an increased capital requirement on the Bank. Verde's business was also affected by deteriorating economic assumptions. Estimates of integration costs also increased, largely in relation to data migration. The result was that the business plan for the combined entity became increasingly unattractive.

9.29 At the end of 2012, KPMG provided a 'Ready and Able' third line assurance report which gave a glum assessment of the progress of the transaction against the Bank's critical success factors. Among other things, it pointed to:

i The deterioration in the business outlook in terms of profitability and capital strength since Heads of Terms.

ii A serious risk of failing to meet the timetable for the Sale and Purchase Agreement – an important consideration for Lloyds Banking Group because of the EC stipulation that it had to dispose of Verde by November 2013.

iii Deficiencies in the Co-operative Banking Group's governance and risk management frameworks which would apply to the new entity from Day 1.

9.30 Neither the deterioration in economic outlook nor the warnings in KPMG's report significantly arrested momentum. There is no evidence that either the Bank Audit Committee or the CBG Board seriously considered withdrawal. Instead, a new plan ('Plan D') was developed. The new plan accelerated cost savings (including redundancies) and assumed manual rather than automated migration of customer accounts from CBG to the Lloyds Banking Group platform.

9.31 In January 2013, the Regulator dramatically increased the Bank's capital requirements (see Chapter 12 for further details), which might have been expected to have put an immediate stop to the deal. Surprisingly, it did not.

9.32 In March 2013, KPMG issued its final 'Ready and Able' third line assurance report. It concluded that the incremental profitability of the transaction was significant. But it also noted the continued risk of a prolonged low interest rate environment and the challenge of achieving planned synergies. It highlighted the many risks that remained - capital, conduct, 'Living with Lloyds', and execution. In a meeting of the Group Board, KPMG explicitly advised the CBG Board

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not to proceed. Even at this stage, however, Peter Marks and some others remained supportive of the deal.[133]

9.33 In April 2013, the Group finally gave up and formally withdrew from negotiations. This is unlikely to have come as a surprise to Lloyds Banking Group, which had not renewed the Co-operative Group's exclusivity when it expired at the end of 2012. It had paused further discussions pending more due diligence and achieving greater comfort on CBG's future financial performance.[134]

9.34 The Co-operative Bank was now left in a difficult position. The Executive had not by this point developed any substantive contingency plans against the possibility of failure of the negotiations.

The impact of the Verde negotiations on the capital shortfall

9.35 The Verde negotiations demonstrated serious failings in both Bank and Group. The attraction of what was on offer as the result of a forced sale with few other obvious purchasers makes it understandable why the Group Board succumbed to the temptation of taking an initial look. But the Bank was not in a good shape to take on Verde; and, arguably, if the Group Board and Executive had had a clearer and more articulated grasp of strategy they would have decided against exposing the organisation to the greater risks and potentially increased demands for capital which would have resulted from a much larger presence in the banking industry. Having embarked on the negotiations, they allowed them to drag on - despite the many warning flags raised by the Regulator.

9.36 Most of the root causes of the Bank's capital problems were in place before the transaction was contemplated. The likelihood is that the Bank would still have a significant capital shortfall had the Verde transaction never been attempted.

9.37 But it would be wrong to conclude that the prolonged negotiations had no impact.

9.38 The direct impact on capital was relatively small. The transaction costs amounted to a total of £73 million in 2012 and 2013 – not a trivial amount, but small in relation to the eventual shortfall.

9.39 The indirect impact was far more significant. The prolonged negotiations were a significant distraction from business as usual:

i A number of key staff were removed from their day-to-day roles and re-assigned to the Verde project. In particular, Rod Bulmer, head of the Bank's Retail division, was made Verde programme director in January 2012. Several of his direct reports moved with him. There were other knock-on effects. The CEO transferred the responsibility for customer service operations to Keith Alderson, Managing Director of the Corporate and Business Banking business (CABB). Keith Alderson then ran both of these areas, which must have been quite a stretch at a time when sharper focus on the corporate loan book was particularly important. He had no previous experience in retail call centre operations. Under normal circumstances, it might have been expected that these responsibilities would be transferred to the Managing Director of Retail. But he had been asked to head the Verde team and so had been replaced, temporarily, by a less experienced executive.

ii Decisions which might be impacted by the acquisition were put on hold, for example those relating to the branch network or the recruitment of new management. Uncertainty about future employment prospects must have affected staff morale.

[133] Co-operative Group Board minutes, 7 March 2013.
[134] CBG Board minutes, 12 February 2013.

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iii The CEO and CFO spent significant amounts of their time on the project when their attention might have been better directed at other issues. The CFO's team found it challenging to get access to him given his time commitment to Verde.

iv The CBG Board was informed in March 2013 that the Capital Action Plan and the Verde transaction were drawing on the same resources, *"creating significant management stretch across the business"*. Had the Verde process not continued for so long, the Capital Action Plan might have gained greater momentum sooner.

v Had the negotiations not been under way the CBG Board might well have appointed someone other than Barry Tootell to the role of CEO when Neville Richardson left. The negotiations made that difficult, and also kept an inexperienced CFO in place for a considerable time.

9.40 The general impression was that on this occasion, as at other times, a limited number of capable people in the Bank were assigned to fix all the most pressing problems. These individuals then became severely stretched. Other people were put into roles in which they lacked either the capabilities or experience to perform effectively.

9.41 It is difficult to assess the overall impact of all these indirect effects. But it must be possible that, had Verde not happened, the Bank would have had a more effective senior management in place before June 2013. Without the distraction caused by Verde, the emerging capital issue might have been better recognised and more effectively addressed at an earlier stage.

Postscript

9.42 Paul Flowers has asserted to the Treasury Select Committee and on the BBC's Newsnight that pressure was put on the Co-operative Group from outside to progress the Verde transaction. I have been unable to discuss this assertion with Paul Flowers since he declined an invitation to meet me, as did the relevant Treasury Minister at the time (Mark Hoban MP). It was in the Government's interest as the major shareholder in Lloyds Banking Group to meet the EC divestment requirement through a sale to a trade buyer. It was also likely to see advantage in the creation of a stronger challenger bank if that was the result. But no-one to whom I have spoken has provided compelling evidence of pressure from Government Ministers or anyone else for the Verde transaction to take place. Indeed the Regulator was consistent in pointing out the obvious difficulties. The Co-operative Group and Bank were capable of making mistakes without any help.

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10 INTERACTIONS WITH THE REGULATOR

10.1 In November 2013, the Chancellor of the Exchequer announced an independent investigation into events at the Co-operative Bank, which will include an examination of the Regulator's relationship with the Bank.[135] It is my understanding that this investigation will not start until it is clear it will not prejudice any actions the relevant authorities may take, including any enforcement investigations by the PRA and FCA. Two questions will be whether the Regulator took effective enough action to address the concerns it had about the Bank and whether the Bank's approach to the Regulator was sufficiently open and transparent. The first of these is outside the scope of my Review. I offer a comment on the second later in this chapter in the context of my consideration of the relationship as a whole. It is, however, difficult to be definitive on the subject of the Bank's interactions with the Regulator without access to the Regulator's own records.

Exhibit 19: The regulatory environment

- Banks and building societies fulfil a unique role in our economy. Their stability and smooth running are essential if people, businesses, governments and other bodies are to go about their daily business. Banks move, lend, hold and protect money for customers. They facilitate commerce and help manage risk. Because the largest banks are systemically important and carry significant inherent risk, governments and regulators have developed a framework of legal and regulatory requirements. Banks and building societies have a strict duty to comply with these requirements and to communicate with the Regulator in an open and cooperative way. Firms failing to meet the requirements can face severe consequences, including capital and liquidity constraints, financial penalties, remediation activities and, in the most severe cases, withdrawal of a banking licence. The consequences for individuals within firms can also be serious, including termination of employment and enforcement proceedings.
- Firms need to abide by eleven principles – fundamental obligations – laid out in the Regulator's handbook. Principle Eleven addresses a firm's relations with the Regulator and states that "*A firm must deal with its regulators in an open and cooperative way, and must disclose to the appropriate regulator appropriately [sic] anything relating to the firm of which that regulator would reasonably expect notice*."[136] Approved Persons have an analogous personal obligation.
- Over the last five years, regulatory requirements and expectations have become increasingly stringent. It is likely they will only become more so to reflect the evolution of business practices and developments in the regulatory environment. The pace of change following the financial crisis may have exacerbated the challenges firms face in meeting new requirements, particularly as they relate to capital and liquidity.
- The Regulator has a number of internal mechanisms to monitor and assess the performance of UK banks and building societies. As part of its regulatory reviews, the FSA conducted Advanced Risk-Responsive Operating frameWork (ARROW) reviews and Core Prudential Programme (CPP) reviews. The Regulator has increasingly used a watchlist to track firms and escalate risk internally to its senior management.
- Since its creation on 1 April 2013, the PRA has conducted its assessment work on a continuous cycle. The precise supervisory activities increase in frequency and intensity in line with a firm's potential impact.
- The PRA works closely with the rest of the Bank of England, including the FPC. The FPC is able to

[135] Press Release: "Chancellor confirms independent inquiry into events at Co-op Bank". https://www.gov.uk/government/news/chancellor-confirms-independent-inquiry-into-events-at-co-op-bank

[136] PRA's 'Principles for Businesses': http://fshandbook.info/FS/html/PRA/PRIN/2/1

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make recommendations and give directions to the PRA. The PRA also cooperates with the Bank's Resolution Directorate on resolution and operational resilience.

x The PRA works closely with the Financial Conduct Authority (FCA), which is the conduct regulator for PRA-authorised firms and the conduct and prudential regulator for many other UK firms.

The Regulator's concerns

10.2 Prior to the merger, Britannia was on the FSA's Watchlist because of its comparatively high-risk lending, declining profitability and concerns about the sustainability of its business model in the context of the developing financial crisis.

10.3 The Regulator continued to have concerns after the merger. It placed the combined Bank on its Watchlist in September 2009, citing issues about the Bank's business model and strategy, its capital adequacy and the level of operational risk created by the scale of change it faced - most notably replatforming and post-merger integration. It repeated some of these concerns in its May 2010 ARROW letter and a number of subsequent communications. It also used some of the regulatory tools it had available, for example requiring the Bank to instruct an independent third party to perform a Section 166 Skilled Persons Review and imposing stricter capital and liquidity requirements. In August 2010, the FSA wrote to the Bank CEO to inform him that it had removed the Bank from its Watchlist, on the grounds that the integration was progressing well and that the Bank was taking action to improve its capital position.

10.4 It put the Bank back on the Watchlist in June 2012, primarily because of concerns associated with Verde.[137] The Bank is still on the Watchlist, for obvious reasons.

10.5 It might have been expected that the Bank would take particular care and attention in its dealing with the Regulator in the light of the Regulator's consistent and repeated concerns. The opposite appears to have been the case.

The Bank's approach to the Regulator

10.6 A number of current and former Bank employees have criticised the Bank's interactions with the Regulator. Criticisms include:

i Ignoring key regulatory correspondence and not escalating regulatory issues to the Board on a timely basis.

ii Failing to respond quickly enough to regulatory concerns.

iii Not always being as open and transparent with the Regulator as it could have been.

10.7 An internal review in July 2013 of the Bank's historic process for dealing with regulatory letters supports the first contention.[138] It identified an uncoordinated approach and a lack of clarity about responsibility for dealing with each letter.

10.8 The clearest example of the Bank failing to respond sufficiently quickly or decisively to the findings of the Regulator relates to its risk management framework and was described in Chapter 6. In April 2011, the Regulator identified material weaknesses in the framework design – particularly as it related to governance, second line challenge and its approach to monitoring risk-

[137] FSA Risk Assessment letter to the Co-operative Banking Group, June 2012.
[138] 'Regulatory Letters Response' presented to CBG Board, 16 July 2013.

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taking.[139] One year later, the Regulator's June 2012 risk assessment letter reiterated the same issues. It noted that progress on the risk management framework had been slow, and questioned whether there had been universal support within the Bank for its development.[140] One interviewee told the Review that he was *"staggered"* with the lack of progress on risk management following the 2011 FSA letter.

10.9 Different chapters of the report have noted a number of occasions where there is some lack of clarity about whether the Bank was as proactive and fully transparent with the Regulator as might have been desirable. Possible examples include removing the capital deduction for replatforming spend, changing the unwind profile of the Leek Notes prior to merger completion, and the size and profile of the remaining Fair Value unwind of those Leek Notes (see Chapter 11). It has not been possible for the Review to establish the facts definitively since I do not have access to the Regulator's own records.

10.10 It is not easy to understand why the Bank should have been slow or incomplete in its responses to the Regulator. Possible explanations include:

i *A degree of complacency* because the Bank had so far come through the financial crisis unscathed and had not suffered any other serious crisis in its history.

ii *Significant management stretch* stemming from pursuing so many challenging activities at the same time (post-merger integration, replatforming, and later Unity and Verde).

iii *The Bank might simply not have understood the Regulator as well as it should*. The Bank's slowness to recognise the strength of the Regulator's messages about the hurdles which would need to be overcome in the Verde negotiations appears to reflect a degree of wishful thinking, rather than any lack of clarity from the Regulator. It is possible that had the Bank been located in London it might have found it easier to interact more closely with the Regulator.

iv *Neville Richardson's approach*. A bank's chair and CEO play particularly important roles in setting the tone of a firm's interactions with the Regulator. Britannia appears to have had a more challenging relationship with the Regulator before the merger than did the Bank. Neville Richardson's more robust approach continued when he became CEO of the enlarged Bank after the merger. The FSA recorded in October 2011 that its relationship with the Bank was generally good, but had become more adversarial since the merger.[141] In the same letter, it noted that *"The threshold at which CBG senior management intervened and escalated issues within the FSA [appears] to have been lower than its peers"*. Barry Tootell appears to have adopted a less confrontational approach when he became CEO.

10.11 It may sometimes be appropriate to be robust with the Regulator – at the right times and for the right reasons. In the circumstances which the Bank faced, a more thoughtful approach might have been wiser.

[139] FSA Core Prudential Programme letter, April 2011.
[140] FSA Risk Assessment letter to the Co-operative Banking Group, June 2012.
[141] FSA Core Prudential Programme letter to the Co-operative Banking Group, October 2011.

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Conclusion

10.12 The apparent sloppiness of a number of features of the Bank's relationship with its Regulator was symptomatic of the general way it was managed and governed during the period under review. I find it slightly surprising that in 2011 the FSA should have regarded its relationship with the Bank as generally good in the light of what we now know of the Bank's attitude to regulatory correspondence, its slowness in dealing with some regulatory concerns and its incomplete transparency on some important matters. The Bank would have been wise to respond much more swiftly and decisively to the Regulator. Had it done so, it might have addressed the weaknesses in its governance and risk management framework earlier. It might also have called off the Verde negotiations at an earlier stage, or possibly not even have started them in the first place.

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11 ACCOUNTING JUDGEMENTS

Exhibit 20: Annual Report and Accounts

- In preparing its Annual Report and Accounts, a firm must adhere to a set of legal, regulatory and accounting standards. These standards vary by jurisdiction. But the overarching purpose is the same. A consistent set of principles combined with appropriate disclosures allows financial performance and position to be reliably measured and enables comparability of performance across different institutions. The Annual Report and Accounts underpins a firm's credit rating, supports the market's perception of a firm's value and informs a regulator's view of its financial stability.
- A firm's directors must approve the Annual Report and Accounts and ensure it gives a true and fair view of assets, liabilities, financial position and financial performance. Their responsibilities also include ensuring that the firm keeps adequate accounting records, selects appropriate accounting policies, applies them consistently and makes judgements and estimates that are reasonable and prudent. These tasks are typically overseen by a board audit committee.
- To add rigour to the process, a firm is required to hire an independent firm of chartered accountants to conduct an external audit and express an opinion on whether the Annual Report and Accounts gives a true and fair view. In determining their opinion, external auditors are critically dependent on representations made by management.
- Both firms and auditors are overseen by an external body whose job is to help ensure that the accounts conform to the appropriate standard. In the UK this regulator is the Financial Reporting Council (FRC).
- In practice, the information in a firm's Annual Report and Accounts is subject to significant judgement and interpretation by a firm's directors. The areas requiring most judgement are often the most complex and important. There is frequently no black or white answer. For accounts to be regarded as materially accurate, key judgements need to fall within an acceptable range.
- Typically, the external auditor meets with the Audit Committee shortly before the Annual Report and Accounts are finalised and will usually provide an assessment of the significant judgements.

11.1 This chapter looks at three sets of accounting judgements made during the period under review which proved to be important to understanding the emergence of the capital shortfall – accounting for the Leek Notes, the treatment of IT replatforming spend and provisioning on the corporate loan book. The Review has not looked in detail at the myriad of other judgements that inevitably underlay the Annual Report and Accounts published during the period under review.

11.2 The observations made in this chapter are the result of interviews conducted and documents reviewed. The Review did not undertake either an audit or a forensic accounting exercise, which would have required considerably more time and resource. Even then it might not have yielded firm conclusions. With hindsight, some of the accounting judgements might have proved to be inappropriate. But that does not necessarily mean that they were unreasonable at the time. So far, the only restatement of the figures that the Bank has thought necessary is in relation to replatforming spend. That adjustment was made in the 2013 Annual Report and Accounts.[142] The Financial Reporting Council has, however, begun an investigation of the preparation, approval and audit of the Bank's financial statements covering the period up to 31 December 2012.

[142] This followed an FRC Conduct Committee Review of the 2012 Annual Report and Accounts.

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11.3 I have not looked at the detailed workings of the Bank's external auditor, KPMG. I am aware, however, that the FRC's Audit Quality Review (AQR) team performed a review of KPMG's audit of the 2011 Financial Statements of the Co-operative Bank. Its review focused on some of the more complex and judgemental areas, including KPMG's audit work relating to certain of the Bank's corporate and retail loans and advances.

11.4 The conclusion of the AQR review, communicated in early 2013, was that KPMG's audit work was *"of an acceptable overall standard with improvements required"*.[143]

11.5 In relation to KPMG's audit work on corporate loans, the AQR reported the following findings regarding specific loan loss allowances:

"The audit approach in relation to corporate loans and the specific loan loss allowances included testing the operating effectiveness of internal controls and a detailed review of loans on the 'credit committee watchlist'...This review entailed consideration of management's assessment of each loan, principally in respect of the valuation of collateral and the likely repayment of loan exposures. The audit files included notes of supporting documents obtained and the conclusions reached by the audit engagement team.

"Our review of the auditor's assessment of corporate loans found insufficient evidence of substantive audit procedures relating to the...non-watchlist loans and [insufficient evidence of] auditor challenge in relation to the 'unprovided' exposures (after deducting collateral) for some of the more complex loans requiring judgement.

"In our view, further procedures should have been performed and further evidence requested from management to evaluate and support its assessment of the loans concerned.

"Furthermore, subsequent events procedures performed by the audit engagement team identified a number of potential further impairments. The audit engagement team concurred with management's view that other provisions, such as the collective provision, and potential gains from other loans meant that further provisions were not required. In our view, the audit engagement team should have challenged management on whether further specific and collective provisions for corporate loans were required."

11.6 In relation to KPMG's audit work around corporate collective loan loss allowances, the review reported:

"The audit engagement team reported to the [Bank] Audit Committee that 'the collective provisioning methodology has been developed since the half year... We recommend continued refinements to the calculations to ensure potential risk elements in the portfolio are adequately captured.'

"In our view, the collective provision model should have included all loans not currently in arrears and the adequacy of the provision should have been considered without reference to other valuation adjustments such as the fair value adjustments. While the audit engagement team had identified and reported some concern regarding the process undertaken by management in developing the model, in our view they did not sufficiently challenge the adequacy of the collective provision in relation to these matters."

[143] For comparison, in the three years to March 2012, 38 per cent of the FRC's reviews fell into this category, with less significant areas requiring improvement being reported in 49 per cent, and more significant improvement being required in the remaining 13 per cent.

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11.7 KPMG responded to, and in certain respects, challenged the AQR team's observations. KPMG shared the AQR team's letter with the CBG Audit Committee in March 2013, together with a paper setting out more context of the AQR team's findings and actions that it would be taking in subsequent audits.

Leek Note restructuring[144]

Exhibit 21: Leek Notes

- The Leek Note securitisation programme was a key component of Britannia's wholesale funding. Britannia used underlying mortgage assets as collateral to generate additional long-term funding to support business growth. The way the Notes were structured meant that the securitised mortgages remained on Britannia's balance sheet as an asset. All income and costs associated with the securitisation were recorded in its income statement. The Leek Notes themselves were recorded as a liability on its balance sheet.
- The programme was set up in 1996. Britannia subsequently completed a total of eighteen residential mortgage-backed securitisations (Leek 1 – 19, but no Leek 13), with a combined value of over £9 billion. Broadly speaking, the size of the Leek 14 to 19 securitisations was significantly larger than those which preceded them.
- The Leek Notes typically matured approximately twenty to twenty-five years after issuance. However, they included an option for the issuer (i.e. Britannia and subsequently the Co-operative Bank) to buy them back ('call' them), typically five years after issuance, after which the coupon increased ('stepped-up') until maturity.
- Prior to merger, Britannia's first twelve securitisations had all been called at step-up. At the point of merger, six securitisations (Leek 14-19) remained outstanding. In line with accounting convention, these liabilities were adjusted downwards to their fair values at that time (see Chapter 3). This adjustment would be unwound over the expected life of the Notes.

Issue name	Issue date	Issue amount	Date of step-up	Fair Value Adjustment at merger
Leek Finance 14*	October 2004	£1,046 million	December 2009	£54 million
Leek Finance 15*	April 2005	£1,080 million	June 2010	£136 million
Leek Finance 16*	October 2005	£961 million	December 2010	£163 million
Leek Finance 17**	April 2006	£1,168 million	June 2011	£225 million
Leek Finance 18**	October 2006	£1,048 million	December 2011	£298 million
Leek Finance 19**	April 2007	£833 million	June 2012	£383 million

*Called at step-up post-merger
**Restructured under Project Lotus in June 2011

11.8 Chapter 3 explained that the final merger business plan constructed for the combined business assumed that the outstanding Leek Notes 14-19 would not be called at step-up, but instead held until maturity.[145] This was contrary both to what Britannia had always done previously and to

[144] The Leek Notes have a complex structure which is difficult to summarise in simple, non-technical terms. The simplified description provided here should not be taken as a full and precise account of the legal and commercial responsibilities.

[145] Technically, each Leek Note is required to be repaid once the outstanding value of the mortgage assets within the securitisation drops to approximately ten per cent of the original issuance, which will depend on the timing of the

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market expectations. The maturity assumption was important. It markedly improved the profitability for the combined business shown in the three year plan. But it did so by pushing into the future the unwind of the £1.3 billion Fair Value Adjustment. This delayed the depressing effect the unwind would have on profitability and capital.

11.9 Consistent with this, the Bank's 2009 Annual Report and Accounts also assumed that the Fair Value Adjustment would be unwound over the longer period to maturity.[146] For the Bank's directors and auditor to be able to conclude that this was an appropriate assumption for accounting purposes they needed to assure themselves that it was in accordance with the Bank's intention at the time. The presumption must be that they felt able to do this because the Bank's corporate, funding and regulatory plans all pointed in that direction.

11.10 The difficulty for the Bank was twofold. Ignoring market expectations and not calling the Notes at step-up would be likely to constrain significantly future access to the liquidity markets. The accounting treatment used implied that the Bank would not require such access in the future, which seems unlikely.

11.11 Nor was the corporate plan and accounting treatment adopted by the Bank consistent with what it did just a few months after the merger was completed. In December 2009, that is before the 2009 Annual Report and Accounts were approved, the first of the Notes (Leek 14) reached the point of step-up, whereupon the Bank redeemed it. Redemption crystallised its remaining Fair Value unwind, resulting in a one-off, unbudgeted charge to the income statement. The Bank did the same thing with Leek 15 in June 2010, and again with Leek 16 in December 2010.

11.12 The Bank's dilemma was that it wanted to call the Leek Notes at step-up to avoid compromising its position in the liquidity markets. But it also wanted to avoid a change in accounting assumption for the remaining Leek Notes from one of maturity to one of step-up. Such a change would bring forward the negative unwind with its accompanying adverse impact on capital. In an appendix to a June 2010 paper for the Bank Board it was noted that there would be an approximately £90 million capital impact in 2010 if the Leek Note assumption was changed to step-up, with even greater impacts in 2011 and 2012. The later Notes carried a much bigger Fair Value Adjustment than those already redeemed. Had these remaining unwinds been crystallised at step-up, it is possible that this could have caused the Bank to breach its capital requirement earlier than it did.

11.13 Shortly before redeeming Leek 15, the Bank decided to resolve its dilemma by attempting to restructure the remaining Leek Notes so as to avoid the need to call them at step-up. It is not clear why it did not reach this decision five months earlier when it redeemed Leek 14.

11.14 The first attempt, Project Albany, began in May 2010. It was unsuccessful. In October 2010, the Regulator ruled that the 'underlying substance' of the complex transaction the Bank had devised was equivalent to calling the Notes. That made Project Albany pointless. It was after this ruling that the Bank redeemed Leek 16 at step-up.

11.15 In October 2010, the month Project Albany failed, the Bank Finance team seem to have been concerned that after successive redemptions at step-up the auditor might take the view that it was no longer appropriate to assume that the remaining Notes would be redeemed at maturity. One of the team wrote in an email that communications with KPMG about the Leek Notes "*need*

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mortgage asset reductions (for the purpose of the 2009 Annual Report and Accounts, management forecast this to be approximately 4 to 5 years after step-up). For ease of explanation, this requirement is referred to as 'maturity'.

[146] The unwinding of the Fair Value Adjustment is charged to the income statement. The annual charge is greater the shorter the period over which the unwind is assumed to occur.

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to be carefully managed". This presumably reflected a worry that after successive redemptions at step-up the auditor might take the view that an assumption that the remaining Notes would be redeemed at maturity no longer remained appropriate. At one point in the same month, the team decided to assume in its strategic plan (and related Board paper) that all future Leek Notes would be called at step-up. A member of the team subsequently realised the impact that this would have on the Fair Value unwind and the Bank's capital. The following day, the team decided instead that the calling of each Leek Note would "*be reviewed on its merits at the step-up date*". The Board paper was amended accordingly. This echoed what the Audit Committee and KPMG had been told in June 2010, the month in which Leek 15 had been redeemed at step-up.[147]

11.16 The second attempt to restructure the Notes, Project Lotus, was successful. This project involved renegotiating terms with investors, providing them with a higher return in exchange for holding the Notes for longer. It was announced on 30 March 2011, the same day that the Bank's 2010 financial results were published. From an accounting viewpoint, the renegotiation of terms occurred after the 2010 year end and is therefore a non-adjusting "subsequent event".[148]

11.17 The Regulator specifically requested that the market announcement for Project Lotus should disclose figures for the value of future unwinds. Surprisingly, but consistently with other aspects of its attitude to communications from the Regulator, the Bank did not do this. Nor did it make clear what the effect would have been if the Notes had instead been called at step-up.

11.18 Project Lotus succeeded in putting off for a time what would otherwise have been successive hits on the Bank's capital. But it carried a price. The premium paid to investors for their agreement increased its funding cost. Nor did the relief it gave last very long. Part of the reason for the very substantial increase in the capital requirement imposed on the Bank in January 2013 was because of the size and timing of the Fair Value Adjustment unwinds yet to come relative to its capital position.

11.19 The sequence of events for the Annual Reports and Accounts was therefore as follows:

i In the 2009 Annual Report and Accounts, the underlying assumption was that the Notes would be redeemed at maturity, allowing the unwind to occur over the longer period. These accounts were signed off after Leek 14 had been redeemed at step-up. But the corporate, funding and regulatory plans all implied an intention to redeem the other Notes at maturity.

ii In the 2010 Annual Report and Accounts, the underlying assumption was changed to step-up plus five years, presumably based on expectations relating to the repayment of underlying collateral.[149] By the time these accounts were signed off, Leek 15 and 16 had also been redeemed at step-up. The completion of Project Lotus seems to be irrelevant because it did not happen until after the year end, as recognised by the Bank's Finance team in a paper to the external auditor. But Management's stated intention was to review each Note on its merits at the step-up date and by then the Bank was actively attempting to restructure the

[147] The Audit Committee minutes for June 2010 record that: "*A Director queried the decision to redeem the Leek Notes and whether this impacted the FVA. It was reported that the 3 year plan did not allow for the call of the Notes at step-up date and the decision would be taken on a case by case basis.*"

[148] Under accounting conventions, "subsequent events" can be adjusting or non-adjusting. Only subsequent events deemed to be adjusting can impact accounting judgements in the previous year's Annual Report and Accounts.

[149] The March 2011 Audit Committee minutes record that *"In respect of Leek Notes, management had made an assumption implicit in Project Lotus regarding the timing that they would run until 5 years after the step-up date and it was noted that the assumption at the year-end was aligned to this, based on experience of the speed of redemption of the underlying collateral...KPMG reported that all the assumptions were individually supportable."*

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Notes. The auditor deemed this sufficient evidence to conclude that the assumption was reasonable.

iii In the 2011 and later Annual Report and Accounts, the Bank again used an assumption of step-up plus five years. This was consistent with Project Lotus, which by then had been successfully completed.

11.20 The Bank's income statements from the merger onwards consistently showed the current year Fair Value unwind as a charge against the income statement. The 2010 Annual Report and Accounts recorded the assumption made about future unwinds. It stated in its critical judgement and estimates on page 81 that "*It has been assumed that debt securities will be redeemed in full at five years after the interest step-up date.*" No analysis was provided of the timing or amount of the future Fair Value unwind. There was no analogous declaration in the Annual Report and Accounts for 2011 and later years, presumably because the completion of Project Lotus resulted in the future Leek Note unwind profile being predetermined.

11.21 It is debatable whether the assumptions made about the Leek Notes were appropriate at the time they were made. Accounting convention would appear to require that the assumptions be consistent with management's intentions for the redemption of the Notes. The stated intention was to consider each Note on its merits at the point of step-up. The difficulty for the Directors in approving the Annual Report and Accounts was that in the three cases which arose in 2009 and 2010 the decision was always to redeem at step-up – as it had been for all previous Notes. Assuming something else for the remaining Notes consciously and consistently favoured the short-term financial performance and capital position. Nor were the Bank's disclosures as transparent as they might have been, even if no accounting requirements were actually breached.

The funding of the Bank's replatforming project

Exhibit 22: Accounting treatment of IT investments

- The costs associated with development of a new IT system are typically capitalised on a firm's balance sheet as an intangible asset, subject to meeting certain accounting criteria. These costs do not therefore immediately affect the income statement. Once the system is put into use, the intangible asset thus created is amortised (charged to the income statement) over its expected useful life. The effect is to charge the costs of producing the asset to the income statement over the same period that the benefits are realised.
- If at any point it is judged that the expected future benefits are less than the remaining value of the intangible asset, the asset is regarded as impaired and any impairment is charged to the income statement.
- In the case of a regulated entity like the Co-operative Bank, intangible assets on the balance sheet are deducted from a firm's capital resources for capital assessment purposes. So while the costs of the intangible asset are not charged to the income statement until the asset is either in full working order or impaired, the total value of the costs would already have been reflected in the banking firm's capital resources assessment. IT projects therefore impose an increasing strain on a bank's regulatory capital as spend accumulates.

11.22 The Bank's approach to the funding of its replatforming programme is the second example of the Bank adopting an accounting treatment which had the effect of improving its capital position in the short-term. By the end of 2012, the cumulative spend had reached £349 million (Exhibit 23).

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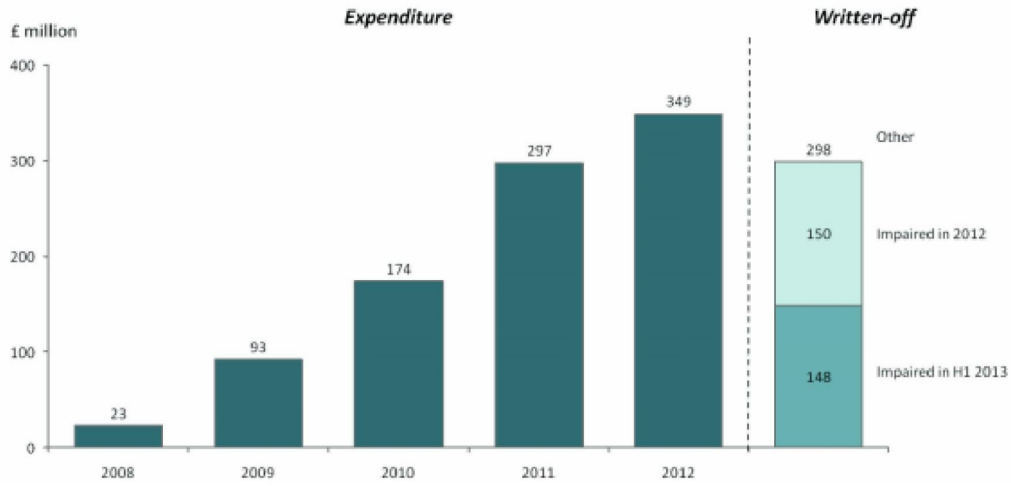
Exhibit 23: Cumulative replatforming expenditure and amounts written-off



Source: CBG Finance department, Co-operative Bank financial statements, Kelly Review analysis.

11.23 The Bank chose to finance the programme through a separate entity, Co-operative Financial Services Management Services (CFSMS). CFSMS is a service company owned by the Banking Group, as opposed to the Bank, and which the Banking Group used for a significant proportion of the administrative expenses (including property costs and payroll) of both the Bank and the insurance businesses. It is not unusual to use a separate service company to manage operational expenses within a group structure. The Bank may initially have decided that CFSMS should fund the replatforming programme because of a belief that the programme would benefit both the Bank and insurance businesses.

11.24 If the Bank had decided to fund the replatforming programme directly, it would have built up an intangible asset on its balance sheet as costs were incurred - which would need to be fully deducted for capital assessment purposes. Funding it through CFSMS instead meant that the Bank held an inter-company balance with CFSMS – which did not have to be deducted from capital.[150] The intangible asset was recorded on the balance sheet of CFSMS, which was not part of the regulated bank entity.

11.25 Once the IT system became fully operational, CFSMS would be expected to amortise the intangible asset over its expected life. The intention was that CFSMS would recharge the amortisation to the Bank as it occurred. The recharge would flow through the Bank's income statement as an expense, reducing its capital resources as it did so.

11.26 Initially the Bank took no capital management advantage of the CSFMS vehicle, which suggests that it had not initially chosen to adopt this structure for capital reasons. In its capital adequacy returns to the Regulator, it treated replatforming costs incurred by CSFMS as a capital deduction within the Bank, even though the intangible asset was on the balance sheet of CSFMS.

11.27 The Bank changed its approach in October 2010. It removed the capital deduction, which at that point was expected to have a £252 million impact by the end of 2011. The change was deliberate and significant. It was unambiguously made to ease near-term capital constraints. It formed part

[150] But a very small amount of capital would have had to have been held against the asset.

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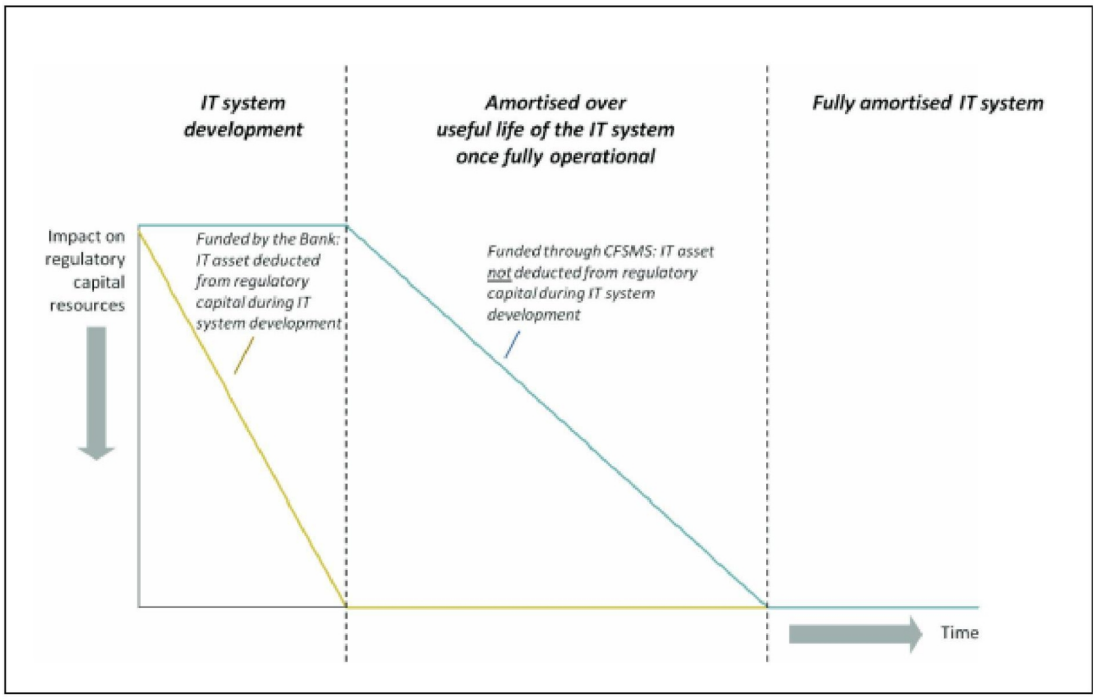
of an £876 million capital action plan agreed as part of the Bank's 2011-2013 corporate planning process.

11.28 Some of the former management team believe that the change was pointed out to the Regulator at the time. The auditor was informed by the Bank that the Regulator had agreed. Neither the PRA nor the current Bank management team have found any correspondence to support that contention.

11.29 As we now know, the new IT system never became fully operational. The intangible asset which had been built up was partly impaired by £150 million in December 2012, which must imply that the Bank and its auditor thought that it still had some value. The auditor highlighted to the Audit Committee in March 2013 that it considered the impairment to be within an acceptable range, but optimistic. Only six months later, in June 2013, the asset was impaired by a further £148 million (Exhibit 24).

Exhibit 24: Regulatory capital impact of different accounting treatments of IT systems



11.30 The impairments would have affected the Bank's income statement and profitability to the same extent and at the same time irrespective of whether CFSMS had existed or not. The effect of using CFSMS was to change the timing of the impact of the replatforming programme on the Bank's capital. Had the Bank accounted for the programme on its own balance sheet, its capital would have been affected earlier, albeit more gradually, as costs were incurred. The capital effect would have been reflected in its 2010 and 2011 Annual Report and Accounts, not just those for 2012 and 2013. Funding the cost of development through CFSMS meant that the Bank delayed the effect on capital until the impairments were incurred.

11.31 The Bank disclosed the size of its related party transactions with CFSMS in its Annual Report and Accounts. It did not, however, disclose that CFSMS was funding its replatforming programme until the first impairment was incurred in 2012. Whether or not the Directors considered such disclosure to be mandatory, it would have been more transparent if they had chosen to make it.

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11.32 The Bank restated its 2012 balance sheet and capital position for the purpose of its 2013 Annual Report and Accounts. All its replatforming spend is now accounted for within the Bank rather than CFSMS. The change was prompted by an FRC review in 2013. That review highlighted the fact that the risks and rewards lay broadly with the Bank and should be recognised as such. The result was to reduce the Bank's Core Tier 1 ratio at the end of 2012 from 8.8 per cent to 7.4 per cent.

11.33 The FRC conclusion suggests that from an accounting viewpoint it would have been more appropriate for the Bank to have recorded its replatforming expenditure as an intangible asset on its own balance sheet, once it became clear that the risks and rewards of the programme lay broadly with the Bank. I suspect this is an area where significant accounting judgement is required. More important than the appropriateness of the accounting judgement is further evidence of Bank management purposefully taking an action which made its capital position look stronger in the short-term when greater prudence might have suggested a different approach.

Provisioning against corporate loans

Exhibit 25: Accounting for loan impairments[151]

- The accounting requirements for loan impairments are governed by 'International Accounting Standards (IAS) 39: Financial Assets: Recognition and Measurement'. Under IAS 39, loan impairments are recognised under an 'incurred loss' model. This model assumes that all loans will be repaid until evidence to the contrary (known as a 'loss event') is identified. Only at that point is the impaired loan written down to a lower value. A simple example of a 'loss event' on commercial lending would be loss of a tenant which results in a borrower suffering payment difficulties and falling into arrears.
- Once a loss event is deemed to have occurred, a bank is required to assess whether the asset should be impaired. Typically, a bank does this by estimating the level of future cash flows that it will receive from the customer (taking into account the underlying property value) and comparing this to the customer's outstanding balance. If there is a shortfall, an impairment is charged to the income statement.
- This approach is different to the exercise performed by the Bank for the purposes of the Fair Value Adjustments when it acquired Britannia. In that situation, Credit Fair Value Adjustments are calculated on the basis of the acquirer's assessment of the total lifetime expected losses on acquired assets and do not require a loss event to have occurred. A Fair Value Adjustment exercise is therefore more forward-looking than the IAS 39 incurred loss approach.

11.34 The final set of accounting judgements which this chapter considers relates to the provisions taken against losses in the Bank's corporate loan book.

11.35 Corporate loan provisioning can be driven by many factors, including:

i *Changes in strategy* - for example the impact on values of pursuing a more aggressive approach to asset disposals.

ii *Deterioration in the market* - for example a reduction in commercial real estate prices reducing the value of collateral.

[151] Loan impairments are a complex accounting requirement which is difficult to summarise in simple, non-technical terms. The high level description provided here, for loans that are held at amortised cost, is not intended to be a full and precise account of the accounting requirements.

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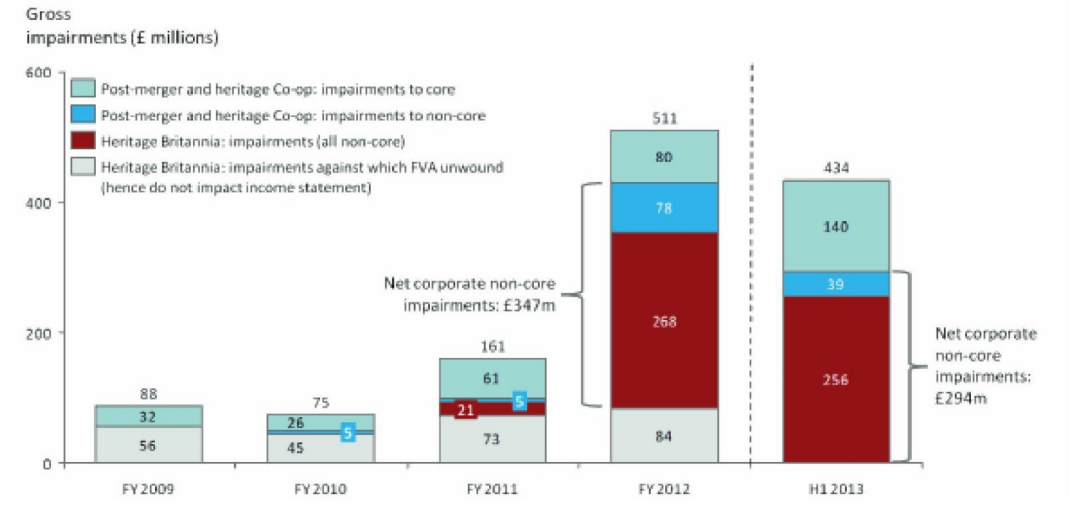
iii *Circumstances specific to individual customers*, such as the loss of an anchor tenant in a commercial building.

iv Change in accounting requirements.

11.36 The history of the charges taken against the Bank's corporate loan book between 2009 and 2013 (Exhibit 26) is set out in paragraphs 4.18 and 4.19. In brief, the Bank was protected initially against the impact of impairment of the heritage Britannia corporate lending by the Fair Value Adjustment made to that portfolio at the time of the merger. By early 2012, the Fair Value Adjustment had been largely used up and the portfolio was showing increasing signs of distress. In its 2012 Annual Report and Accounts, the Bank charged impairments against its corporate loan book as a whole of £427 million. In the first half of 2013, it charged further impairments of £434 million, £250 million of which reflected a change to a more active disposal strategy.

Exhibit 26: Corporate loan impairments



Note: Does not include the £27 million Fair Value Adjustment to the non-distressed Britannia corporate assets which was unwound to the income statement separately. Numbers do not sum due to rounding differences.
Source: Co-operative Bank Finance, Kelly Review analysis.

11.37 A number of those on the Bank Board or Executive at the time have attributed the size of the 2012 impairments to two main factors:

i A loan loss provisioning letter from the FSA in mid-December 2012 which, in their view, had the effect of *"moving the goal posts"*.

ii A series of events specific to a number of their largest customers.

11.38 The FSA letter was industry-wide, not aimed just at the Co-operative Bank. It followed an expression of concern from the Bank of England's Financial Policy Committee about the way banks and building societies were accounting for their assets. The letter was highly technical. It addressed two key issues – when impairment should be taken (when the 'loss event' has occurred) and how to estimate the size of the resulting loss once a loss event has been identified.

11.39 The letter seems to have had a more significant impact on the Co-operative Bank than on its peers. It caused the Bank materially to recalibrate its loan provision methodology. Its receipt also

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coincided with the appointment of a new Finance Director of Corporate and Business Banking, who apparently provided fresh perspective and, supported by the auditor, stimulated a more rigorous assessment of the commercial real estate portfolio.

11.40 The Regulator's view is that its letter merely reinforced its existing position that firms should avoid taking an optimistic approach to provisioning. The PRA's Chief Executive told the Treasury Select Committee that the Co-operative Bank's attitude to impairment before the letter had been out of line both with the Regulator's expectations and with the rest of the industry.[152] In his judgement the Bank had failed properly to scrutinise its balance sheet and underlying asset quality. A number of Bank interviewees have supported this view.

11.41 On the second factor, it almost certainly is true that part of the increase in provisioning was the result of some of the Bank's major customers facing refinancing difficulties, even though commercial real estate prices were relatively stable in 2012. Of course, these events would not have affected the Bank to the extent they did had its portfolio not been so heavily concentrated.

Should the Bank have recognised corporate loan provisions earlier?

11.42 The view of its external auditor, as expressed to the Bank Audit committee at the relevant times, was that up to the end of 2011 provisioning across its corporate book was in an acceptable range, although looking increasingly optimistic. The extent of the provisioning in 2012 and 2013, and the Regulator's remarks to the Treasury Select Committee, inevitably raise the question of whether some of the impairments made then should have been recognised earlier.

11.43 The timing of the recognition of the impairments taken in the first half of 2013 have already been the subject of an independent review commissioned by the Bank from PwC ('Project Jules'). PwC concluded that, based on management's assertions as to the new information and facts available to management under the relevant accounting guidance, it was not inappropriate to recognise those adjustments in the financial statements for that period. PwC's procedures did not include any analysis in respect of the amount of impairment losses or the means by which they were computed.

11.44 No similar independent exercise has been performed to date to assess whether the provisions in 2012 should have been recognised earlier. It will be clear from what I have said earlier in this report that I have serious doubts about the quality of the Bank's risk management framework. In March 2013, the Bank's Internal Audit team reviewed corporate exposures and gave it a red rating. It identified *"significant weaknesses in three key areas of the control framework for managing Corporate Exposures: monitoring of exposures and the triggers for identifying high risk exposures; subsequent monitoring and management of high risk exposures; and the process for providing against these exposures."* In light of these findings it is hard not to question whether in earlier periods the underlying data used as the basis of the corporate provision were sufficiently robust. It follows that there must be a possibility that some of the 2012 provision might have been recognised earlier had the data been better.

11.45 Conversely, a significant proportion of the provisions taken against the commercial real estate part of the portfolio are to cover losses that have not yet crystallised. One instance has been brought to my attention where an impairment taken in 2012 has subsequently been reversed to reflect a more favourable outcome than had been anticipated when the provision was taken. Only time will tell whether positive reversals become material.

[152] Andrew Bailey's oral evidence presented at the Treasury Select Committee on 11 February 2014. http://data.parliament.uk/writtenevidence/WrittenEvidence.svc/EvidenceHtml/6549

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The role of the Executive in decisions about provisioning

11.46 It is clearly important for the Executive team to ensure that the numbers provided by Finance and the business units are robust. But there can be a fine line between an appropriate level of challenge and inappropriate override.

11.47 Several interviewees told the Review that they were uncomfortable with the extent to which some members of the Executive team influenced the numbers in the preparation of the Annual Report and Accounts, as well as of monthly reporting and forecasts. It is fair to say that the Review was not given many documented examples of such Executive override of judgements made elsewhere in the business. One of the cases drawn to my attention does, however, stand out.

11.48 In February 2012, on a Friday afternoon, prior to the Bank publishing its 2011 Annual Report and Accounts, the Bank Finance team, Risk team, and CFO agreed that an additional £20 million provision should be charged against the corporate portfolio. The external auditor did not object. The Finance team worked over the weekend to update the draft Annual Report and Accounts. On the following Monday morning, the additional £20 million provision was reversed, apparently on the instruction of the Bank's Acting CEO. The reversal was thought by some of those involved to have followed a conversation between the Bank CEO and the Group CEO. But there is no direct evidence of this. The Bank CEO has no recollection of any of these events and the Group CEO denies that any such conversation ever took place. Before approving the Annual Report and Accounts, the Audit Committee was not told of this change of heart by either Bank management or the auditor. The auditor concluded that although the combined level of corporate provisions were acceptable before taking the additional £20 million, the initial provision was towards the more optimistic end of the acceptable range.

11.49 The additional provision would have had the knock on effect of nearly halving the Bank's £40 million bonus pool for its employees and directors. The Finance team who worked over the weekend were aware of this.

Conclusion

11.50 The three examples discussed in this chapter have two features in common. They illustrate consistent tendencies to seek ways of favouring short term financial performance and capital where the Bank believed the letter of accounting rules allowed it to do so, even if that was not fully within their spirit. And, where it believed it had a choice, the Bank tended to opt for less transparency rather than more.

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12 CAPITAL

Date	Event
August 2009	x Regulator sets initial capital requirements for the merged entity
December 2009	x Bank's Core Tier 1 ratio is 8.7 per cent
May 2010	x Bank starts Project Albany, its first attempt at restructuring the Leek Notes
July 2010	x Regulator sets updated and increased capital requirements for the Bank
October 2010	x Bank decides to remove its capital resources deduction for the IT replatforming spend being incurred within CFSMS x Bank cancels Project Albany
January 2011	x Bank starts Project Lotus, its second attempt at restructuring the Leek Notes
June 2011	x Bank completes Project Lotus, restructuring the Leek Notes and deferring the Fair Value unwinds
July 2011	x FSA's Andrew Bailey tells the Board that the Bank has a weak capital position relative to peers and that a sustainable Core Tier 1 ratio of 10 per cent would be appropriate (compared to 9.6 per cent at June 2011) x Andrew Bailey also points out that this will need to be increased further under Basel III
November 2012	x The Regulator tells the Bank that its ICG is going to increase significantly
December 2012	x Bank's Core Tier 1 ratio falls to 8.8 per cent (before restatement of the 2012 balance sheet and capital position in its 2013 Annual Report and Accounts)
January 2013	x Regulator sets updated and significantly increased capital requirements for the Bank x Bank's capital resources fall below its CPB (but above its ICG) x Bank launches Project Pennine x Bank completes Project Calico, increasing its Core Tier 1 ratio by 0.4 per cent
May 2013	x Moody's downgrades the Bank's deposit and senior debt ratings by six notches
June 2013	x Bank announces £1.5 billion 'capital shortfall' following a one-off industry-wide exercise performed by the Regulator on eight banks and building societies x Bank's Core Tier 1 ratio is 4.9 per cent x Bank breaches its ICG (but not its Pillar 1 requirement)
August 2013	x Bank publishes its interim 2013 accounts x Bank's auditor includes an 'emphasis of matter' in its audit report because of uncertainties around the Bank's ability to continue as a 'going concern'
November 2013	x Bank announces its final £1.5 billion recapitalisation plan, including details of the Liability Management Exercise (LME)
December 2013	x Bank completes its LME
March 2014	x Bank accounces it will require an additional £400 million of Common Equity Tier 1 capital
April 2014	x Bank publishes its 2013 Annual Report and Accounts

12.1 Capital is fundamental to any bank. It determines its capacity to lend and it provides protection for depositors in the event that a bank's assets decline. It is essential that firms hold a quality and quantity of regulatory capital commensurate with the nature and scale of their activities and the risks such activities pose. Preservation of capital is particularly important for mutuals, or mutually-owned banks like the Co-operative Bank, because they have more limited capital-raising capabilities than their non-mutual equivalents.

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12.2 Holding capital can be expensive. Shareholders demand a higher return than depositors or debt holders to compensate them for the risk they undertake. Banks typically try not to hold capital significantly in excess of that required to absorb potential losses.

12.3 Previous chapters have considered various events in the history of the Co-operative Bank leading up to the announcement in June 2013 that it faced a significant capital shortfall. In those chapters, I have also commented on the extent to which those elements contributed to the shortfall. This chapter brings the different parts of the story together and addresses the Bank's capital position as a whole. It describes the setting of the Bank's capital requirement, the evolution of the capital position over time, the main factors affecting that, and the extent to which the Bank anticipated its emerging problem and took action to address it.

Exhibit 27: The setting of a bank's capital requirement

- As a registered UK deposit-taking institution, the Co-operative Bank is required to maintain adequate financial resources at all times - including minimum levels of capital and liquidity. These minimum levels were set and monitored by the Financial Services Authority (FSA) and then by the Prudential Regulation Authority (PRA) from April 2013. Capital and liquidity requirements apply to all banks and building societies within the UK. The firm (the term used by the Regulator) must publish its Pillar 1 capital requirement,[153] but its iCG and CPB are confidential to the firm and to the Regulator.
- Prior to 1 January 2014 (and therefore during the period under review), capital was divided into three different "tiers" depending on quality (i.e. how easily it can be accessed to absorb losses). Tier 1 capital (the highest quality) included retained earnings and share capital (including preference shares). Core Tier 1 is a subset of Tier 1; it includes only the highest quality capital, excluding instruments such as preference shares. Tier 2 included certain types of subordinated debt. Tier 3, which included short-term subordinated debt, has been removed under the latest regulations, but qualified during the period under review for limited purposes such as certain types of market risk. Then, just as today, a firm's capital base should have consisted predominantly of Tier 1 capital. The Regulator published rules regarding the quality of capital that a firm can use to meet its capital requirement. Since 1 January 2014, most of these rules are directly applicable under EU regulations (Capital Requirements Directive IV and Capital Requirements Regulation).
- Banks and building societies are required on a frequent basis to assess for themselves the minimum level of capital they need to hold in order to withstand a series of hypothetical stress events, taking into account their overall risk profile. To do this, they conduct an Internal Capital Adequacy Assessment Process (ICAAP). The ICAAP includes an unaudited assessment of each principal risk faced by the firm (credit risk, market risk, operational risk, concentration risk, pensions risk and so on) and a forward-looking view of the firm's capital under stressed conditions.
- On a regular basis, the PRA performs a Supervisory Review and Evaluation Process (SREP) on each firm, focusing on the firm's capital and risk management. The frequency of a SREP depends on the size and importance of the firm. For larger firms, it typically occurs at least every 2 years. Additionally, the Regulator carries out stress testing assessments of firms. The SREP and stress testing assessments inform the setting of individual firm capital requirements.
- During a SREP, the Regulator reviews the firm's ICAAP and evaluates its management of capital. The assessment typically involves a review of key documents and discussion with management and the non-executive directors, but is not an audit. The SREP enables the PRA to determine how much capital the firm should hold. The Regulator sets a minimum level of capital which must be

[153] Basel II and III use a 'three pillars' concept – (1) minimum capital requirements (addressing risk), (2) supervisory review and (3) market discipline. The first pillar (dealing with maintenance of regulatory capital) is the minimum capital required under EU law and is calculated for three major components of risk: credit risk, operational risk, and market risk.

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maintained at all times. This is called an Individual Capital Guidance (ICG). To calculate a firm's ICG, the Bank calculates its Pillar 1 capital requirement, which takes into account the firm's credit, operational and market risks. The Regulator then increases the requirement according to its assessment of the firm's risk profile - including any risks not considered within Pillar 1, as well as in light of its risk and control environment. The resulting ICG is expressed as a percentage of the Pillar 1 capital requirement, plus a fixed amount.

- On top of the ICG, the Regulator sets a Capital Planning Buffer (CPB) which can be used by the firm to absorb losses at particular times of stress. It follows that, in particularly stressed times, the firm can be within its CPB as long as it is above its ICG. In business-as-usual conditions, a firm should hold capital in excess of both its ICG and CPB (the combination of which is referred to in this report as the 'capital requirement'). A firm is not required to publish the size of the CPB set for it.
- Three capital ratios are also used to assess a Bank's capital strength. These ratios express capital as a percentage of its risk-weighted assets (RWAs). RWAs are a firm's total on and off-balance sheet exposures, weighted according to risk. For example, a prime residential mortgage exposure with no arrears attracts a significantly lower risk-weighting than an equivalent commercial real estate exposure with significant arrears but no provision. A firm's capital ratios can therefore be affected by both its absolute level of capital and its RWAs.
- A firm's Core Tier 1 ratio is its Core Tier 1 capital expressed as a percentage of its RWAs. A firm's Total Capital Ratio is all eligible capital (Tier 1 plus Tier 2 plus Tier 3) expressed as a percentage of RWAs. Finally, from 1 January 2014 the EU legislative package known as CRD IV (Capital Requirements Directive IV) was introduced by the European Commission. This Directive will gradually increase the quantity and quality of capital that firms are required to hold. It introduced a new Common Equity Tier 1 ratio which replaces the existing Core Tier 1 capital ratio, and is similar in many regards (albeit more restrictive) on what qualifies as Common Equity Tier 1.
- During and immediately after the financial crisis, most firms looked to shrink their balance sheets in order to reduce their RWAs and improve their capital ratios. In some instances, firms sold higher risk portfolios at a loss. When this happened, the reduction in RWAs nevertheless resulted in an improvement in capital ratios – notwithstanding the loss.

The emergence of the capital shortfall

12.4 A firm has capital headroom if its capital resources exceed its capital requirement. It has a capital shortfall if its capital requirement exceeds its capital resources. Exhibit 28 shows how the Bank's capital resources and requirements changed relative to each other over the period from shortly after the Britannia merger to June 2013.

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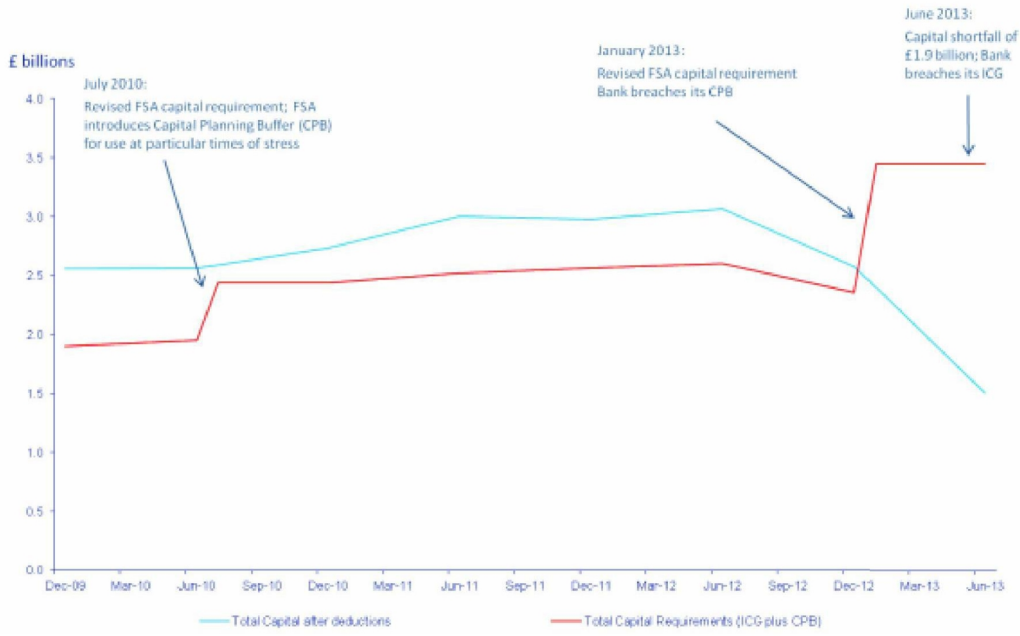
Exhibit 28: Co-operative Bank capital resources and capital requirements Dec 2009 – Jun 2013



Note: Capital resources do not include an adjustment for the Bank restating its 2012 balance sheet and capital position in its 2013 Annual Report and Accounts.
Source: The Co-operative Bank PLC FSA003 capital returns at 31 December and 30 June each year, Kelly Review interpolations.

12.5 In December 2009, five months after the merger, the Bank's capital position appeared adequate.

12.6 The Bank's total capital resources after deductions then amounted to nearly £2.6 billion, of which around £1.7 billion was Core Tier 1. Its capital requirement (including both ICG and CPB) was £1.9 billion, leaving headroom of £0.7 billion. Its total capital ratio was 13.5 per cent and its Core Tier 1 ratio was 8.7 per cent. The Bank was also profitable, delivering profit before tax of £172.4 million for the 2009 financial year.[154]

12.7 Even at this point, however, there were several factors which might have given the Bank pause for thought about whether it should be initiating moves to strengthen its capital base:

i Prior to merger, the Regulator was already expressing concerns about the deteriorating capital position of both Britannia and the Bank.

ii It was widely anticipated that the fallout from the financial crisis would lead to regulatory demands for financial institutions to hold more capital. The exact nature and scale of the increased requirements could not then be known definitively. But the direction of travel was clear.

iii The Bank would be worse-placed than many others to respond to these demands, being wholly owned by a mutual. Only its ultimate parent, the Co-operative Group, could provide additional equity capital, either through its subsidiary (CBG), which could transfer funds

[154] Before profit-based payments to Group to fund membership dividend.

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generated in the insurance businesses to the Bank, or by transferring funds from the trading group. The trading group was itself financially stretched, having recently taken on a substantial amount of debt for its acquisition of Somerfield. Alternatively, the parent could accept dilution of its ownership. If neither of these options were acceptable, the Bank would need to reduce its risk-weighted assets.

iv The Bank knew that it would have to account in due course for the significant interest Fair Value Adjustments to Britannia's Leek Notes. Unwinding these adjustments over a number of years through the income statement would depress future profits. The effect, £1,259 million in total (almost twice the size of the Bank's capital headroom in December 2009), was bound to limit severely the Bank's primary means of generating capital from future retained earnings.

v The Bank's profits were certain to come under pressure during the economic recession because of low interest rates and pressures on its borrowers.

12.8 Perhaps prompted by these considerations, the Bank's immediate parent (CBG) made a series of capital injections from its reserves (partly generated by its insurance businesses) between 2009 and 2012, bolstering capital by £522 million. [155]

12.9 In July 2010, the FSA increased the Bank's capital requirement by approximately £0.5 billion following its SREP. The increase cannot have come as a great surprise given the Regulator's focus on increasing capital levels and given that it was introducing the CPB requirement for the first time. Other banks were also facing increases in their requirements at this time. The higher requirement did not put the Bank in breach.

12.10 For the next couple of years, the Bank's capital resources remained fairly stable and above its capital requirement, even though its underlying business performance was deteriorating. Its position would, however, have looked a lot weaker had it not been for the restructuring of the Leek Notes in March 2011 and the decision the Bank made in October 2010 not to take a capital deduction for the replatforming project.

12.11 From June 2012 to June 2013, the Bank's capital resources deteriorated rapidly and substantially, mainly as the result of the provisions taken against its corporate loan portfolio and of the decision to write off the costs of the abandoned IT replatforming project. Meanwhile, its capital requirement increased. In January 2013, following a further SREP, the Regulator increased the requirement by approximately £1.1 billion. The result was that the Bank's capital resources fell below its CPB (which was permissible because it was deemed to be in stressed conditions), though it remained above its ICG.

12.12 The Bank's capital resources fell still further in June 2013 following a loss before tax of £709 million for the previous six months. At this point, the Bank's capital resources after deductions amounted to only £1.5 billion, of which about £0.8 billion was Core Tier 1. Its Core Tier 1 ratio fell to 4.9 per cent. The Bank's Common Equity Tier 1 ratio was then 3.2 per cent, based on the

[155] The Co-operative Banking Group made capital injections to the Co-operative Bank of £175 million in 2009, £180 million in 2010, £87 million in 2011 and £80 million in 2012. See Co-operative Bank Annual Reports and Accounts, 2009 to 2012 for details.

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incoming (and more stringent) Capital Requirements Directive (CRD IV) requirements,[156] well below the minimum threshold.

12.13 By June 2013, the Bank's capital requirement (including its CPB) reached £3.4 billion. So with capital resources after deductions of only £1.5 billion, it had a capital deficit of £1.9 billion, putting it below both its ICG and CPB, but still above its Pillar 1 capital requirement.[157] This situation prompted the auditor to include an 'emphasis of matter' section in its audit report, citing material uncertainties which cast significant doubt on the Bank's ability to continue as a 'going concern'.

The Financial Policy Committee capital assessment

12.14 The £1.9 billion shortfall described above is different to the £1.5 billion figure which has been widely quoted elsewhere to be the size of the 'capital hole'. To avoid confusion it is worth explaining the £1.5 billion figure, which was the result of a separate exercise.

12.15 In early 2013, after the approval of the Bank's 2012 Annual Report and Accounts, the PRA began a review of eight[158] major UK banks and building societies, including the Co-operative Bank. The review followed a recommendation from the Financial Policy Committee of the Bank of England in November 2012. The starting point was each firm's financial position at December 2012 as disclosed in its Annual Report and Accounts. The Regulator then adjusted the financial position to reflect a more conservative assessment than that used by each firm. The adjustments increased future expected impairment losses on each firm's assets, added an estimate of future conduct-related costs, and made a more conservative assessment of risk-weighted assets. Using this adjusted financial position, the Regulator then assessed the amount of additional capital that each firm would require to achieve a Common Equity Tier 1 ratio of 7 per cent as required under the fully transitioned CRD IV.

12.16 The results, published in June 2013, suggested an aggregate capital deficiency on this basis of £27.1 billion for the eight firms combined.[159] The Co-operative Bank's share was assessed by the PRA as £1.5 billion. This figure amounted to approximately 88 per cent of the Bank's capital resources at 31 December 2012,[160] significantly larger than the equivalent figure for any of the other seven. Following the Bank's £709 million reported loss before tax in its interim 2013 accounts, this proportion increased further. For comparison, on the same basis the deficit faced by RBS, proportionally the second largest, amounted to 37 per cent of its capital resources.[161]

Factors contributing to the deterioration in the Bank's capital position

12.17 Both the Bank's capital resources and its capital requirement have been affected by a variety of factors over the period of review. So it is not straightforward to present a simple arithmetic account of how the final shortfall arose. It is, however, possible to identify the main influences on

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[156] While the majority of the rules contained within CRD IV are effective from 1 January 2014, the 7 per cent Common Equity Tier 1 requirement is not immediately effective. Inorder to allow firms to build up their capital holdings over time, this requirement is being transitioned in retrospectively for the period 1 January 2013 to 31 December 2018.

[157] Note that a significant proportion of the £1.9 billion capital deficit is due to the CPB, which is allowed to be utilised in times of stress. The bank's deficit against its ICG in June 2013 was substantially less than £1.9 billion.

[158] Barclays, CBG, HSBC, Lloyds Banking Group, Nationwide, RBS, Santander UK, Standard Chartered.

[159] News release: 'Prudential Regulation Authority (PRA) completes capital shortfall exercise with major UK banks and building societies'. http://www.bankofengland.co.uk/publications/Pages/news/2013/081.aspx

[160] To ensure like for like comparison, capital resources have also been calculated at 31 December 2012 assuming full implementation of CRD IV, resulting in an estimate of £1.7 billion.

[161] Published results: http://www.bankofengland.co.uk/publications/Documents/news/2013/pracaprec.pdf

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both sides of the equation. This section describes the main factors determining capital resources which might be regarded in some sense as being special, as opposed to the normal swings in profitability. The subsequent section identifies the main reasons for the increase in the capital requirement, to the extent that can be determined.

12.18 Some of the significant factors acting to reduce the Bank's capital resources over the period are more measurable than others.

12.19 The most significant of the measurable factors are:

i *Impairment of corporate loans*. Between January 2009 and June 2013 corporate impairments amounted to £1,268 million. £802 million of this stemmed from Britannia-originated loans, before taking into account the Fair Value Adjustments of £284 million allocated at the time of the merger.[162] The remainder related to loans originated by the Co-operative Bank – either before or after the merger.

ii *Replatforming costs*. The Bank made provisions of £298 million against the cost of the abandoned replatforming programme. The Bank recorded impairments of £150 million in the 2012 Annual Report and Accounts and a further £148 million in the 2013 Interim Accounts.

iii *PPI mis-selling*. The Bank made provisions against the cost of rectifying PPI mis-selling. By the first half of 2013 these totalled £269 million.

iv *Verde*. The costs of pursuing Verde amounted to at least £73 million.

12.20 Other factors which are important, but more difficult to quantify, are:

i *The economic environment*. The business case for the merger with Britannia was based on the expectation of an economic recovery. Importantly, this included an assumption of an increase in the Bank of England base rate within the planning horizon, thereby improving net interest margins and profitability. Although this may have been a supportable assumption at the time, these expectations were not, of course, borne out by events. Instead, interest rates remained low. The Bank's total operating profit (before tax and exceptional items and impairments) for the entire period from 1 January 2010 to 30 June 2013 totalled only £636 million. This was insufficient to offset the corporate impairments recorded in 2012 and the first half of 2013.

ii *The indirect effects of the various weaknesses discussed in other chapters*, including the management stretch and disruption caused by Verde and Project Unity, a poorly executed risk management framework and a lack of effective governance.

12.21 The Britannia-originated corporate lending was by no means the only contributor to the reduction in the Bank's capital. It was, however, the largest single factor even after taking into account the Fair Value Adjustment made at the time of merger. Moreover, the impairment charges were not the only way the merger contributed to the crisis faced by the Bank. It is also necessary to take into account the increase in complexity the merger caused to the replatforming programme and the (unknowable) impact of the new leadership on areas like risk and overall capital management compared to what might have happened under different leadership.

[162] This included £257 million allocated against the distressed pool and £27 million against the non-distressed pool.

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Factors causing the Bank's increased capital requirement

12.22 As explained earlier, the increase in the Bank's capital requirement occurred primarily in two steps following regulatory SREPs - by £0.5 billion in July 2010 and a further £1.1 billion in January 2013.

12.23 A number of other firms faced increases in their regulatory capital requirements in the same period because of a heightened perception of risk and greater understanding of the possible systemic implications of major failures. But the relative scale of the increase which the Regulator imposed on the Bank is striking. The Bank Executive had been warned verbally by the Regulator in November 2012 to expect a significant increase after the second SREP. The Bank Board was informed of this shortly thereafter. Even so, both Executive and Board appear to have been taken aback by the size of the increase.

12.24 Arguably some part of the increase was unpredictable. The precise mechanics of some of the calculations performed by the Regulator may not always be fully clear. But a significant part of the increased requirement reflected issues or concerns particular to the Bank of which it should already have been aware.

12.25 Increases were applied both to the Bank's ICG and to its CPB.

12.26 The increases to the ICG in January 2013 reflected, in particular, the Regulator's assessment of:

i *Pensions risk*. Employees of the Bank were members of the Group's defined benefit scheme. For both accounting and regulatory capital purposes, the Bank had historically treated its payments to the Group scheme in respect of its employees as if they were part of a defined contribution scheme. This is normal practice for accounting purposes. A defined contribution scheme does not require a bank to hold any regulatory capital against it. With a defined contribution scheme there is no risk of the bank having to make further contributions to make up an actuarial deficit. In contrast, a defined benefit scheme does carry such a risk. In the event that other participating bodies become insolvent and the full statutory debt is not recovered on insolvency, the Bank would become liable for the remaining liabilities. Following the July 2010 SREP, the Regulator decided that for regulatory capital purposes the scheme should in future be treated as if it was a defined benefit scheme. The Regulator consequently imposed an initial capital requirement for pensions risk. This change in approach seemed to take Bank management by surprise. But the Regulator had been using the same approach with CBG's insurance businesses since the end of 2009.

   In January 2013, the Regulator increased significantly the amount of capital required for pensions risk – presumably to recognise changes in economic assumptions. A number of other firms were also required to increase pensions-related capital over the same period. Before the 2012 SREP, the Bank's ICAAP had estimated a smaller pensions risk capital requirement. The Bank underestimated the requirement because of a combination of a mistaken technical interpretation, a deterioration in the Bank's forecasts and a misunderstanding of part of the pensions risk calculation.[163]

[163] The PRA did not accept one of the Bank's proposed management actions. The PRA also believed that, following deterioration in its forecasts after the ICAAP had been submitted to the Regulator, the Bank placed too much reliance on future profit offset despite not expecting to be profitable for a number of years. In addition, the Bank claimed a 'Pillar 1 allowance' for the accounting deficit of the pension scheme even though the deficit was held at a Co-operative Group level for accounting purposes.

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ii *Operational risk.* In July 2010, the Bank had been required to hold a small amount of capital for operational risk. In the January 2013 ICG, the Regulator increased this, and also required capital for PPI and transitional risk. A requirement to hold additional capital for operational risk is not unusual in the industry. The size of the increase faced by the Bank reflected the Regulator's view of the inadequacy of the Bank's operational risk framework, and the lack of sufficiently skilled individuals for an organisation of its size. The Bank had lagged behind other banks in improving its operational risk framework while the Regulator was increasing its scrutiny of this area. Had the Bank adopted a more robust operational risk framework, this would almost certainly have resulted in a significantly lower operational risk capital requirement.

iii *Concentration risk.* The Bank had significant exposure to concentration risk, particularly in its corporate lending. From July 2010, the Bank was required to hold capital for concentration risk. In January 2013, the Regulator increased this substantially. The precise reason for the increase is not entirely clear. It is possible that it resulted from additional regulatory attention to this area, coming on top of the Regulator's 2012 review of the Bank's asset quality.

If the Bank had not acquired Britannia, or if post-merger it had pursued a more aggressive corporate asset disposal strategy, the concentration risk might have been lower and attracted a lower capital requirement. The requirement would never have been zero, however, because of the Bank's UK focus and some concentration risk in its own pre-merger book.

12.27 The January 2013 increase to the Bank's ICG was dwarfed by the increase to its CPB.

12.28 The Regulator introduced the CPB assessment at the end of 2009.[164] It is calculated by stress testing a bank's corporate plan and then overlaying it with a Regulator-defined methodology for identifying the additional capital required for the Bank to survive a severe but plausible stress event. In its July 2010 assessment, the Regulator introduced a sizeable CPB for the Co-operative Bank. In January 2013, it tripled the July 2010 requirement.

12.29 The scale of the increase in the CPB reflected two main issues:

i The magnitude and timing of the Fair Value unwinds yet to come relative to the Bank's capital position.

ii Future losses which could be incurred in a stress scenario, particularly in the non-prime lending book inherited from Britannia and in corporate lending (much of which was also inherited from Britannia). This effect was compounded by low operating profitability driven in part by the Bank's high cost base and the low return on capital from the Optimum and corporate portfolios. All this combined to make the Bank more vulnerable to economic downturns than its peers.

12.30 The Bank's own ICAAP assessment in 2012 implied the need for a much lower CPB than the Regulator's January 2013 assessment, and even slightly lower than the Regulator's previous assessment in 2010. A degree of subjectivity and judgement is involved in such assessments. So it is reasonable to expect some difference between the Bank's own assessment and that of the Regulator. But for a small bank, a difference as dramatic as that between its own assessment and that of the Regulator implies either a fundamental misalignment of opinion on the quality of the underlying business and its future prospects or a material misunderstanding in the calculation

[164] Policy Statement 10/14: Capital Planning Buffers.

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and application of principles. It is hard to argue that the Bank's own assessment could be considered reasonable in the light of everything which had happened since the 2010 assessment, including the significant reduction in the Bank's capital ratios at the end of 2012. A recurring theme of this report has been the Bank's consistently optimistic view in relation to its financial position and the quality of its assets.

12.31 Had the Bank's own assessment of its capital requirement been endorsed by the Regulator following the 2012 SREP, its capital resources would not have been below its CPB. The formal notification of the new requirement in January 2013 was therefore something of a bombshell. It was particularly troublesome for the Bank because it came only a month after the Regulator's December 2012 provisioning letter. This letter had the effect of increasing the impairment charge made in the 2012 Annual Report and Accounts, reducing the Bank's capital resources just as its requirement was increasing. If it had not been clear before, the Bank can have been in no doubt from this point that it faced a serious capital issue which it had to address immediately – and which made the Verde acquisition unviable.

Key questions

12.32 So far this chapter has focused on the main drivers of the Bank's capital shortfall. A significant part of the explanation was a combination of the economic environment and generic increases in demands for regulatory capital which applied to all banks following the financial crisis. But it is equally clear that a large number of the wounds were self-inflicted – the decision to merge with Britannia and then take a relatively inactive approach to the management of the substantial part of the acquired assets that were outside the Co-operative Bank's risk appetite, the mishandling of the replatforming programme, the weakness of the approach to risk management, the looming unwind of the Fair Value Adjustment to the Leek Notes and some of the other factors behind the Regulator's decision to increase the capital requirements so dramatically.

12.33 The rest of this chapter discusses whether the Bank could have identified the magnitude of the capital issue sooner and the adequacy of the actions the Bank took to manage capital during the period.

Capital forecasting

12.34 Earlier chapters have made clear that concerns about capital were prominent in the minds of some, at least, of the Bank Executive even before the Britannia merger was completed. The Board appeared to be less conscious of the problem.

12.35 The Executive's record of forecasting either its capital requirement or its capital resources was consistently poor. To give one example, in December 2011 the Bank gave the Regulator a forecast of its capital resources and requirements on a best endeavours basis for the next eighteen months. It anticipated having a capital surplus of £0.5 billion by end-June 2013. As this chapter describes, it actually incurred a capital deficit of £1.9 billion at that point.

12.36 The Bank's failings in planning and forecasting capital resulted from a number of factors:

i *Optimistic planning assumptions* relating both to the external economic environment and to the performance of the Bank's assets (including projected impairments). The level of profitability predicted at merger has not materialised. It is fair to say that the Bank was not alone in over-estimating the speed of the economic recovery.

ii *A 'command and control' culture* under Neville Richardson (something he vigorously denies) which discouraged challenge and – in the context of the 'good news' tone set from the top –

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resulted in favourable, and at times unrealistic, assumptions for budget purposes. This contributed to projections and forecasts being volatile and prone to last minute change.

iii *A generally weak planning process*, driven by inadequate systems, poor planning capabilities and poor communication across different business lines.

iv *Poor management information.* Management information was often untimely, lacking in clarity and sometimes inaccurate.

v *The use of a three-year planning horizon* despite a back-loaded Fair Value unwind profile which ballooned beyond the three-year horizon. The unwind profile resulted in a near-term benefit to the income statement, followed by a drag to future profitability over a longer time period which, the Bank hoped, would be offset by an improvement in operating profit. A longer-dated planning horizon would have provided a more balanced view of the Bank's financial and capital position.

12.37 If a more balanced approach to planning and better quality management information had been presented to the Board, the true nature of the Bank's problems may have been more transparent, and the Board may have acted more quickly. A Board with more banking experience might have identified this weakness, and so have been more demanding in this regard.

Capital actions taken by the Bank

12.38 As early as January 2008, before the merger discussions had even begun, the Regulator had expressed concerns that CBG, although still adequately capitalised, had a deteriorating capital position. It suggested that the Board should take steps to improve it.

12.39 In practice, though it did take some steps to improve its capital position such as attempting to sell its life insurance business, until a fairly late stage the Bank paid more attention to short-term profitability and managing to budget. As discussed in previous chapters, a number of the capital actions it took had the effect of improving the short-term capital position at the expense of the long-term. This approach was despite the fact that the Bank must have known that its regulatory capital requirement could only increase in the future. It appears to have hoped, rather optimistically, that by that stage the economy would have picked up and its profitability and retained earnings would have increased commensurately.

12.40 In September 2009, one month after the merger had been completed, management identified a number of significant 'emerging risks' that had not been included within the post-merger business plan. These new risks included the additional funding of the Transformation Programme, an anticipated requirement to make further contributions to the pension scheme, the costs to address PPI mis-selling and more pessimistic economic assumptions. Most, or all, of these factors relating to the financial strength of the Bank were not taken into account in the final version of the post-merger business plan. If they had been, they would have made it look much worse.

12.41 The buy-back of Leek 15 at step-up was approved by the FSA in May 2010. The buy-back at step-up was in contrast to the business plan assumption of holding to maturity. Consequently, the redemption crystallised the remaining Fair Value unwind on the Note and stimulated the Bank's attempts at restructuring the Leek Notes, first through Project Albany and then Project Lotus.

12.42 The Bank Executive produced its 2011-13 corporate plan in October 2010. During its preparation, the Executive revised the Leek Note unwind assumptions on two separate occasions. The Bank eventually settled on the most optimistic outcome from a forecast profitability and capital perspective. The assumption had a material impact on the content of the plan. The presentation

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of the plan to the CBG Board did point out in an appendix that if the Leek Notes were called at step-up instead of being restructured, the Bank would suffer a loss of £213 million in 2011. This would mean that its Core Tier 1 ratio would fall below its expectation of 8 per cent. The Board's lack of response to what ought to have been an important warning suggests that it either did not understand this, or did not recognise the importance of something relegated to an appendix.

12.43 The plan included £876 million of capital management actions over and above the Leek Note restructuring. The actions included removing the capital deduction taken for replatforming spend – which like the restructuring of the Notes simply shifted a problem into the future. It also included challenging the ICG add-on for pensions risk. The Bank forecast that it would be in breach of its capital requirements by the first half of 2011 if it either failed to find a solution to the Leek Note problem or did not execute the capital management actions. A team was set up at the end of 2010 to deliver these actions.

12.44 Restructuring the Leek Notes was capital-destructive in the long-term. It required a sweetener to Note holders in the form of an increase in coupon to compensate them for holding the Notes for a longer period of time.

12.45 Conversely, the Bank did not take a number of other actions which could have significantly improved its underlying performance. It never tackled wholeheartedly its high cost/income ratio, although the replatforming programme was intended to help by reducing running costs and increasing income through improved customer relationship management. It did little to improve its risk management framework. It also failed to manage the commercial real estate portfolio more aggressively until trouble hit.

12.46 It is only possible to speculate what might have happened had the Bank adopted different approaches in relation to the Leek Notes and replatforming. But it seems reasonable to suggest that:

i The Bank's capital requirements would have been breached earlier. That might simply have brought forward the crisis. But it might also have made it easier to deal with it before the increase in the capital requirement in January 2013.

ii The Bank would have been unlikely to pursue Verde - in which case the associated costs, management stretch and organisational disruption would not have been incurred. Management would have been more focused on effective day-to-day running of the Bank.

iii The new management team may well have been in place earlier, and would have had more time to deal with some of the issues they now face.

The end game

12.47 A number of steps have been taken to bolster capital since the receipt of the January 2013 capital requirement.

12.48 In January 2013, the management team began a search for capital actions (Project Pennine). As part of this, it completed Project Calico, a Residential Mortgage Backed Security (RMBS) securitisation which had the effect of offloading some of the risk associated with a portfolio of loans originated under Britannia's Platform brand. This transaction bolstered short-term capital.

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It reduced the Bank's risk-weighted assets and increased its Core Tier 1 ratio at the time from 8.8 per cent to 9.2 per cent.[165] However, it is also capital destructive in the long-term.

12.49 In March 2013, the management team agreed the sale of its life insurance and asset management business, which had been under negotiation since before Neville Richardson's departure, for £219 million. The transaction completed in August 2013.

12.50 In May 2013, Moody's downgraded the Bank's deposit and senior debt ratings by six notches. This was the largest Moody's downgrade since Enron. It might have complicated the capital raising plan. It provided external confirmation of what should have already been clear internally.

12.51 By June 2013, the previous Chair, Chief Executive and CFO had left the Bank and been replaced by a new team. All three of the new team have significant previous experience of working in a bank.

12.52 In June 2013, the new management team launched a £1.5 billion recapitalisation. The plan was finalised in November 2013, (and implemented in December 2013) with improved terms for bondholders and a reduction in the Group's shareholding in the Bank from 100 to 30 per cent. The Bank raised £1.1 billion of capital in 2013 and is due to raise a further £0.4 billion in 2014. The main elements of the recapitalisation are:

i £1.2 billion of Common Equity Tier 1 capital raised through the Liability Management Exercise.

ii A contribution from the Co-operative Group of £333 million of Common Equity Tier 1 capital by the end of 2014.

iii £40 million of Common Equity Tier 1 capital in 2014 from interest savings on the securities surrendered in the LME.

12.53 As at the end of 2013, the Bank's Core Tier 1 ratio was 9.2 per cent, and its Common Equity Tier 1 ratio was 7.2 per cent. It is not currently compliant with its ICG, although it does meet its Pillar 1 capital requirement.

12.54 The Liability Management Exercise (LME) prospectus explained that, even after full completion of the £1.5 billion Recapitalisation Plan, the Bank did not expect to meet its CPB by the end of its five year business plan, but did expect to meet its ICG by then. This approach was agreed with the PRA.

12.55 In March 2014, the Bank announced that it would require an additional £0.4 billion of Common Equity Tier 1 capital, over and above the 2014 contribution from the Co-operative Group. The Bank still does not expect to meet its CPB by 2018.

Conclusion

12.56 A wide range of factors were involved both in the Regulator's decisions to increase the Bank's capital requirement and in the reduction in the capital resources available to the Bank to meet that requirement. A number of these factors are inter-related.

12.57 It is, however, possible to draw a number of conclusions:

i The decision to merge with Britannia was by no means the only cause of the crisis. It was, however, a significant one, especially when the possible indirect effects on both capital

[165] Before restatement of the Bank's capital position in its 2013 Annual Report and Accounts.

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resources and capital requirement are taken into account as well as impairment to the corporate loan book.

ii Some of the wounds were self-inflicted and could have been avoided with better management and leadership.

iii Instead, the Bank focused too much on its short-term profitability and capital position and took a number of decisions deliberately designed to improve the short term at the expense of the long term. It seems to have over-optimistically expected an economic upturn which would improve its profitability and get it out of trouble.

iv Such optimism and such trade-offs between the short and long term would not have been prudent at the best of times. It was particularly imprudent for a mutually-owned bank during a period when regulatory capital requirements were only going to increase and in the face of a severe economic recession which led to several similarly-sized UK banks requiring financial support or failing.

v Despite external appearances to the contrary, there were weaknesses in the Bank's capital position from the time of the Britannia merger, or even before. It is impossible to be certain what might have happened if a different set of decisions (and not just relating to capital) had been taken or if a different set of people had been in charge. Facing up to the Bank's capital weakness earlier might simply have brought the crisis forward. But it is at least possible that it could have produced a very different result, not excluding the Group retaining control.

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13 GROUP AND BANK GOVERNANCE

13.1 Failures in governance at both Group and Bank contributed significantly to the Bank's problems.

Exhibit 29: The Group Board

- Until the appointment of Lord Myners as Senior Independent Non-Executive Director in late 2013, the Group Board was a wholly-elected body. It consisted of 15 members (known as Regional Representatives) elected from Regional Boards and five members (known as Independent Society Representatives) elected by independent co-operative societies.
- Regional Representatives reach the Board through an indirect route.
- The approximately 7.6 million members of the Co-operative Group, including significant numbers of Bank customers and employees, are eligible to elect around 500 of their number to represent them on 45 Area Committees. The Area Committees each consist of 10 to 12 members.[166] One third of each committee is up for re-election each year. In practice, only about 250,000 of the 7.6 million members take part in elections.
- The members of the Area Committees elect 100 of their number to seven Regional Boards. Again, one third of the members of Regional Boards are up for election every year. Regional Boards include at least one representative from each area. Members serve on an Area Committee for two years before they are eligible to be elected to a Regional Board. Regional Boards monitor trading operations in their regions, review regional business plans and approve certain items of capital expenditure and the closure of stores.
- The Area Committees also elect 15 of the 100 members of the Regional Boards to the Group Board. To be eligible for election, members must have served for two years on a Regional Board and have completed the requirements of the Group Board Development Centre.[167] Each Region has a defined number of members on the Group Board. Just as for other levels, one third of the Regional Representatives on the Group Board is up for election each year. Regional Representatives on the Group Board lose their positions on the Group Board if at any time they lose their seat on either the Area Committee or Regional Board.
- Two consequences flow from this method of election. First, Regional Representatives on the Group Board have to commit significant time. They also sit on Regional Boards and Area Committees and have to ensure their re-election at all three levels, and are members of one or more of the Group subsidiary boards or committees. Second, when vacancies occur on the Group Board the number of individuals eligible to compete for them is typically small. There can even at times be no eligible candidates at all.
- The Independent Society Representatives are elected by the 80 or so independent societies that trade with the Co-operative Group. Votes are weighted according to each society's share of transactions with the Group. Not surprisingly, those elected tend to come from the larger independent societies. They are usually (but do not have to be) their CEOs.

[166] Northern Ireland has a 20-strong Members Council which performs Area Committee functions.

[167] Requirements are Strategic, Financial, Co-operative Group Knowledge, Values and Principles, Stakeholder Legal Responsibilities, Business and Analytical; Source: Information for Group Board Candidates, 2013.

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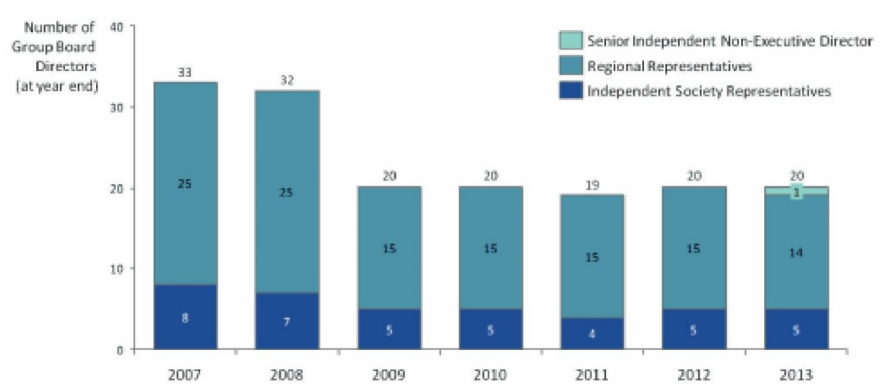
The Co-operative Group's election process



Source: The Co-operative Group

x The Group Board was much larger before it cut its membership to its present size in 2009 following a constitutional review. Immediately after the merger between the Co-operative Group and United Co-operatives it had 33 members. Even at its present size, it is still larger than those of other major retailers.[168] It is almost twice the size of the average FTSE 100 board.[169]

Size and composition of the Co-operative Group Board



Source: The Co-operative Group Annual Report and Accounts, 2007-2013.

x There are four committees of the Group Board: the Group Remuneration and Appointments Committee, the Group Audit and Risk Committee, the Value and Principles Committee and the Chairs Committee.[170]

[168] Marks and Spencer has 14 Directors, Tesco 12, Asda 11, J Sainsbury's 10 and Morrisons 7.
[169] The Female FTSE Board Report 2013, Cranfield University School of Management.
[170] The latter consists of the Group Chair, the Chairs of the three subsidiary Boards (although no longer the CBG Chair) and the Chair of the Group Remuneration and Appointments Committee.

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The Group's oversight of the Bank

13.2 Group and Bank traditionally operated at arms length. The Bank was (and is) based in its own headquarters. Until Project Unity, it had an entirely separate set of HR, finance, legal, IT and other functions. The relationships between Group and its other subsidiary businesses were traditionally much closer.

13.3 The Group owned 100 per cent of the Bank. It was its only source of equity capital apart from the Bank's own retained earnings. As events demonstrated, the Bank's activities posed significant reputational, financial and other risks for the Group.

13.4 A ring fence between Group and Bank was appropriate given the Bank's regulated status and the fact it was subject to the Regulator's Approved Persons regime.

13.5 The Approved Persons regime requires that only fit and proper individuals perform certain controlled functions within a bank. It allows an Approved Person to report to someone who is not an Approved Person, but the Regulator does not regard it as best practice.

13.6 The regime is not intended to prevent the operation of normal shareholder oversight. As the Bank's sole shareholder acting on behalf of the Co-operative Group members, the Group had an obligation to take a strong interest in the Bank's strategy, risk appetite, competence of its Board and executive leadership, and to monitor its capital, risk, liquidity and profitability. Because the Bank was wholly owned by the Group, and because the Group was a mutual, the Bank was not typically subject to the kind of regular, detailed appraisal by institutional analysts that other banks would expect. If the Group was not monitoring the Bank, no-one was – apart from the Regulator.

13.7 It would be natural to expect the arrangements for exercising the Group's shareholder responsibilities to be set out in some form of agreed statement. Such a statement might be expected to describe the framework within which the Bank could operate independently, identify its responsibilities to its parent and set out those matters which are reserved for the parent. Models of this kind are operated, apparently successfully and to the satisfaction of the Regulator, in the case of both Sainsbury's Bank and Tesco Bank (Appendix E). Both are examples of regulated entities wholly owned by a non-regulated retail trading group. I was very surprised to find that, prior to November 2013, no such document or clearly articulated arrangement was in place at the Co-operative Group.

13.8 So it is unsurprising that interviews with Group Executives and Non-Executive Board members revealed during interviews a degree of uncertainty and confusion about the extent to which it was legitimate to involve themselves in Bank matters. The importance of the Bank to the Group, and the complexity inevitably caused by the Approved Persons regime, make this lack of complete clarity dangerous.

13.9 It is clear from the Board papers and minutes, and from what interviewees have told the Review, that the Group Board normally spent relatively little time on Bank matters. The CBG CEO presented a written report to every Group Board meeting. But there was seldom much discussion or challenge. On the rare occasions when the Group Board did challenge the Bank, it was typically about its adherence to co-operative values and principles, rather than on banking matters. The Group's interest in the Bank seems to have focused on reputational rather than financial risk.

13.10 The Group Board's involvement in key moments in the Bank's history was very limited until Verde. It was required to approve the Britannia merger, which it did with relatively little detailed discussion after a recommendation from a combined Group and Bank Audit Committee. It was

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possibly distracted at the time by the acquisition and subsequent integration of Somerfield. Its more active engagement in Verde was justified partly on the grounds that the transaction would have a significant impact on the Group and would require it to inject a substantial amount of capital into the Bank. No doubt its interest was also stimulated by the Group Chief Executive's championship of the transaction.

Limitations on the Group Board's oversight to the Bank

13.11 The Group Board faced two limitations on its ability to provide effective oversight of the Bank and to hold the Bank Board and Executive to account for their stewardship of one of the Group members' major assets.

13.12 The first was its size. The Group Board was very large at the time of the Britannia acquisition. Although reduced in size subsequently, it remained relatively large throughout. The Review was consistently told that the number of Board members had significant implications for its effectiveness, making it difficult to orchestrate, stifling debate and leaving it prone to internal politics and division. The problem of size was exacerbated when the Group Board was joined in session by the CBG Board, as happened when Bank issues like Verde were discussed.

13.13 The second, more serious limitation, was one of experience. The approach followed for electing Regional Representatives to the Group Board, and the time commitment required of those elected, are unlikely to produce, or attract, individuals with substantial experience of business.

13.14 The Review's understanding is that most of the Regional Representatives have little or no senior-level commercial experience. Such individuals may be well-qualified to represent the views of members and customers. They are also expected to be important guardians of co-operative principles. It is in these two areas where most see their main function to lie. But boards of major organisations have responsibilities which go much wider. Many of the individuals put significant time and commitment into their role as Board members, but without appropriate skills and experience they are unlikely to be able to exercise appropriate oversight of a £13 billion conglomerate comprising such a disparate set of businesses. One of the most surprising features of this whole episode is that the Board seemed unaware of its limitations.

13.15 Appropriate skills and experience are especially important when one of the businesses being overseen is a bank navigating a serious financial crisis. None of the Regional Representatives on the Board during the period of the review had any senior experience of working in a bank. Some of them allegedly needed basic financial terminology and concepts to be explained. Except for those Group Directors who also sat on the CBG Board, it also took significant time for Group Directors to get up to speed because of the limited nature of discussion in the Board on Bank matters.

13.16 The lack of necessary experience cannot easily be rectified by training courses, however well conducted. The Review has not investigated the quality of the Board courses provided by the Co-operative College. It is worth recording, however, that a number of those close to the courses have asserted that the training was not very rigorous. It has also been alleged that pressure was sometimes put on assessors to pass individuals who might otherwise have failed the assignments.

13.17 Independent Society Representatives can provide the Board with some significant business experience. The UK's largest independent co-operative has sales of around £1 billion. But the CEOs of many independent societies have worked only within the co-operative movement and are unlikely to have banking experience.

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13.18 The Chair of the Group Board from 2007 to November 2013 was Len Wardle. He is a former local government officer, local councillor and university lecturer with no previous experience of chairing any other large organisations prior to being appointed.

13.19 The absence of any individuals on the Group Board with any previous senior-level experience of working in a bank is in stark contrast to the position in the parents of Sainsbury's Bank and Tesco Bank. J Sainsbury plc's Board has two non-executives, including the Chair, who have previously held positions in a major bank. The Chair of the Board of Tesco plc and two other non-executives have senior banking experience.

13.20 After a 2007 constitutional review of Group governance, the Group Board had the power to appoint up to three independent professionals to join its ranks. Until the appointment of Lord Myners in December 2013, it chose not to exercise this right, despite deeming IPNEDs appropriate for the subsidiary boards.

13.21 The relative absence of business experience on the Group Board inevitably meant that it relied heavily on the Group Executive for commercial matters. There is is little evidence that, as a group, the Executive fully understood the complexities of the financial services industry; and, apart from the Chief Executive, they had limited appetite for getting involved in Bank matters. The Review was told that the relationship between Group Board and Group Executive deteriorated over time, with that between Group CEO Peter Marks and the Board being particularly strained. The evidence is that he is a strong character and few people appear to have been willing to challenge him directly. Many interviewees asserted that little happened in the Co-operative Group without his support. The Co-operative Group thus found itself in a situation in which it had a strong-willed Chief Executive and a Board too weak and inexperienced to hold him adequately to account. It is notable that the two projects affecting the Bank with which he was most associated – Unity and Verde – were both problematic. They were driven through despite the reservations many of those on the CBG Board and Executive say in retrospect that they had at the time.

13.22 The Group Board discussed their Chief Executive's style privately on several occasions. Interviewees suggested several reasons why he was not replaced earlier than May 2013. The most important seem to have been that he had already announced a date for his retirement and the Board did not want to undermine the Verde negotiations.

Consequences

13.23 The weakness in the Group Board's ability to provide effective oversight of the Bank on behalf of its members made a significant contribution to the story described in this report. Its impact was felt in a number of ways.

13.24 Most importantly, the Group Board paid insufficient attention to the Bank's capital, risk and liquidity and did not hold the Bank Board and Executive to account for their performance in these areas with the rigour that would be expected of any other sole shareholder. Nor did it ensure that its own Executive had the capability to undertake these responsibilities on its behalf.

13.25 Had the Group overseen the Bank more effectively, it might have been aware of the capital and other difficulties it was facing at a much earlier stage. It might then have legitimately demanded that more effective action be taken to address them. As it was, the Bank's difficulties appear to have taken many of the members of the Group Board largely by surprise.

13.26 It is not a legitimate excuse to claim, as some Board members have, that they were kept in the dark. Non-executive directors of major organisations have a duty of care. The lack of relevant expertise possessed by members of the Group Board makes it difficult to see how they could

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have been expected effectively to undertake this critical board function in respect of the Bank at any time, let alone during a period of such change both in the Bank and in the markets in which it operated.

13.27 In addition, the Group Board:

i Failed to ensure that it had a clear perspective on the long term place of financial services in general, and the Bank specifically, within the Group's portfolio.

ii Allowed itself, in consequence, to be seduced by the prospects of an apparently favourable price for Verde assets without giving sufficient thought to the strategic implications or the impact on business as usual. It compounded that by failing to call a halt even when it became clear that the Bank was not in any condition to see through the transaction.

iii Failed to ensure adequate capability and experience within the governance and senior management of the Bank.

iv Appointed Paul Flowers as Banking Group Chair. Whatever his other skills, he manifestly did not have the experience appropriate for the role.

v Allowed the Group Chief Executive too much latitude in the implementation of Project Unity in a way which suggests that neither he nor the Board fully understood the implications.

vi Failed to appoint an experienced, permanent Bank CEO following the resignation of Neville Richardson in July 2011.

13.28 For these reasons of omission and commission the Group Board has a significant share of the responsibility for the position in which the Group as a whole found itself through the Bank's difficulties, and for the loss by their members of 100 per cent ownership of the Bank which bears the Co-operative name.

13.29 The fact that the Group Board failed in its oversight does not, however, diminish the culpability of the CBG Board, who had prime responsibility for the way the Bank conducted itself.

The CBG Board

13.30 For most of the period under review, CBG included life and general insurance businesses as well as the Bank.[171] For legal reasons the Bank and the insurance businesses each had their own boards. But in practice all essential business was conducted in the CBG Board.

13.31 The composition of the Board varied over time. But in the period under review it always contained:

i Group Board Directors, both Regional Representatives and Independent Society Representatives.

ii Group executives.

iii Independent Professional Non-Executive Directors (IPNEDs).

iv Bank executives.

[171] The life business was finally sold in 2013. The general insurance business (CIS) is now part of the Group following the change in ownership of the Co-operative Bank in December 2013.

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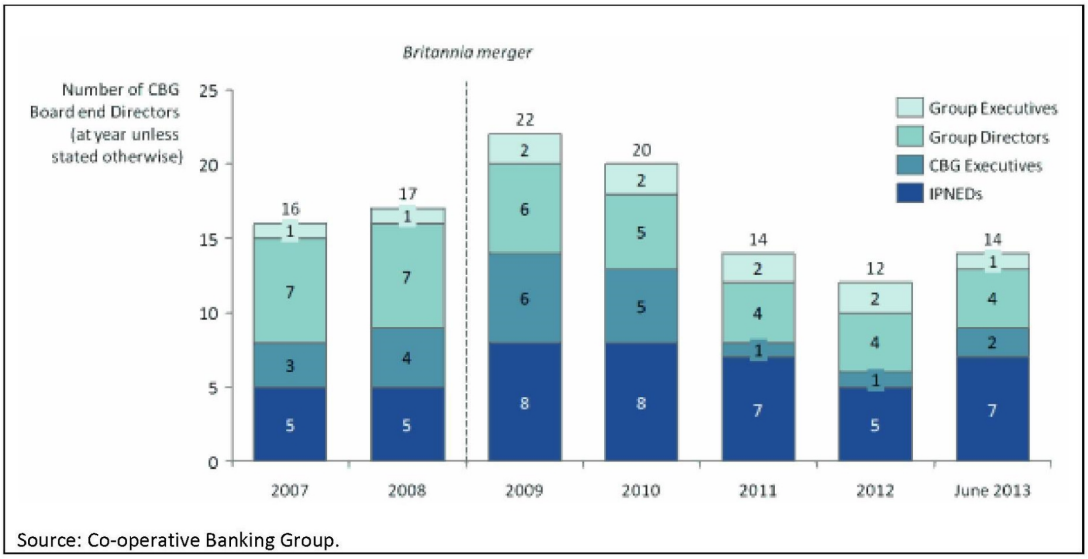
13.32 Immediately after the Britannia merger, when four ex-Britannia Board members joined, the CBG board had 22 members. There were still 20 members in June 2011. Following strong guidance from the FSA, numbers were then reduced to 14. Four of the six departing Directors were Bank Executives,[172] one was an IPNED and just one a Group Director (Exhibit 30).

Exhibit 30: Size and composition of the CBG Board



Source: Co-operative Banking Group.

13.33 In contrast to the Group Board, the CBG Board has included a number of IPNEDs since 2003. There were five IPNEDs at the time of the Britannia merger out of a total Board membership of 17, eight immediately after the merger (out of 22). The reorganisation in 2011 brought the number down to five (out of 12). It was only in 2013 that they formed a majority for the first time.

13.34 A number of the IPNEDs had relevant experience, gained from working either in a senior position in a bank or building society, or in a close advisory role. Until late 2013, at least two had an insurance background, reflecting CBG's other businesses (Exhibit 31).

13.35 From 2007 to 2013, at least a third of CBG Board members were either Group Directors or Executives. Included in this number were the Group Chair and, from June 2009 onwards, the Group CEO. There were seven Group Board Directors on the CBG Board immediately before the Britannia merger, six after it, four in 2011 and 2012 and two in 2013 after the crisis materialised. Under the new ownership structure, the Co-operative Group has the power to appoint two members to the Bank Board.

13.36 It was reasonable for the Group to wish to have representation on the CBG Board.[173] It is also understandable in the light of co-operative values and principles why it should wish some of these representatives to be democratically elected. It is less clear that the preservation of co-operative principles required representation in such numbers, particularly since few of them were able to add much expertise in other areas.

[172] The relevant Bank executives still continued to attend Board meetings.

[173] J Sainsbury plc nominates two non-executive directors to the Sainsbury's Bank Board, neither of whom is a member of the plc Board, as well as appointing an independent chair. Tesco plc nominates two non-executive directors to the Tesco Bank Board, two of whom also sit on the plc Board.

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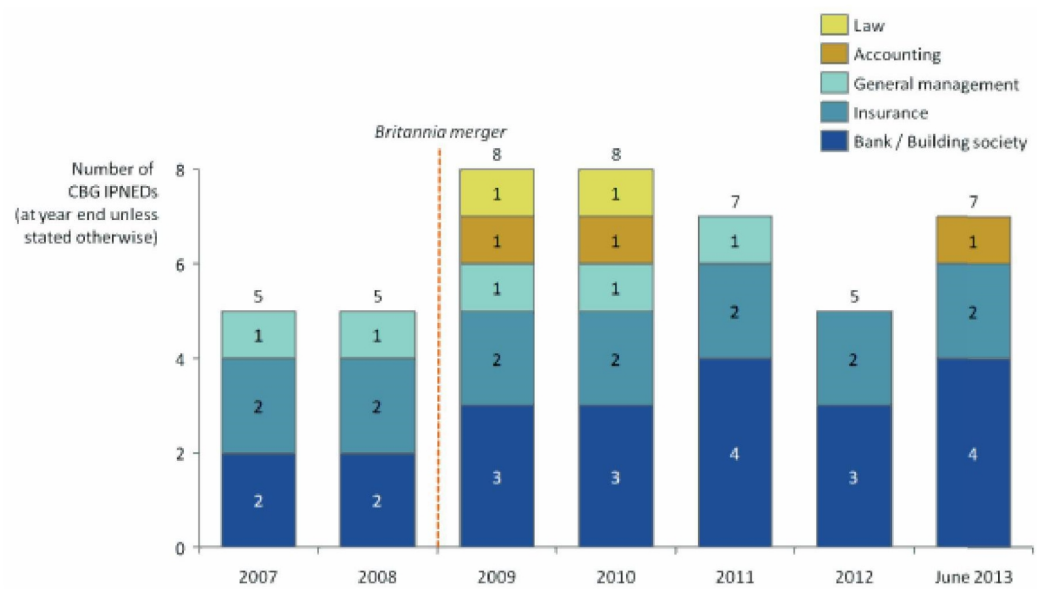
Exhibit 31: Experience of Banking Group IPNEDs



Source: Co-operative Banking Group, Kelly Review analysis.

The Chair of the CBG Board

13.37 The Group Board appointed the Chair of the CBG Board. For the period between 2004 and 2010, it appointed an Independent Society Representative (Bob Burlton). In 2010, it appointed in his place a Regional Representative (Paul Flowers). Neither had any other Group and CBG Board experience. Since June 2013, the Bank has been a period on an experienced independent with extensive banking experience (Richard Pym).

13.38 For the 2010 appointment of a new CBG Chair, the Group Board established a selection panel of three Group Directors, including the Group Chair. None of the panel had banking experience beyond membership of the CBG Board.

13.39 Group and CBG Board Directors were invited to apply. Four did so: two Bank IPNEDs (Rodney Baker-Bates and Paul Hewitt) and two Regional Representatives who also sat on the CBG Board (Paul Flowers and Stephen Watts). There is no evidence to suggest that the panel considered the

[174] The Walker Review identified two *"desirable conditions"* – the ability to lead the board and an ability to draw on substantial relevant financial industry experience from an earlier senior executive role in banking. Of the four candidates, only Rodney Baker-Bates, with over 40 years of experience in the financial services sector, could be said to meet both conditions.

[174] Walker Review: http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/walker_review_information.htm

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13.42 The panel unanimously recommended Paul Flowers. The Review was told that he scored more highly than any of the other candidates on all the selection criteria. But it is evident that he was not suitably qualified for the role if both Walker criteria are to be taken seriously. It is difficult to avoid the conclusion that, despite their apparent readiness to consider other candidates, the panel placed great weight on the Chair being a champion of the co-operative movement. Even now, some interviewees continue to express the view that it was desirable for the CBG Chair to be someone who had been democratically elected. It may also have been a factor that the other obvious candidate, Rodney Baker-Bates, was the former Chair of Britannia. It might have looked wrong to some that both Chair and Chief Executive should be ex-Britannia.

13.43 The Group Board ratified Paul Flowers' appointment. It did not interview the candidates, challenge the findings of the panel, or hold a vote. This contrasts with the process the Group Board followed in appointing the Chair of the Food Board in the same year. On that occasion, candidates were required to make presentations to the Group Board, with Directors given the opportunity to question and challenge each candidate. The Board then held an anonymous vote and appointed the candidate receiving the most votes. The Review was offered no explanation as to why the Group Board followed two different processes.

13.44 The Regulator approved the appointment of Paul Flowers as Bank Chair, noting that *"there may be areas of more technical knowledge that it would be of benefit to Paul in his role as Chair to gain"*.[175] In an effort to compensate, two experienced and long-serving IPNEDs, Rodney Baker-Bates and David Davies, were appointed as Deputy Chairs.

13.45 In a CBG Board Effectiveness Review conducted in 2010, Paul Flowers was rated highly by his Board members (including the IPNEDs). Interviewees told the Review that he was effective in chairing CBG Board meetings. Chairing a bank, however, requires a great deal more. Despite the amount of time he appears to have devoted to the role, his lack of relevant financial services experience and knowledge meant that he was ill-placed to advise, challenge or performance manage the Bank CEO - still less to give the Bank strategic direction at a time of great difficulty.

13.46 I have not investigated the allegations which have been made about his use of expenses or other aspects of his behaviour. Such issues are outside my terms of reference. I did not need to look into them to form the view that he was a wholly unsuitable person to chair the CBG Board.

13.47 Paul Flowers declined to speak to the Review. It has not therefore been possible to discuss these issues with him to get his perspective either on what others have said or on what the documentary evidence suggests.

Effectiveness of Bank governance

13.48 As in any organisation, the responsibility for running the business lay with the Executive. It is the Executive, and in particular the successive Chief Executives, who are accountable for the large number of poor decisions taken during the period under review.

13.49 But it was the role of the Board to ensure that the Bank had the capability to do what was required of it, to agree an appropriate strategy, and to monitor and challenge the way the strategy was implemented. It should also approve and monitor the Bank's risk appetite. Judging by the results, it failed in all these areas.

[175] FSA letter approving Paul Flowers' appointment as CBG Chair, 19 March 2010.

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13.50 Crucially, it failed to focus on capital, even though that is an essential duty of any bank board and despite the capital difficulties the Bank was facing. Capital was a major preoccupation at this time for most other UK banks.

13.51 There are dangers in generalising because the composition of the Board changed over the period. But the explanation for the extent of the governance failure appears to lie in five factors:

i *The capability of the Executive Team*. Even a good, well-skilled board cannot make up for ineffective Chief Executives and senior teams. The CBG Board had little chance of doing so.

ii *Its Chair*. The chair is critical to any board. If he or she for reasons of experience lacks the capability to understand the business of the organisation, the board as a whole is unlikely to be effective, whatever the quality of its other members. This is particularly the case where the business is as complex and technical, and as inherently risky, as banking.

iii *The small number of Board members with any banking experience*. The IPNEDs were never in a majority until 2013, and not all of them had a banking background. Their influence on major issues was constrained accordingly, even though other members relied on them heavily on technical issues. It is noteworthy that the Verde negotiation continued even after the two experienced Deputy Chairs came to oppose it.

iv *Poor process.* The assessment of Paul Flowers by his colleagues possibly reflected the fact that he ran meetings better than his predecessor. But meetings still appear to have been overly formal. The normal procedure was said to be for Bank executives to deliver a presentation, followed by all Directors being invited in turn to ask questions. That is not an approach that encourages debate.

v *Poor management information*. The Board was presented with a lot of information, but not always in a way which brought out the key issues very clearly. Management information presented to the CBG Board often lacked sufficient quantitative analysis and was sometimes one or two months out of date.

13.52 Most if not all of the IPNEDs, and some of the other Board members, were aware of these deficiencies. But they seemed unable to do anything about them. Some, particularly those appointed in the latter part of the period when the causes of the capital shortfall were already well-established, became increasingly frustrated.

13.53 The Regulator also had misgivings about the effectiveness of Bank governance. The Bank addressed some of these concerns. However, significant issues remained. In its June 2012 Risk Assessment letter to the Bank, the FSA stated that the current Board structure *"does not provide sufficient oversight, coverage, depth of debate and challenge to management"*, particularly given the large number of projects under way at that time.[176] In the same letter the Regulator said that it had observed over-reliance on just a few IPNEDs and that the balance between IPNEDs and Group NEDs on the CBG Board needed to change. The Bank was very slow to make the necessary changes.

[176] FSA Risk Assessment letter to The Co-operative Banking Group, June 2012.

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Conclusion

13.54 It is hard to avoid the conclusion that the Group Board, as constituted, was never likely to be able to exercise any form of effective shareholder oversight of its banking subsidiary. The CBG Board did include some experienced and capable individuals. But it was greatly handicapped by the lack of banking experience of its Chair, by poor process and by inadequate information. If the Executive had been more capable, that might not have mattered so much. The combination of poor decisions by the Executive and weak governance proved very damaging.

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14 LESSONS

14.1 My terms of reference ask me to identify what should be learnt from the events described in this report.

14.2 Most of the lessons are not new. Some of them are so basic that it should be a matter of considerable regret to those involved in the past management and governance of the Bank and Group that they needed to be learnt again.

I. Running a full-service bank, even a small one, in a regulated environment is a complex business. In pursuing its ambitions the Bank failed to understand the limits of its own capability.

14.3 The Bank ignored the limitations imposed by its size, its talent pool and, arguably, its location. Had management and Board really understood the extent of their own capability they might have been more inhibited about:

i Launching an ambitious replatforming programme.

ii Continuing with the programme when circumstances made it even more complex.

iii Doubling the Bank's size through the merger with Britannia.

iv Pursuing the Lloyds Banking Group negotiations even though it had not then completed the replatforming or the Britannia integration and was simultaneously adding to management stretch through Project Unity.

14.4 A bank, like other businesses, should focus on areas in which it has competence, only pursuing business and allowing complexity when it is confident that it possesses, or can acquire, the capability to deal with it. However attractive individual projects may be on a stand-alone basis, attempting to pursue too many at the same time can risk failure of all.

II. The most important task for any board is to put in place the right Executive leadership for the business. The Bank failed to do so.

14.5 At no time between the Britannia merger and the spring of 2013 did the Banking Group Board have in place a Chief Executive with appropriate experience. In 2009, at the height of the banking crisis, it appointed Neville Richardson. He had no previous experience of a senior leadership role in a bank and had presided at Britannia over the creation of the high risk BCIG portfolio, including the subsequently toxic commercial real estate lending. When he left in 2011, the Group promoted Barry Tootell, who struggled in the role.

14.6 Some interviewees claimed that on both occasions the Board had no choice. Neville Richardson's appointment appears to have been presented to the Banking Group Board as a condition of the merger. Barry Tootell was initially given the role on an interim basis. His tenure became prolonged only because of the inordinate length of time taken by the Verde negotiations and because of the decision, part way through, to appoint a Lloyds executive as Chief Executive of the enlarged entity should the negotiations be successful.

14.7 I do not accept this argument. There were alternative choices which could have been made in both cases, even if one involved (possibly temporarily) walking away from the Britannia merger. The evidence suggests that the wrong choice was made on both occasions. Boards need to be prepared to take hard decisions when circumstances warrant it.

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III. Ownership of a regulated bank by a non-bank requires a clearly articulated statement addressing in sufficient detail the management and governance relationship between the Co-operative Group and Bank. The Group and Bank Boards failed to put one in place.

14.8 Because of the complexity of modern banking, and of the risks associated with it, the Regulator requires that important roles in a bank should only be given to Approved Persons. A non-bank owning a bank needs to ensure that the relationship between the executive teams and boards of the bank and its parent is clearly defined.

14.9 The Co-operative Group failed to do this properly. I was amazed to discover that until very recently no document existed which clearly set out for everyone concerned the legitimate role of the Group in relation to the Bank, what matters were reserved for the Group Board and so on. If such a document did exist, no-one could find it for me, which tells its own story. A lack of clarity about the appropriate relationship between Group and Bank allowed a situation which was both too tight and too loose. It was too tight in that the Group Executive was allowed to involve itself too closely through aspects of Project Unity, and to some extent Verde, in matters which ought to have been the preserve of the Bank. It was too loose in that the Group failed to exercise sufficient oversight of the Bank in areas where it had a legitimate interest, like overall strategy.

IV. Failures in board oversight are inevitable if the criteria used to elect its members do not require those elected to have the necessary skills. The Group Board lacked the skills and expertise to oversee the Group's complex portfolio of businesses effectively.

14.10 Sustained success requires effective governance. Effective governance requires a high performing board. The composition of the Co-operative Group Board, and the limited pool from which its members were drawn, made a serious governance failure almost inevitable.

14.11 The current approach to the election of non-executive directors has conclusively shown itself incapable of producing a Group Board with the necessary governance competences or the business and technical skills required for successful stewardship of the Group's assets. It promotes activists with concerns about issues important to those who elect them, not individuals with skill sets relevant to overseeing the business. Nor is it realistic to expect these shortcomings to be rectified by training, even if the training is more effectively delivered than appears to have been the case here.

14.12 The Regional Representatives may be well-qualified to represent the views of members and customers or to be guardians of co-operative principles. But Boards of major organisations have responsibilities which go much wider. Many of the individuals put much time and commitment into their role as Board members; but without appropriate skills and experience they are unlikely to be able to exercise appropriate oversight of a £13 billion conglomerate comprising such a disparate set of businesses.

14.13 It is not a legitimate excuse to claim, as some Board members have, that they were kept in the dark about what was going on in the Bank. Non-executive directors of major organisations have a duty of care which the members of the Group Board were not capable of exercising. Their lack of relevant expertise makes it difficult to see how they could have been expected effectively to undertake this critical board function in respect of the Bank at any time, let alone during a period of such change both in the Bank and in the markets in which it operated.

14.14 As CEOs of significant businesses, the five directors currently elected to the Board by the Independent Societies do bring substantial business experience. But many have worked only within the co-operative movement. None have worked in banking. All will have been conditioned, at least in part, by their long association with the co-operative way of doing things.

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14.15 It was not within my remit to examine the relationship between the Group Board and its subsidiary businesses other than the Bank. Technical, high-risk businesses like banking probably require a higher level of qualified oversight than other organisations. Even so, it would be surprising if some of the shortcomings evident in relation to the Bank were not also apparent in the Group Board's relationships with its other businesses.

14.16 The Co-operative Group is well-advised to be re-examining its governance arrangements. It must be possible to find a way of recognising the co-operative ownership of the Group which does not come at the expense of having a capable board of a size consistent with the effective oversight of business. Many other effective consumer co-operatives in the UK and other countries have succeeded in doing so.

14.17 Even though it is no longer the sole shareholder, the Group Board still needs to be clear about its role in relation to the Bank. A 30 per cent shareholding represents a material asset. The Bank still bears the Co-operative name. So it also creates significant reputational risks. There is a strong argument for ensuring that at least one of the Group Board members should be an experienced banker.[177] It is striking that both J. Sainsbury plc and Tesco plc, which are trading companies with wholly-owned banking subsidiaries smaller and less complex than the Co-operative Bank, have experienced bankers on their main boards.

V. To be effective, a bank board must include sufficient numbers of technically competent Directors. At no point before June 2013 did the Bank have this, which helps to explain some of the failures of oversight.

14.18 It is essential, as the Walker Review recommended, that the board of a bank should include in sufficient numbers individuals with the technical depth and experience to exercise proper oversight of a complex and (by definition) risk-taking business. It is not possible for a bank board to be high performing without such capabilities. The need to understand the business is particularly strong in the case of the chair.

14.19 Unlike the Group Board, the CBG Board included a number of non-executive directors with banking or insurance experience throughout the period under review. The other non-executives took considerable comfort from their presence. But those with banking experience did not form a majority before June 2013. The outcomes experienced by the Bank strongly imply that, as a group, they were not as effective as might have been expected - perhaps partly for that reason.

14.20 The fact that successive Chairs had no senior banking or other financial services experience must have been a serious handicap. It is not easy for any individual non-executive to perform effectively if the Chair is not up to the job. I have no doubt that, had the Board been chaired by an experienced banker of the kind now in place, the challenge and oversight provided to the Bank Executive would have had a much greater chance of forestalling or mitigating some of the problems the Bank faced.

14.21 I have seen no evidence that the Bank was managed more in tune with co-operative values and principles as a result of the Chair being an elected democrat.

[177] On the same basis, since they now directly own a general insurance business, the Board also requires insurance expertise.

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VI. To exercise appropriate supervision and challenge, boards need to be supplied with good management information, and to demand it if it is not forthcoming. Failure to obtain such information explains some of the failings in oversight at both Group and Bank.

14.22 Effective boards need clear and relevant information, provided in a timely fashion. This is particularly the case when those receiving the information have little experience on which to rely in understanding what is important.

14.23 Both Group and CBG Boards would have had a greater chance of providing effective oversight if their Executives had provided them with better information. Board papers examined during the course of the Review were frequently long on detail. But they sometimes omitted important information (or included it, but not in a prominent way), failed adequately to draw out key facts, or gave an overly-optimistic picture of what was really happening.

14.24 This does not excuse either Board. Effective board members should have the ability to identify the information they need and the forcefulness to ask for it when not provided. It is hard to understand why the Group and CBG Boards, in particular the IPNEDs on the CBG Board, were not more forceful in demanding better information.

VII. It is fundamental that a bank should develop and implement robust risk governance and oversight and an appropriate control framework. The Bank failed to take timely and robust action to address serious deficiencies in these areas.

14.25 In principle, the Co-operative Bank approach to managing risk followed the standard three lines of defence. In practice, all three lines were weak for most of the period. The relationship managers in the corporate bank were not provided with sufficient guidance, training or oversight. Proposals to advance loans outside the agreed framework prompted little comeback. The second line appears to have lacked the ability to provide independent challenge to the first line or to report effectively on risk to senior management and Board. The third line – Internal Audit – was similarly weak.

14.26 It was only towards the end of the period, after repeated warnings from the Regulator, that the Board and Executive began to address these shortcomings. It would have been better if they had acted earlier and with more resolve.

14.27 A more rigorous approach to risk management might have prompted greater scrutiny of the due diligence on Britannia, improved the subsequent management of the commercial loan book and led to more rigorous interrogation of the replatforming programme. A more risk-aware Board would also have recognised the difficulty of taking on Verde in the light of everything else with which the Bank was dealing – notwithstanding the challenge of countering Peter Marks' enthusiasm.

VIII. Before launching a significant IT transformation project, any institution is well-advised to test whether more modest alternatives will suffice. If it decides to go ahead, it must strive to keep the programme as simple as possible, phase delivery in a manageable way, deploy the right resources, plan for contingencies, and treat the programme as a business priority. The Bank failed in all these areas.

14.28 IT is at the heart of running an effective bank. Most banks have elderly legacy systems. Few have attempted total replatforming. Only a handful has done so successfully. None had succeeded in the UK at the time the Co-operative Bank attempted it. The Bank's ambition to leap ahead of its competitors was commendable. But it was always an unlikely candidate for such endeavour. Success would have required strict compliance with best practice. What happened instead provides a case study of how not to go about it.

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14.29 When the project began, before the Britannia merger, it might have had a credible chance of success – though it was always going to be high risk and, like most IT projects, vulnerable to cost escalation. The Bank demonstrably did not have the capability to deliver successfully the project itself. Initially the proposal involved sharing risk and costs with IBM, who would have had a considerable stake in a successful outcome because of the implications for future business with other banks. The project became distinctly less credible when the Britannia merger made it more complex and when the Bank's relationship with IBM ended. The Bank nevertheless decided to continue, with little evidence of much prior deliberation.

14.30 The Bank did the minimum it thought necessary to update its legacy systems as regulatory and other requirements changed (and may not fully have succeeded). Apart from that, it put all its faith in the one replatforming initiative. The consequence was to put a number of other issues on hold, not least the completion of the integration of the Britannia branches. The new management of the Bank is now addressing a number of issues that should have been dealt with some years ago.

IX. Financial institutions ignore regulatory signals at their peril. The Bank should have paid closer attention and responded with greater urgency to what the Regulator told it.

14.31 The Bank's slowness in responding to repeated warnings about its risk management framework was symptomatic of its general approach to the Regulator. It was also indicative of a fairly fundamental misunderstanding of the Regulator's role and importance. There is evidence in its other dealings with the Regulator of an overly-casual approach to regulatory correspondence, of failures to escalate regulatory issues to the Board in a timely fashion, of misunderstanding regulatory pronouncements and, at times, of what appears to have been incomplete transparency.

14.32 The Group Executive and the Group Board, perhaps not surprisingly in view of its composition, also appear to have had a limited appreciation of the nature of a bank's relationship with its Regulator.

14.33 It can be appropriate, though not necessarily wise, for a bank to have a robust relationship with its regulator. It was not appropriate for the Bank to pay so little attention to the significant issues clearly and consistently identified by the Regulator over a long period. The size of the increase in the capital requirement imposed on the Bank in January 2013 - one of the main triggers for the crisis which the Bank faced in the spring of 2013 - appears to have taken the Bank by surprise. Had the Bank better understood, or paid more attention to, what the Regulator was saying at an earlier stage it might have avoided the need for at least part of that increase.

X. Institutions should pay careful attention to the advice of their external advisers. The Group and Bank ignored well-founded, if inconvenient advice. This proved costly.

14.34 There is little sense in appointing external advisers if the institution consistently ignores or underplays serious concerns and criticisms.

14.35 The Bank had no shortage of external advice in relation to the Britannia merger, replatforming, Verde or other issues. CBG Board and Executive consistently failed to challenge the advice they received, misunderstood limitations on its scope (as with the KPMG due diligence advice on the Britannia merger) or gave inadequate attention to warning flags (for example, in relation to replatforming). They would have been better served by responding more purposefully to what their external advisers were telling them.

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XI. Postponing dealing with problems is almost never a sustainable solution. The Bank consistently eased short-term difficulties by pushing problems into the future.

14.36 Any organisation can, on occasion, face the need to make trade-offs between the short-term and long-term. It is important to make such trade-offs explicitly and transparently. The business otherwise not only risks giving a false impression to outside observers. It can also mislead itself about its own position.

14.37 The Bank Executive had a consistent record from the time of the merger discussions onwards of looking for ways to ease short-term capital pressures by pushing problems into the future. The tendency was evident in the treatment of the Fair Value Adjustments to the Leek Notes, in the treatment for capital purposes of the costs of replatforming and, arguably, in its approach to provisioning. This appears to have happened partly because of a misplaced optimism about an imminent improvement in the economy, which was expected to bring increases in margins, profitability and the value of collateral.

14.38 Most, or all, of the relevant decisions were taken with the knowledge of the Bank's auditor. But the fact that something may be allowable under accounting conventions does not make it sensible.

14.39 At best, management's reporting to the Group and Banking Group Boards on these issues was patchy and obscure. If they relied solely on management reports, neither Board can have had a clear enough idea of the extent to which problems were building up. Even now, some interviewees have unrealistic views about the Bank's underlying position before 2012.

14.40 Too much emphasis on the short-term creates a risk of focusing only on those areas which appear to be critical at the time. Effective organisations put in place processes which improve the likelihood of anticipating problems. For a bank, the chances of avoiding constant crisis management are greatly increased by monitoring and managing potential issues before they become problematic. The Co-operative Bank gave little appearance of managing risk proactively. It seemed permanently to be in crisis mode. Critically, both Board and Executive knew that most of the inherited BCIG portfolio was outside the Bank's risk appetite when acquired, even though they may not have fully appreciated its dangers. But there was little serious discussion about alternatives to letting it run down naturally until very late in the day, when some of it was already causing difficulties.

XII. If an organisation's values and sense of purpose are to affect the way staff act, they need to be translated into meaningful guidance. The Bank's ethical positioning should be made much more apparent in a way which influences employee behaviour and means something to customers.

14.41 A key part of the Co-operative Bank's offer to its customers, and its main competitive advantage, is its branding as an ethical bank and the trust that inspires. If it is to continue to reap the benefit, the Bank in its new guise will need to achieve greater clarity for its staff on what being an ethical bank implies.

14.42 Some aspects of what is distinctive about the Co-operative Bank's ethical approach are clear – for example the prohibition on lending to businesses with links to oppressive regimes, or the strong commitment to support local communities with profits which in a publicly-listed company would accrue to shareholders. Other aspects are surprisingly less clear. Ethical principles did not, for example, protect the retail side of the Bank from its share of mis-selling payment protection insurance or, it appears from recent announcements by the Bank, from other examples of not treating customers fairly. Some of the lending practices in the corporate part of the Bank appeared at best to demonstrate a poor understanding of what the principles meant. At worst

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the principles were an excuse for poor adherence to normal banking processes in areas like forbearance or the taking of security.

14.43 A more effective translation of the Bank's ethical position into customer propositions and business practices would have helped ground the organisation in what it was trying to deliver to customers and would have guided staff and management behaviours.

XIII. Effective strategies address tangible issues of competitive advantage and disadvantage. Mantras about scale and ethics are no substitute for strategies grounded in a real understanding of competitive position, market economics, and organisational capabilities. The Bank lacked such a strategy.

14.44 Fundamental decisions about strategy cannot be taken properly unless an organisation has a clear understanding of its strengths and weaknesses relative to current and prospective competitors, an accurate appreciation of its market and economic environment and a realistic view of the capabilities it needs to succeed - and of how to build or recruit those capabilities if they are not already in place. The Co-operative Bank showed no great aptitude in any of these areas. Nor did it seem willing to make hard choices in the context of scarce resources as the set of overwhelming initiatives (from replatforming to Verde) accumulated.

14.45 In the absence of a coherent strategy, the Bank embarked on a journey in search of scale which it proved ill-equipped to pursue, while at the same time choosing to compete across the gamut of retail banking and commercial lending. A more thoughtful and considered approach might have helped it think twice about the Britannia merger until market conditions improved, be more proactive about managing down the acquired assets which were outside its risk appetite, and resist the temptation of acquiring the Verde assets at what appeared to be a knock-down price.

XIV. Talent management is critical in any organisation. The Bank's failings owe much to its lack of capability in important areas, driven significantly by weaknesses in its recruitment and subsequent management of talent.

14.46 The Bank struggled to identify and recruit top talent. It entrusted the enlarged and more complex institution created by the Britannia merger to individuals whose experience was more closely attuned to running a smaller institution. It created further problems with weak succession planning. By 2012 there were capability gaps across most parts of the business. By the time a significant number of external hires were made in late 2012 and early 2013, the Bank appears to have been closer to crisis management than talent management.

XV. Tolerating – as the Bank did - a culture of underperformance, weak transparency and a lack of accountability, constrains an organisation's ability to respond quickly and robustly to any challenges it faces.

14.47 Culture is pervasive. The tone is set by leaders and reinforced by management systems.

14.48 In the Bank, the culture did too little to discourage the wrong behaviours or to focus attention on areas of highest risk, encourage staff to speak up about potential issues, work collaboratively with the Regulator, or address issues as soon as they became apparent.

14.49 There are a number of aspects of the culture of the Bank that contributed to the difficulties it faced. Those which are particularly important in understanding what happened include:

i *Acceptance of mediocrity*. The Bank was often excessively inwardly-focused. There is not a great deal of evidence that it benchmarked itself against competitors. The result was an organisation set in its ways, often unaware of the extent to which it lagged behind industry

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best practice and lacking some of the capabilities to execute change successfully during a financial crisis. It was not helped by the absence of external shareholders, which meant that it was subject to relatively little public scrutiny, by the fact that its sole shareholder was poorly equipped to deal with technical banking matters, and by the tendency of the Group Board's members to focus on issues like store location or products sold rather than the efficiency with which the businesses were conducted.

ii *Weaknesses in accountability*. The Bank seems to have allowed confused accountabilities even in important areas like risk or change management. There was a widespread unwillingness to shoulder responsibility.

iii *Failure to address poor performance*. There appears to have been a general tendency to deal leniently with under-performers and a number of instances where lazy, outdated or ill-advised practices were tolerated. Several interviewees, particularly those hired from other banks, observed that they had found practices in the Bank which would have been considered poor elsewhere. Others noted that something which might have taken a week in most banks would take months in the Co-operative Bank. Even in 2012, when the Bank was in considerable financial difficulty, the Executive continued to receive generally positive reviews.

iv *Tendency to discourage challenge*. The Bank had a notably hierarchical culture. Neville Richardson was said to dislike challenge, despite professing otherwise, and to have preferred to deal with difficult issues outside management meetings. The Bank appears to have operated within silos, with managers discouraged from speaking beyond their own areas of responsibility. When staff try too hard to anticipate the reaction of their bosses, self-censorship can lead to important issues being suppressed.

v *Good news culture*. CBG Board papers were consistently more positive than circumstances justified and when greater balance and recognition of the facts would have been more appropriate. Staff were wary of reporting bad news, encouraging them to hide, moderate or ignore issues that should have been escalated more quickly.

vi *Lack of realism about the Bank's position*. There was a pervasive lack of realism about the underlying strength of the business, partly arising out of a belief that as an ethical bank it was doing the right things, reinforced by the fact that initially the Bank appeared to have escaped the financial crisis relatively unscathed. When problems began to emerge, the Bank convinced itself that they would be resolved by an improvement in the economy. When this did not happen, the Bank Executive found itself under pressure to keep up with overly-optimistic forecasts.

14.50 The Bank under its new ownership structure needs to address these issues robustly if it is to prove successful.

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14.51 These lessons have come at a great cost to the Co-operative Bank, its staff, its customers and the members of the Co-operative Group. The failings are very basic. The circumstances which led to them being set out here must pain all who care about the co-operative movement.

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APPENDICES

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APPENDIX A – ABOUT THE REVIEW

Terms of reference

To investigate the robustness and timeliness of the Board's and the management's strategic decisions which ultimately led to the need to adopt a Capital Action Plan by the Co-operative Bank to address its £1.5 billion capital shortfall;

To look at the management structure and culture in which those decisions were taken; lines of accountability which governed those decisions; and the processes which led to them;

To identify lessons which can be learnt to strengthen the Co-operative Bank and the wider Co-operative Group, and the co-operative business model generally;

To review the financial accounting practices of the Bank, the representations made by management to the independent auditors regarding these practices and the role of the independent auditors in reporting to the Audit Committee of the Bank and giving an opinion on its financial statements;

To publish the findings of its review to members, colleagues and other key stakeholders.

Approach to the Review

Internal and external data

The Review conducted independent analysis of internal data and external data provided by the Co-operative Group and the Co-operative Banking Group. Internal data included minutes and papers for both Group Board and Co-operative Banking Group Board, their sub-committees and their respective Executive Committees, as well as management papers, policy documents, adviser reports and communications with the Regulator. The Review was given unlimited access to a database of emails, files and papers dating back to 2007. Externally available data included annual reports and accounts, regulatory requirements and guidelines, and documents and transcripts published by the Treasury Select Committee.

Interviews

The Review team conducted over 130 interviews with:

i Co-operative Group staff and Board members, both current and former.

ii Co-operative Banking Group staff and Board members, both current and former.

iii Britannia Building Society staff and Board members.

iv Professional advisers to the Co-operative Group, the Co-operative Banking Group and Britannia Building Society.

v Regulatory bodies dealing with The Co-operative Banking Group.

vi Lloyds Banking Group employees engaged on the Verde transaction.

vii Executives from Sainsbury's Bank and Tesco Bank.

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viii Key stakeholders in the co-operative sector and other interested parties.

I am very grateful to all who spared the time to meet with the Review.

Submissions to the Review

In addition to those invited to interview, over 100 people wrote to the Review by post or email to share their perspectives. Some also submitted documentary evidence. The Review team gave careful consideration to all submissions. The Review also conducted interviews with some of these individuals.

Cost of the Review

The total cost of the Review was £4.4 million (including VAT). This figure includes professional support and general administrative expenses, as well as fees for Sir Christopher Kelly's time.

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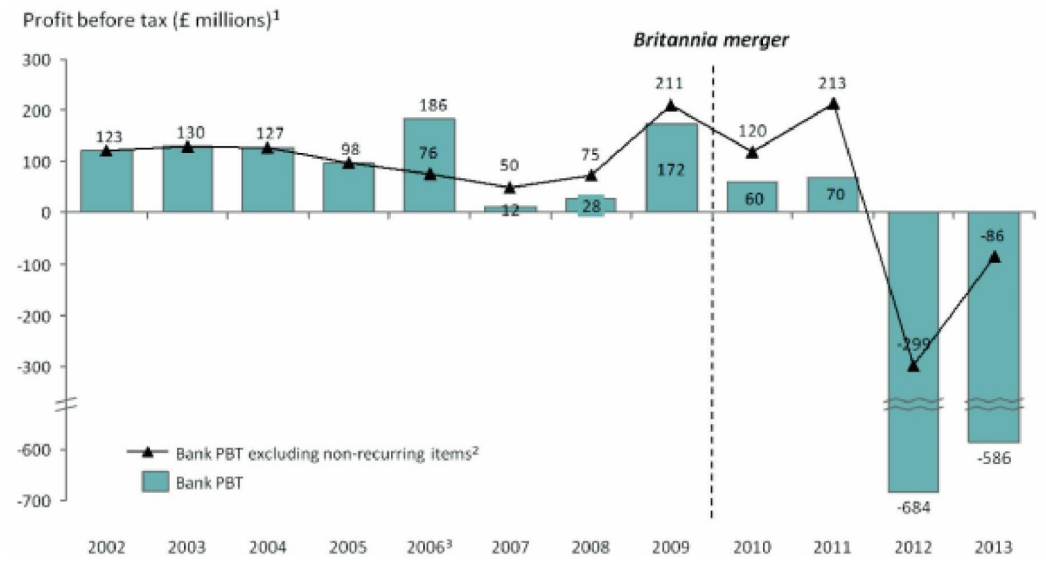
APPENDIX B – ADDITIONAL FINANCIAL INFORMATION

Co-operative Bank profit before tax 2002 to 2013



1. Before profit-based payments to members of the Co-operative Group. Includes income from joint ventures.
2. Non-recurring items include transformation and integration costs, pension liability transfers, provisions for conduct issue claims, Verde due-diligence, impairments to IT systems, bank separation costs and profit from the 2013 Liability Management Exercise.
3. In 2006, the CFS pension plan was changed from defined benefit to defined contribution. As part of the change, the Bank transferred its pension deficit to the Group for no consideration, registering a £109 million one-off benefit to the Bank.

Source: Co-operative Bank Annual Report and Accounts. Kelly Review analysis.

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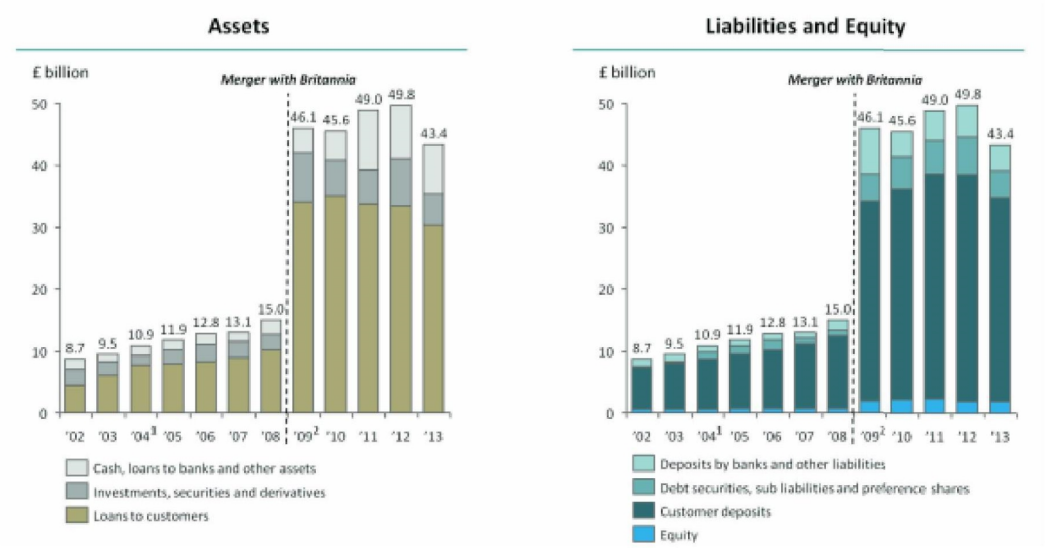
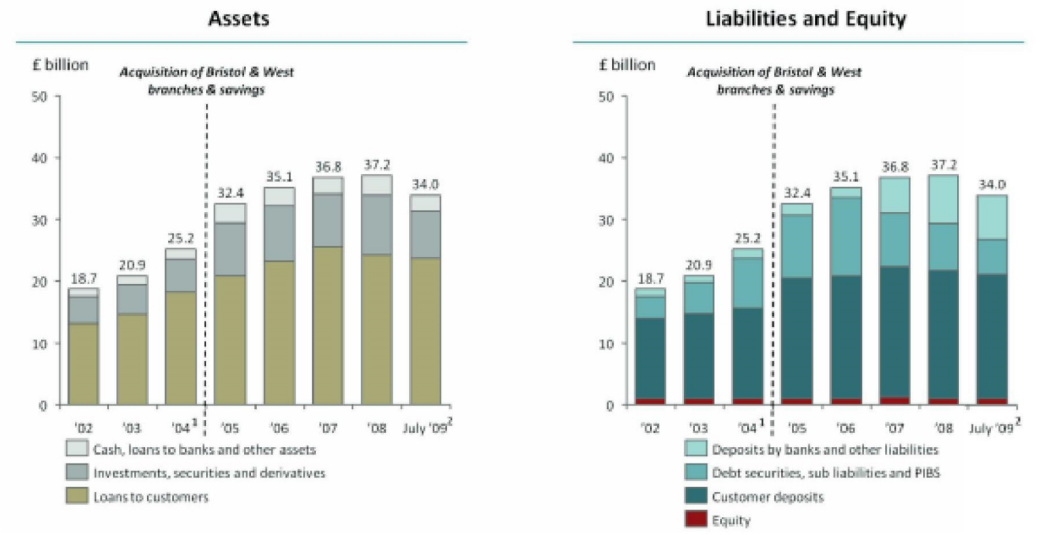
Co-operative Bank balance sheet 2002 to 2013



1. Figures from 2004 onwards prepared under International Financial Reporting Standards.
2.Year-end changed from 10 January to 31 December.
Note: All figures are from year-end. 2012 figures were updated in the 2013 Annual Report and Accounts.
Source: Co-operative Bank Annual Reports and Accounts; Kelly Review analysis.

Britannia balance sheet 2002 to 2009



1. Figures from 2004 onwards prepared under International Financial Reporting Standards.
2. July 2009 cessation accounts do not include Fair Value Adjustments.
Note: All figures are from year- end, except for July 2009.
Source: Britannia Building Society Annual Reports and Accounts; Kelly Review analysis.

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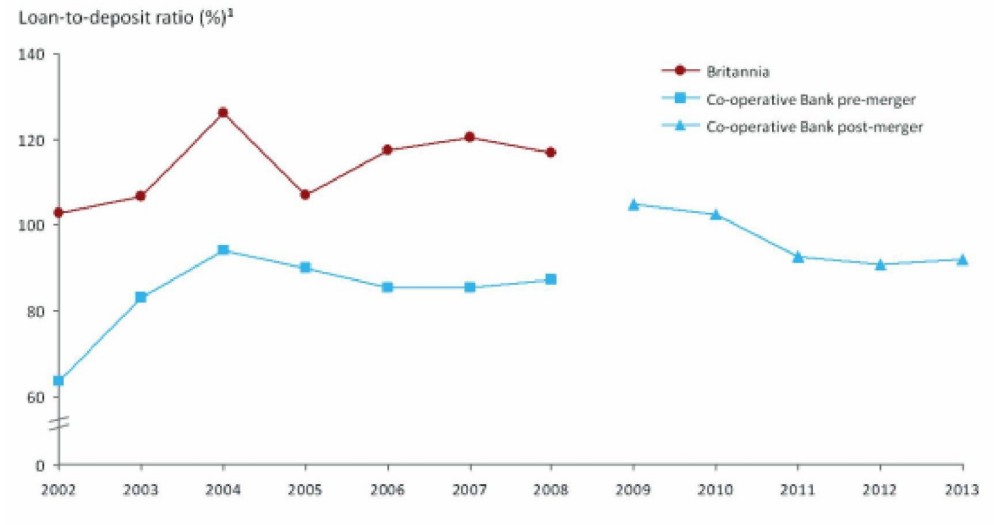
Co-operative Bank and Britannia loan-to-deposit ratio 2002 to 2013



1. Customer loans as a percentage of customer deposits.
Note: Customer deposits includes guaranteed equity bonds and other deposits. All figures are from year–end.
Source: Co-operative Bank and Britannia Building Society Annual Reports and Accounts, Kelly Review analysis.

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APPENDIX C – HISTORY OF THE CO-OPERATIVE GROUP[178]

Introduction

The history of the British co-operative movement and the history of the Co-operative Group are inextricably linked. The amalgamation of hundreds of individual co-operatives over the past 170 years created an organisation that accounts today for over 80 per cent of co-operative trading in the UK. In their day, co-operatives were some of the most commercially advanced enterprises in Britain, although this became gradually less true in the post-war period. Many of the mergers out of which the Co-operative Group has emerged were the product of weakness, rather than strength: failing co-operatives tended to be rescued by their larger brethren, and lacklustre organic growth prompted acquisitions to gain scale. Capital was therefore under continual strain, as it remains today.

The Co-operative Group's banking arm was, until overtaken by recent events, unique within the British financial sector. Its ownership structure made it a public limited company without the ability to raise equity capital. It had a unique governance model, with a mixture of elected Group Directors, Group Executives, Bank Executives and Independent Non-Executive Directors. In the 1980s and 1990s it was a leader in banking technology. It had lost this advantage by the time it embarked upon its replatforming programme in the late 2000s.

The Co-operative Group's current governance structure was created in 2001. The movement has always had a democratic ethos. But the manner in which it expressed this ethos through its governance structures has varied considerably over time.

Early history of the co-operative movement

In 1844, the Rochdale Pioneers set up the first truly successful consumer co-operative. Its objectives reflected its principles. It sought to help poorer members of the community, provide them with reliable products, extend democratic participation to all members through the appointment of officers and directors through one-member-one-vote elections, provide educational facilities to its members, and maintain financial stability.

It was a product of its geography and time. The movement emerged in the second half of the nineteenth century alongside the development of a more prosperous working class, a more stable economy, and greater levels of urbanisation. It answered an unmet social need and was wrapped in a sense of community. An important tenet of the movement was to provide a dividend based on the level of custom, rather than ownership.

Initial successes

Favourable social and economic trends did not mean that early successes were achieved easily. It was not until 1852 that legislation was enacted to provide co-operatives with some of the legal protection enjoyed by other corporations. Further legislation in 1862 enabled the formation of secondary co-operatives, meaning that co-operative organisations could themselves be shareholders. A direct result of this change was the establishment of the Co-operative Wholesale Society (CWS) as a secondary co-operative supplying merchandise to co-operative retailers. The CWS was one of the main predecessors of today's Co-operative Group.

[178] The main sources for this section are Wilson, J. F., Webster, A., Vorberg-Rugh, R., *Building co-operation: a business history of the Co-operative Group, 1863-2013* (Oxford: Oxford University Press, 2013) and the Co-operative College, *Celebrating our co-operative heritage, Part A (2012)*. These were supplemented by input from interviews and Kelly Review research.

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CWS quickly became one of Britain's leading enterprises. It combined a democratic governance structure with effective talent management and a capacity to manage transformational change. This enabled it to achieve the advantages of national scale. It needed to be competitive to achieve its success. Although CWS was required to trade exclusively with co-operatives, those societies were under no such reciprocal obligation, and so it had to compete effectively on price and quality.

The co-operative movement (and CWS in particular) reached a high watermark during the Second World War. Total membership in the movement swelled from 1.7 million in 1900 to almost 10 million in 1945, and in 1950 co-operative retail accounted for close to a quarter of all retail trade in the UK. However, a number of problems which began to emerge in the inter-war period became more severe in the following decades.

Drawn-out decline: 1950-1990

From the 1950s, the co-operative movement struggled to adapt to changing market circumstances and the emerging consumer culture. The movement still pioneered innovations in British retailing such as self-service. But it began to lose market share to large retail chains - who were developing their own supply networks. Moreover, in contrast to the co-operatives, the retail chains were able to access capital through the stock market, allowing them to invest in their businesses. The financial pressure placed on retail co-operatives as a result, caused many to cancel their dividend payments in the 1960s. This further diminished their appeal to shoppers. Then, as now, the lack of access to equity capital forced co-operatives to rely on either debt or the surplus generated within the business, to fund growth.

A report on the state of the movement, issued in 1958 by the Co-operative Independent Commission, called for consolidation. The report emphasised the extent to which the movement, including CWS, had fallen behind its competition. It was critical of a number of areas, such as governance and talent management, in which CWS had had a competitive advantage fifty years previously, but in which it had steadily lost ground. The report criticised the co-operatives' ability to differentiate and connect with customers, underscoring the extent to which the movement had changed since its inception.

There were attempts to reform CWS in the 1960s. A newly constituted Board of 30 part-time directors replaced the full-time executive Board, and fresh talent was brought in through the external appointment, in 1967, of Philip Thomas as its first CEO. However, the impetus for change soon dissipated. Following Thomas' death in 1968, institutional obstruction further prevented the intake of new talent from outside the co-operative movement. Consequently, CWS languished through the 1970s and 80s.

The period from 1950 to 1990 witnessed a string of rescues of failed co-operatives, with the number of solvent societies decreasing from over 900 in 1958 to just 217 in 1976. By the mid-1970s, Co-operative Retail Society (CRS) alone had acquired or merged with 162 societies. In 1973, CWS rescued the Scottish CWS, a systemically important society which had been bankrupted by difficulties in its banking arm. CWS merged with a further 41 societies between 1973 and 1990. These rescues saddled CWS with the losses from the societies it took over, draining it of the capital needed to re-invest in the business. CWS also integrated the societies poorly, and failed to drive benefits from its increased scale. In the same period, the CWS's membership gradually changed, with an influx of individual members. Its enlarged retail presence made it more akin to a primary, rather than a secondary, co-operative.

Attempts at change: 1990 to present

The 1990s were a more encouraging time for the co-operative movement. In 1990, the North Eastern Co-operative Society was transferred to CWS, representing the first major merger from strength rather than weakness. In 1993, the Co-operative Retail Trading Group was formed, which by the mid-2000s had successfully consolidated buying power for the movement.

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However, corporate governance in the movement deteriorated during this period, with societies dominated by cliques and management rocked by corruption scandals. In response to these challenges, the Co-operative Governance Working Party Report was published in 1994, precipitating a review of co-operative governance structures in an attempt to rebuild trust in the movement. In 1995, the International Co-operative Alliance Congress approved a modernised version of the Rochdale Pioneers' principles, which encouraged co-ordination across the movement as well as democratic member involvement. At the same time, the CWS accelerated its reinvention as an 'ethical' brand – building on something that the Bank had initiated in the early 1990s.

An important driver of change was Andrew Regan's failed bid for CWS in 1997. The bid was rejected. But the threat posed to CWS gave CEO Graham Melmoth the opportunity to institute changes. These included promoting the 'ethical' differentiator between the co-operative movement and the rest of the retail sector, as well as overseeing the rescue of CRS (which had experienced serious commercial difficulties in the late 1990s) to form the Co-operative Group in 2001. In addition to consolidating the movement, this merger completed the transition of CWS from a secondary to a primary co-operative.

This change was reflected in the Constitutional Review of 2001, which created the three-tiered Group governance structure that exists today; Area Committees elect representatives to Regional Boards, from which the Area committees then elect individuals to the Group Board. Independent society directors became a minority on the Group Board. The Review also recognised the role of ethics in Group strategy by instituting a Values and Principles Committee at the Group Board level. The Co-operative Commission report, also published in 2001, further reinforced the importance of ethics in the co-operative business model.

Melmoth's successor, Martin Beaumont, continued to modernise the Group. Beaumont strengthened the management team by recruiting external talent and continued Melmoth's strategy of positioning the Group as a convenience-store retailer. He oversaw a re-branding exercise and re-instituted the dividend in 2006, which laid the foundations for an increase in membership from 1.1 million in 2005 to over 7 million today.

Despite these changes, the Group struggled to regain significant market share. In an attempt to gain scale, the Co-operative Group merged with United Co-operatives in 2007, creating an entity which accounted for over 80 per cent of co-operative trading in the UK. Peter Marks, who had been the CEO of United Co-operatives, took over the management of the new group. In an effort to increase scale further, the Group completed the acquisition of Somerfield in 2009.

In 2007, the Group appointed its first democratically-elected Director (Len Wardle) to the Chair of the Group Board. The Chair had hitherto been selected from the Group's independent society members. His successor, Ursula Lidbetter, is the Chief Executive of the Lincolnshire Co-operative.

History of the financial services businesses

CWS opened its banking business in 1872. The Co-operative Insurance Society (CIS) had been established independently five years before. Early on, the CWS Bank was crucial to the movement's strategy, serving as a source of capital for the development of local societies. In the inter-war period, the bank played an important role in helping CWS source its imports, making loans to foreign producers to enable them to export goods to the UK. In 1913, CWS and the Scottish CWS took joint ownership of CIS.

In contrast to the retail co-operative societies, the co-operative financial sector experienced some growth in the period after the Second World War. By the late 1960s, CIS was a major player in the insurance market, and the Bank had also been expanding at a steady pace. Originally set up to provide finance to CWS and other co-operative societies, by the 1930s the Bank was also serving over 10,000 trade unions and 11,000 other mutual societies and clubs. In the decades after the Second World War, a number of

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Labour Party-controlled councils decided to switch to the CWS Bank, with 281 local authorities doing so by the mid-1960s. The Bank continues to have a significant presence in this sector.

However, the Bank found it difficult to compete with the established banks. In 1969, Alfred Wilson, the Chief Executive of CWS, had considered plans to float the Bank as a joint stock company, but the CWS Board rejected the proposal. Aided by subsequent legislation, the Bank became a public limited company in 1972, but was still wholly-owned by CWS and thus remained unable to raise equity.

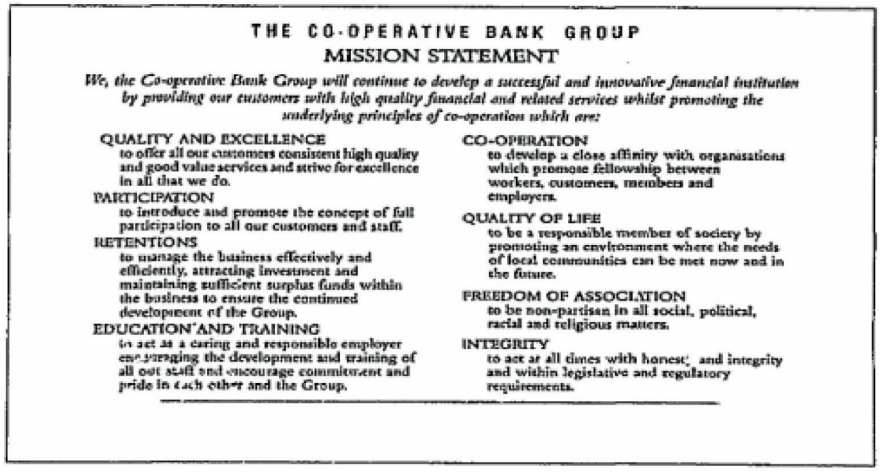
The Bank had offered personal accounts from as early as 1910, but this remained a small part of the business until the 1960s. In 1975, it became a clearing bank in order to capitalise on the growing popularity of retail banking. The 1970s saw a more ambitious Co-operative Bank, and one which was willing to innovate. It appointed Terry Thomas as the first dedicated marketing director in British banking. Thomas' first step was to introduce free personal banking in 1973 – a practice that only became mainstream in British banking in the mid-1980s. In 1982, the Co-operative Bank was the first UK clearing bank to introduce interest on positive current account balances.

The Bank also increased its geographic reach. It augmented its branch network to serve 60 towns by 1980 and it sought to leverage the scale of the co-operative movement's retail footprint. By 1976, 700 co-operative stores included outlets that offered basic banking functions – such as opening accounts and making deposits and withdrawals. 3,500 stores were able to cash cheques. These outlets had the advantage of being open at more convenient times than mainstream banking rivals.

The Bank also invested in new technology. By 1979, it had opened a centralised operations centre, while most British banks continued to use regional offices until the 1990s. The Co-operative Bank was one of the founding members of the LINK consortium, which ran a network of ATMs in the UK. In 1999, the Bank launched 'smile', which was one of the UK's first internet banks. But the Bank's technological advantage was not sustained into the late 2000s, at which point it decided to undertake a complete replacement of its IT platform.

Subsequent to the fall-out from Black Monday in 1987 and the ensuing recession, the Bank faced severe challenges. It made a loss for two years in a row. In response, Terry Thomas, who had become CEO in 1988, recruited a new team to deliver changes to the Bank, including a new marketing strategy. From the early 1990s, the Bank emphasised its ethical stance in an attempt to differentiate itself from other banks and to connect more closely with its customers. The Bank also focused its efforts on delivering high levels of customer satisfaction.

From the Banking Group Annual Report, 1989



THE CO-OPERATIVE BANK GROUP
MISSION STATEMENT

We, the Co-operative Bank Group will continue to develop a successful and innovative financial institution by providing our customers with high quality financial and related services whilst promoting the underlying principles of co-operation which are:

QUALITY AND EXCELLENCE
to offer all our customers consistent high quality and good value services and strive for excellence in all that we do.

PARTICIPATION
to introduce and promote the concept of full participation to all our customers and staff.

RETENTIONS
to manage the business effectively and efficiently, attracting investment and maintaining sufficient surplus funds within the business to ensure the continued development of the Group.

EDUCATION AND TRAINING
to act as a caring and responsible employer encouraging the development and training of all our staff and encourage commitment and pride in each other and the Group.

CO-OPERATION
to develop a close affinity with organisations which promote fellowship between workers, customers, members and employers.

QUALITY OF LIFE
to be a responsible member of society by promoting an environment where the needs of local communities can be met now and in the future.

FREEDOM OF ASSOCIATION
to be non-partisan in all social, political, racial and religious matters.

INTEGRITY
to act at all times with honesty and integrity and within legislative and regulatory requirements.

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Historically, commercial lending was a minor part of the business. In 1993, the Bank appointed Michael Woodward as Director of Corporate and Commercial Banking, growing the business throughout the 1990s and early 2000s. Important areas of growth included the SME, charity and education sectors. The Bank emphasised the personal nature of its interaction with business customers through its corporate centres.

The Bank was profitable throughout the 1990s and the first half of the 2000s. Some of its profits were generated through the mis-selling of PPI, which would eventually lead to the Bank making provisions of hundreds of millions of pounds for compensating customers. The profits generated in the financial services business were instrumental in maintaining CWS's profitability during this period – in 2000, the Bank accounted for 91 per cent of the CWS surplus.

In 2002, the Bank and CIS were merged to create Co-operative Financial Services. CFS was at this point a unique organisation within the British financial services industry. In contrast to other mutuals, its Board was composed of a mixture of CFS and Group Executives, Independent Professional Non-Executive Directors, and elected Non-Executive Directors from the Co-operative Group. Like other mutuals, but unlike other banks and insurance companies, its ownership structure meant that it did not have access to the stock market to raise capital.

The significant increase in profit in the 1990s had reached a plateau by the mid-2000s and began to decline. In 2007, the Bank initiated a new strategy for growth, based on superior customer service and its distinctive ethical brand, which was to be supported by the development of a new set of IT systems. On the eve of its merger with Britannia, CFS remained a small – albeit long-standing – diversified financial services organisation with a unique governance structure and a strong reputation with consumers, but which had limited access to capital and no experience of inorganic growth.

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APPENDIX D – RELEVANT INDIVIDUALS

Name	Role	
Clive Adamson	2008-2011 2011-2013 2013-2014	Director- Major Retail Groups Deivision at the FSA Director of Supervision at the FSA Director of Supervision at the FCA
Keith Alderson	2003-2010 2010-2013	Director of Corporate Banking at Co-operative Financial Services Managing Director of Corporate and Business Banking at the Co-operative Banking Group
David Anderson	2005-2009	CEO of Co-operative Financial Services
Andrew Bailey	2011-2012 2012-2013 2013-Present	Director of UK Banks and Building Societies at the FSA Managing Director of the Prudential Business Unit at the FSA CEO of the PRA
Rodney Baker-Bates	2006-2009 2009-2012	NED of the Britannia Building Society (Chair 2008-2009) IPNED at Co-operative Banking Group
Kevin Blake	2006-2012	Director of Banking Risk and Capital Management at the Co-operative Bank plc
Niall Booker	2013-Present	CEO of the Co-operative Bank plc
Rod Bulmer	2009-2011 2011-2013 May 2013 2013-2014	Managing Director (Retail) at the Co-operative Bank Managing Director (Verde) at the Co-operative Bank Acting CEO of The Co-operative Banking Group Deputy CEO and Executive Director – Core Bank at the Co-operative Bank plc
Bob Burlton	1992-2009 2004-2010	NED of the Co-operative Group (Chair 2004-2007) Chair of Co-operative Banking Director (NED since 1992)
Sir John Butterfill	1983-2010 2006	Member of Parliament for Bournemouth West Introduced The Building Societies (Funding) and Mutual Societies (Transfers) Act 2007.
David Davies	2003-2013	IPNED at the Co-operative Banking Group
Mike Fairbairn	2007-2012	Compliance Director / CRO of Co-operative Banking Group
Paul Flowers	2008-2013 2010-2013	NED of the Co-operative Group Chair of the Co-operative Banking Group (NED since 2009)
Tim Franklin	2003-2009 2009-2011	Managing Director (Member Business) at Britannia Building Society COO of the Co-operative Banking Group
Anne Gunther	2011-2013 2013-Present	IPNED at the Co-operative Banking Group IPNED at the Co-operative Bank plc
Peter Harvey	2008-2009 2009-2013	NED of the Britannia Building Society IPNED at the Co-operative Banking Group
Andy Haywood	2012-Present	CIO of the Co-operative Group
Fiona Haywood	2010-2011 2011-2013	Deputy Head of Internal Audit at the Co-operative Banking Group Head of Internal Audit at the Co-operative Banking Group
Mark Hoban MP	2001-Present 2010-2012	Member of Parliament for Fareham Financial Secretary to the Treasury
Phil Lee	2002-2008 2008-2009 2009-2012	Group Finance Director at the Britannia Building Society Managing Director (BCIG) at the Britannia Building Society Director of Integration and Change at the Co-operative Banking Group
Merlyn Lowther	2011-2013 2013-Present	IPNED at the Co-operative Banking Group IPNED at the Co-operative Bank plc

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Name	Role	
James Mack	2010-2011	Financial Controller at Co-operative Financial Services
	2011-2012	Acting CFO at the Co-operative Banking Group
	2012-2013	CFO at the Co-operative Banking Group
Peter Marks	2007-2013	CEO of the Co-operative Group
	2009-2013	NED of the Co-operative Banking Group
Grahame McGirr	2013-Present	Interim CRO and Executive Director Co-operative Asset Management (CoAM) at The Co-operative Bank plc
Karen Moir	2000-2009	Director of Organisational Development at the Britannia Building Society
	2009-2011	Director of Organisational Development at Co-operative Financial Services
Lord Myners	2013-Present	Senior Independent Non-Executive Director of the Co-operative Group
Gerry Pennell	2003-2008	CIO of Co-operative Financial Services
Barry Pert	2013-Present	Director of Operational Risk at the Co-operative Bank plc
Paul Pester	2011-2013	CEO Verde at Lloyds Banking Group
	2013-Present	CEO TSB Bank plc
Richard Pym	2013-Present	Chair of the Co-operative Bank plc
John Reizenstein	2003-2008	CFO of Co-operative Financial Services
	2008-2010	Managing Director of Corporate and Markets at Co-operative Financial Services
Neville Richardson	2002-2009	CEO of the Britannia Building Society
	2009-2011	CEO of Co-operative Financial Services
David Rutherford	2013-Present	Internal Audit Director of the Co-operative Bank plc
Peter Shaw	2012-2013	Interim CRO of the Co-operative Banking Group
Euan Sutherland	2013-2014	CEO of the Co-operative Group
Barry Tootell	2008-2011	CFO of Co-operative Financial Services
	2011-2012	Acting CEO of the Co-operative Banking Group
	2012-2013	CEO of the Co-operative Banking Group
Len Wardle	2007-2013	Chair of the Co-operative Group
	2002-2013	NED of the Co-operative Banking Group

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APPENDIX E – GOVERNANCE AT OTHER RETAILER-OWNED BANKS

Sainsbury's Bank

Established in 1997, Sainsbury's Bank was initially a joint venture between J Sainsbury plc and Bank of Scotland plc (subsequently HBOS and then Lloyds Banking Group). Since 31 January 2014, Sainsbury's Bank has been wholly-owned by J Sainsbury plc.

Bank Board composition	x	Sainsbury's Bank Board currently consists of 12 Directors: ○ 1 independent Chairman ○ 4 Bank Executives (CEO, CFO, CRO and COO) ○ 3 Non-Executive Directors nominated by J Sainsbury plc, one of whom is the Group CFO ○ 4 Independent Non-Executive Directors
	x	With the exception of the 2 Directors nominated by J Sainsbury plc, all Bank Directors have significant financial services experience
Bank appointments	x	J Sainsbury plc appoints the Bank Chair and CEO
	x	Non-executive and Independent Non-Executive Directors are appointed by the Bank Board and ratified by J Sainsbury plc
	x	Bank Executives are appointed by the Bank Board Nominations Committee
Reporting lines	x	The Sainsbury's Bank CEO reports to the Sainsbury's Bank Board. He does not currently sit on the J Sainsbury plc Operating Board (the equivalent body to The Co-operative Group's Executive Committee)
	x	All other Bank executives report to the Bank CEO
	x	There are no instances of Approved Persons in Sainsbury's Bank reporting to individuals who are not Approved Persons in J Sainsbury's plc
Shared services	x	Sainsbury's Bank maintains control over all key functional areas, such as Finance, Risk, and Change and IT
	x	The Bank does share some basic services with J Sainsbury plc (e.g. payroll, HR operations, ATM hosting etc.)

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Tesco Bank

Established in 1997, Tesco Bank (then known as Tesco Personal Finance) was initially a joint venture between Tesco plc and the Royal Bank of Scotland. Since 19 December 2008, Tesco Bank has been wholly-owned by Tesco plc.

Bank Board composition	x	Tesco Bank Board currently consists of 10 Directors: o 1 independent Chairman o 4 Bank Executives (CEO, Deputy CEO, CFO and CRO) o 2 Non-Executive Directors nominated by Tesco plc, both of whom sit on the Group Board o 3 Independent Non-Executive Directors
	x	All Bank Directors have significant financial services experience
Bank appointments	x	Tesco Bank Directors are appointed by the Bank Chair, Senior Independent Non-Executive Director and CEO, in consultation with Tesco plc
	x	The Bank CEO is appointed by the Bank Board
	x	Bank executives are appointed by the Bank CEO with the consent of the Bank Board
Reporting lines	x	The Tesco Bank CEO reports to the Chairman of the Tesco Bank Board. He also sits on the Tesco plc Executive Committee and has a reporting line to the Group CEO
	x	All other Bank executives report to the Bank CEO
	x	Other than the Bank CEO's reporting line as a member of the Group Executive committee, there are no instances of Approved Persons in Tesco Bank reporting to individuals who are not Approved Persons in Tesco plc
Shared services	x	Tesco Bank maintains control over all key functional areas, such as Finance, Risk, and Internal Audit
	x	The Bank does share some basic services with Tesco plc (e.g. payroll, data centre etc.)

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APPENDIX F – GLOSSARY

Term	Definition
Albany	Initial project to restructure the Leek Notes in May 2010 (ultimately cancelled)
Approved Person	Individual who has been approved by the FCA and/or the PRA to perform one or more controlled functions on behalf of an authorised firm
ARROW	Advanced Risk-Responsive Operating Framework. A high-level review by the Regulator to assess a particular risk in regulated firms
Audit Quality Review (AQR)	Financial Reporting Council team that monitors the quality of listed and major public interest audits, and the processes and procedures of the major audit firms
Banking Transformation Programme (bTp)	Name used by Co-operative Banking Group to describe replatforming programme between 2009-2012
Basel II	Second of the Basel Accords - revised international capital framework published by the Basel Committee on Banking Supervision in June 2004
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
BCIG	Britannia Capital Investment Group
BMR	Britannia Membership Reward
Business Leader	Pay grade immediately below that of the CBG Executive Committee
Butterfill Act	Building Societies (Funding) and Mutual Societies (Transfers) Act 2007. Resulted from a Private Members Bill sponsored by the Conservative MP, Sir John Butterfill MP
CABB	Corporate and Business Banking Division of CBG
Calico	Name given to an RMBS securitisation used by Co-operative Banking Group to offload some of the risk associated with a portfolio of loans originated under Britannia's Platform brand
Capital shortfall	Refers to a situation in which a bank's capital requirements exceed its capital resources
Capital ratio	Capital expressed as a percentage of its risk weighted assets. Common capital ratios include Core Tier 1 Ratio, Tier 1 Ratio and Total Capital Ratio
Capital requirement	For the purpose of the Review this is deemed to be the ICG + CPB. The Regulator requires the Bank to hold capital in excess of its ICG
CCA	Consumer Credit Act 1974
Co-operative Financial Services Limited (CFS)	Parent company of The Co-operative Bank, CIS and CISGIL. Re-named The Co-operative Banking Group in September 2011
Co-operative Financial Services Management Services (CFSMS)	Service company owned by CBG for a significant proportion of its administrative expenses. Not part of the Bank for regulatory purposes. Also used as a vehicle to finance the replatforming project
CIS	Co-operative Insurance Society Limited
CISGIL	CIS General Insurance Limited
Common Equity Tier 1	Introduced on 1 January 2014 to replace the existing Core Tier 1 capital; similar in many regards but more restrictive
Concentration risk	Possibility of loss resulting from significant exposure to a specific group of counterparties

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Term	Definition
Conduct risk	Risk that a firm's behaviour, offerings or interactions will result in poor outcomes for customers
Core	The portfolio of assets deemed consistent with the Bank's strategy and risk appetite in early 2012
Core Tier 1 capital	High quality regulatory capital; a subset of Tier 1 capital
Capital Planning Buffer (CPB)	An additional buffer on top of the ICG which can be used by the firm to absorb losses at times of particular stress
Capital Requirements Directive (CRD IV)	Capital Requirements Directive IV; EU legislation to implement the Basel III agreement in the EU. Effective as of 1 January 2014
Cost to income ratio	Operating expenses divided by operating income
CRE	Commercial Real Estate
Credit Risk	Risk of financial loss resulting from a borrower's failure to make the terms of any agreement with a bank
Democrats	Elected members of the Group Board, Regional Boards and Area Committees
Due diligence	An investigation to confirm the material facts regarding the sale of a business
Enterprise Platform	[illegible]
Financial Conduct Authority (FCA)	Formed on 1 April 2013 as a successor, along with the PRA, to the FSA
Finacle	Banking systems product chosen by CBG to replace its existing IT platform
First line of defence	Business management and the day-to-day practices and controls within the customer-facing business
Forbearance	Agreement between mortgage lender and borrower to delay foreclosure
Foreclosure	Legal process by which a lender obtains a court order to terminate a borrower's equitable right of redemption. Required when a borrower fails to comply with the terms of the loan
Financial Reporting Council (FRC)	Independent regulator responsible for corporate governance and reporting in the UK
Financial Services Authority (FSA)	Former regulatory body for the UK financial services industry. It was abolished on 1 April 2013, with its responsibilities being split between the FCA and the PRA
Fair Value	The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction
Fair Value Adjustment (FVA)	[illegible]
Function Leader	Pay grade two levels below the CBG Executive Committee
Heads of Terms	Non-binding document outlining issues relevant to a potential sale and purchase agreement
Internal Capital Adequacy Assessment Process (ICAAP)	Process by which firms assess the level of capital that adequately supports all relevant current and future risks in their business
Individual Capital Guidance (ICG)	The level of capital which the regulator requires a bank to hold at all times
IFRS	International Financial Reporting Standards

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Term	Definition
ILAA	Internal Liquidity Adequacy Assessment
Individual Liquidity Guidance (ILG)	Regulator guidance on the required amount and composition of the liquid assets buffer that should be held by a firm
Illius	A company operated by Britannia which purchased repossessed Platform-originated and residential landlord properties and managed them as investments with the intention to sell once real estate values had recovered
Impairments	A reduction in the value of an asset as a result of a loss event, which has an impact on the estimated future cash flows of the asset
Interest cover	A measure of a firm's ability to make interest payments on outstanding debt. Typically expressed as earnings before interest and tax divided by interest expense
Internal Audit	Department providing assurance that appropriate procedures are in place and being followed. Considered part of the third line of defence
IPNED	Independent Professional Non-Executive Director
IPO	Initial Public Offering
Jules	Independent review conducted by PwC into the impairments taken by the Bank in the first half of 2013
Key Credit Criteria (KCC)	Lending guidelines for the Bank's front-line managers to follow in order to manage credit risk
Leek Notes	A series of floating rate loan notes secured by mortgage assets which were issued by Britannia prior to the merger with CBG
LME	Liability Management Exercise
Loss event	An event that is likely to result in a loss. In banking, this is an event that may result in the reduction in value of an asset, triggering an impairment
Lotus	The second attempt to restructure the Leek Notes. Completed in June 2011
LTIP	Long-term incentive plan
Loan-to-value (LTV)	Ratio of the outstanding value of a loan to the value of the collateral against which it is secured
Material Adverse Change (MAC) 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
Magellan	Project to outsource certain business processes to IBM (one component of what became Project Olympus)
Mutuo	Organisation established in 2001 to promote mutuals and co-operatives
Myners Review	Independent review of the Group's governance led by Lord Myners
NED	Non-executive director
Non-core	A portfolio of corporate loans, mortgages and buy-to-let properties which the Bank separated out from early 2012 on the basis that they did not fit with CBG's strategy and risk appetite
Olympus	Project to outsource business processes (Project Magellan) and IT infrastructure to IBM, and engage IBM to provide Systems Integration and management support for replacement of core banking system

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Term	Definition
Operational Risk	Risk incurred as a result of a firm's activities and external events
Optimum	Term given post-merger to the heritage Britannia loan portfolio containing sub-prime residential mortgages, buy-to-let and a small proportion of prime residential mortgages
Organisational Development (OD)	Bank Function comprising HR, Strategy, Learning and Development, and Culture
PBT	Profit before tax
PIBS	Permanent Interest Bearing Shares
Pillar 1	Minimum capital requirements that should be held for credit, operational and market risk
Platform	Britannia's intermediary business, including sub-prime residential mortgages (e.g. non-conforming and self-certified mortgages), buy-to-let loans and a small proportion of prime residential mortgages
PPI	Payment protection insurance
Prudential Regulation Authority (PRA)	Formed on 1 April 2013 as a successor, along with the FCA, to the FSA
Pennine	2013 Capital Action Plan to address the capital shortfall
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
Recapitalisation plan	CBG's 2013 plan to address its capital shortfall
Regulator	FSA prior to 1 April 2013, PRA or FCA post 1 April 2013, depending on the context
Release 1	IT system replacing the business internet banking system and Financial Director products serving the Bank's corporate clients
Replatforming	Term used in this Report for the project to replace the Bank's IT systems
Risk-weighted assets (RWA)	A measure of a bank's assets adjusted for their associated risks
RMBS	Residential Mortgage Backed Security
Second line of defence	A set of specialist control functions covering risk, regulatory compliance, legal issues and elements of finance and HR
Section 166 Skilled Persons Review (s166)	Review commissioned by the Regulator to obtain an independent view of aspects of a firm's activities
Systems Integration (SI)	The process of bringing together IT components into one system and ensuring their combined functionality
SLRP	Supervisory Liquidity Review Process (performed by the Regulator)
smile	Co-operative Bank's internet banking brand
Somerfield	Supermarket chain acquired by The Co-operative Group in 2009
SREP	Supervisory Review and Evaluation Process (performed by the Regulator)
[illegible]	Parent company of The Co-operative Bank, CIS and CISGIL. Known as Co-operative Financial Services prior to September 2011
Third line of defence	Internal Audit function
Three lines of defence	Conventional structure to risk governance

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Term	Definition
Tier 1 capital	A high quality tier of capital. Includes retained earnings and share capital (including preference shares)
Tier 2 capital	Lower quality tier of capital. Includes undisclosed reserves, revaluation reserves, hybrid instruments, general provisions and subordinated term debt
Transformation Programme	Overarching name for change programme, including replatforming, several other technology projects (e.g. Big Card, Accounting Hub, Telephony) and the integration of Britannia Building Society
TSC	House of Commons Treasury Select Committee
Treating Customers Fairly (TCF)	Regulator guidance that seeks to ensure that firms put the well-being of customers at the heart of how they run their businesses
Unity	Project to bring the various Group businesses closer together, thereby generating cost savings and new sources of revenue
Verde	Retail bank consisting of 632 branches that the European Commission forced Lloyds Banking Group to divest following Lloyds TSB's acquisition of HBOS in 2008 and subsequent State Aid
Walker Review	Independent review of corporate governance in the UK banking industry, led by Sir David Walker and published in 2009
Watchlist	List of firms about which the Regulator has significant concerns

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APPENDIX G – LEGAL DISCLAIMER

The Report has been prepared by Sir Christopher Kelly as independent reviewer commissioned by the executive teams, together with the Boards, of the Co-operative Group Limited (the Group) and the Co-operative Bank plc (the Bank).

The Review's Terms of Reference are set out at the front of the Report.

The views, findings and lessons included in this Report are entirely those of Sir Christopher Kelly and are based on an assessment of the information provided by the Group, the Bank and others in response to requests for information and during the course of interviews. The Group and the Bank will consider and decide for themselves whether, and if so how, to act on the contents of this Report.

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The Kelly Review into the Co-operative Bank's failure

The recent disastrous failure at the Co-operative Bank and its impact on the Co-operative group are well known. The recently published £4.4 million Kelly review of the events leading to that failure contains many insights into what went wrong and why. While there is no comparison with the Post Office, there are several valuable lessons that can be derived for any organisation, in particular those undergoing rapid and substantial change. The following extracts from the review make this clear.

Introduction to the report

This report tells a sorry story of failings on a number of levels. The Bank Executive failed to exercise sufficiently prudent and effective management of capital and risk. The Banking Group Board failed in its oversight of the Executive. The Group Board failed in its duties as shareholder to provide effective stewardship of an important member asset. Collectively, they failed to ensure that the Co-operative Bank consistently lived up to its ethical principles. In all these things they badly let down the Group's members.

The lessons set out below are far from novel. It does no credit to those involved that they should need to be learnt again.

The root causes of the crisis

A number of factors contributed to the debacle of the capital shortfall and the subsequent restructuring:

i. The economic environment.

ii. Increasing capital requirements imposed on banks in general following the financial crisis, and on the Co-operative Bank in particular as a consequence of specific issues that it needed to address.

iii. The merger with the Britannia Building Society in 2009.

iv. Failure by the Bank after the merger to plan and manage capital adequately.

v. Fundamental weaknesses in the governance and management of risk.

vi. Material capability gaps, leading to a serious mismatch between aspirations and ability to deliver.

vii. Past mis-selling of payment protection insurance (PPI).

viii. A flawed culture.

ix. A system of governance which led to serious failures of oversight.

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The Kelly Review into the Co-operative Bank's failure

Lessons learned

Most of the lessons are not new. Some of them are so basic that it should be a matter of considerable regret to those involved in the past management and governance of the Bank and Group that they needed to be learnt again.

I. Running a full-service bank, even a small one, in a regulated environment is a complex business. In pursuing its ambitions the Bank failed to understand the limits of its own capability.

II. The most important task for any board is to put in place the right Executive leadership for the business. The Bank failed to do so.

III. Ownership of a regulated bank by a non-bank requires a clearly articulated statement addressing in sufficient detail the management and governance relationship between the Co-operative Group and Bank. The Group and Bank Boards failed to put one in place.

IV. Failures in board oversight are inevitable if the criteria used to elect its members do not require those elected to have the necessary skills. The Group Board lacked the skills and expertise to oversee the Group's complex portfolio of businesses effectively.

V. To be effective, a bank board must include sufficient numbers of technically competent Directors. At no point before June 2013 did the Bank have this, which helps to explain some of the failures of oversight.

VI. To exercise appropriate supervision and challenge, boards need to be supplied with good management information, and to demand it if it is not forthcoming. Failure to obtain such information explains some of the failings in oversight at both Group and Bank.

VII. It is fundamental that a bank should develop and implement robust risk governance and oversight and an appropriate control framework. The Bank failed to take timely and robust action to address serious deficiencies in these areas.

VIII. Before launching a significant IT transformation project, any institution is well-advised to test whether more modest alternatives will suffice. If it decides to go ahead, it must strive to keep the programme as simple as possible, phase delivery in a manageable way, deploy the right resources, plan for contingencies, and treat the programme as a business priority. The Bank failed in all these areas.

IX. Financial institutions ignore regulatory signals at their peril. The Bank should have paid closer attention and responded with greater urgency to what the Regulator told it.

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The Kelly Review into the Co-operative Bank's failure

X. Institutions should pay careful attention to the advice of their external advisers. The Group and Bank ignored well-founded, if inconvenient advice. This proved costly.

XI. Postponing dealing with problems is almost never a sustainable solution. The Bank consistently eased short-term difficulties by pushing problems into the future.

XII. If an organisation's values and sense of purpose are to affect the way staff act, they need to be translated into meaningful guidance. The Bank's ethical positioning should be made much more apparent in a way which influences employee behaviour and means something to customers.

XIII. Effective strategies address tangible issues of competitive advantage and disadvantage. Mantras about scale and ethics are no substitute for strategies grounded in a real understanding of competitive position, market economics, and organisational capabilities. The Bank lacked such a strategy.

XIV. Talent management is critical in any organisation. The Bank's failings owe much to its lack of capability in important areas, driven significantly by weaknesses in its recruitment and subsequent management of talent.

XV. Tolerating – as the Bank did – a culture of underperformance, weak transparency and a lack of accountability, constrains an organisation's ability to respond quickly and robustly to any challenges it faces.

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The Kelly Review into the Co-operative Bank's failure

Other weaknesses highlighted by the report

Culture

i. A willingness to accept poor performance.

ii. Confused or diffused accountabilities in a number of important areas, including risk and change management.

iii. A tendency not to welcome challenge.

iv. A willingness to accept certain key assertions without subjecting them to proper scrutiny.

v. A tendency to promote good news and to delay bad news.

Risk

i. Risk awareness in the first line was generally low, and not supported by adequate training.

ii. Risk appetite statements were not always translated into effective policies and guidance.

iii. Where policies did exist they were sometimes inconsistent or incomplete.

iv. In areas where policies and procedures were in place, they were frequently ignored, with little apparent comeback either from the management of the front line or from the second line supposed to be policing them.

v. Accountability was not always clear. For example, the FSA expressed concern in 2010 about the lack of clarity in the responsibility for operational risk in front-line managers.

vi. Escalation procedures were frequently unclear and often informal. Informal methods have their place, particularly in small organisations. But they can be unreliable and lead to mistakes which a more formal approach would prevent.

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The Kelly Review into the Co-operative Bank's failure

Relevance to the Post Office

The circumstances and outcomes of the Co-Operative Bank failure bear no relationship to the Post Office's situation.

However, the weaknesses and the lessons identified by the Kelly review provide valuable insights into what can go wrong where governance and risk management are not up to the job. In particular, Post Office should continue to ensure:

- Leadership's focus on governance and risk management are maintained;
- Any tendency to only listen to good news and ignore the bad is avoided;
- Assertions are challenged;
- Sufficient skilled resource is in place to avoid "capability stretch" across multiple change programmes; and
- Policies and guidance, that reflect Post Office's values and sense of purpose, are in place and complied with.

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Question 7 – Recommendations

What are the wider project management and reporting lessons that can be learnt from DMI and applied to other BBC projects?

Background

We have considered the findings in the above sections and make recommendations related to questions 1 to 5 as set out in Figure 1. We recognise that the BBC is in the process of maturing their programme management methodology (the BBC Way) and that certain aspects of our recommendations are in the process of being implemented.

The key lessons to be learned have been broken down into the following areas:

* Programme and Corporate Governance.
* Programme Lifecycle Management.
* Risk and Issue Management.
* Programme Assurance Planning.
* Financial Management.
* Benefits Management and Tracking.

Recommendations have been grouped together to reflect the normal flow of programme initiation and execution rather than indicating a priority for implementation. Our recommendations reflect what we have observed in carrying out this review of DMI. They are based on good practice for managing programmes. We are aware that other large projects and programmes have adopted these good practices, and that there are publicly recognised examples of excellent project management at the BBC (Project W1). Therefore our recommendations, while appropriate for projects which combine complex organisational change with complex technology implementation, may not be relevant or needed for all BBC projects.

Programme and corporate governance

Programme governance structure

The programme governance structure should reflect the needs of the programme to enable the programme to achieve the desired outcome. It has to be appropriate for the type of programme being executed and to provide clarity around the accountabilities for success at all layers in the governance structure, the levels at which decisions are made and risks are managed, and the way in which capital investment and resources are allocated.

The programme governance structure should have clear guidelines on the roles and responsibilities of each governance layer and on the delegated authority for decision-making that can be made at each level. The role of each layer of the governance model should focus on addressing the risks / issues and making decisions rather than being forums for providing an update on progress to stakeholders. Participation in each layer should be restricted to those individuals required to manage the programme and attendance should be mandated.

A key role in the governance structure is that of the sponsor. Programmes should have a single sponsor, responsible for owning the successful delivery of, and outcome for, the programme. The sponsor should have appropriate knowledge of the areas impacted by the programme and have a sufficient level of authority and responsibility within the organisation to deliver the business benefits described in the Business Case.

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The key elements of governance for a technology-enabled transformation programme such as DMI are outlined in the table below:

Group	*Meeting frequency*	*Owner*	*Role*	*Reports to*
Corporate Governance Bodies	Quarterly	Various	The Corporate Governance bodies should be responsible for commissioning programmes and agreeing the key tolerances for delivery.	N/A
Executive Steering Board (ESB)	Monthly	Executive Sponsor	The ESB should be responsible for setting the direction of the programme. They have overall accountability / responsibility for the programme, as long as forecasts remain within tolerances.	Corporate Governance Bodies
Programme Steering Group (PSG)	Weekly / Bi- monthly	Programme Director/Manager	The Programme Steering Group should be responsible for managing the delivery of each stage of the programme. Any deviation from the delivery timelines should be escalated to the ESB.	ESB
Project Workstreams (PW)	Weekly	PMO / Team Manager	The Project Workstreams should be responsible for delivery of individual work packages in line with agreed tolerances. Any movement outside those tolerances should be passed to the PMB.	PSG
Design Authority	Varies	Design Lead	The Design Authority should be responsible for aligning the current and future business requirements to the overall solution.	PW and Corporate Design Authority

Figure 17 - Recommended governance forums

As the programme moves through each stage of its lifecycle, changes may be required to the organisation or governance structure to reflect the changing focus from design through to implementation.

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Recommendation A

* Programmes should adopt a three-tier governance structure where the programme delivers change to the business. For in flight programmes, the governance arrangements should be reviewed and appropriate improvements made where the risk of significant disruption can be managed.
* Attendance at programme governance meetings should be mandatory for all key stakeholders, and attendance monitored closely. Where it is genuinely not possible for key stakeholders to attend, decision-making authority should be delegated to an appropriate person for the meeting in question. This ensures that key progress reporting information can be communicated and that key decisions can be made and the information cascaded down to the relevant parties.
* A single sponsor (sometimes known as a Senior Responsible Owner) for each programme should be appointed during programme start-up. This sponsor will be accountable for the programme's overall success and empowered to make the most important decisions. The sponsor will need to own the Business Case, take accountability for realising the expected benefits, ensure that the business teams are actively engaged throughout the programme and also that the programme maintains its alignment to the business's strategy. The sponsor should have successful delivery of the Business Case embedded in to their objectives.

Role of the Design Authority

The role of the Design Authority is central to providing strategic direction throughout the design and implementation of a technology solution. The Design Authority should ensure the solution's alignment with the business requirements as well as acting as a gate keeper for each formal stage gate in the development lifecycle.

The Design Authority should also take responsibility for implementing strong design governance principles as part of any change management processes.

The size of the Design Authority function on any programme will depend on the scale and complexity of the solution to be delivered.

Recommendation B

* The BBC should formalise the role of the Design Authority as part of the overall programme governance framework. The Design Authority should be clearly linked to the BBC Technology Enterprise Architecture function. The role of the Design Authority should include:
    * Overseeing the technical design of solutions to ensure alignment with good practice as well as alignment with overall technology strategy.
    * Responsibility for ensuring the solution design satisfies the business requirements and that change requests align to the business requirements and Business Case.
    * Ensuring that there is effective engagement from the business in the development of the solution impact assessment. This will improve the likelihood that the developed solution meets the business requirements and results in the expected business benefits.

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Role of Corporate Governance

The BBC's Corporate Governance bodies should be responsible for providing oversight and authorisation for a programme to proceed or stop, rather than to be an active part of day-to-day programme governance. How the programme engages with the Corporate Governance bodies and the information it can provide on progress, risk and issues will be key to ensuring that programmes are successful.

Recommendation C

* The BBC should review the roles and responsibilities between its different corporate and programme governance bodies to implement clearer delineation between corporate and programme roles. This is particularly relevant for both approving and tracking large, complex investment programmes. This review should also include the role and responsibilities of the Trust, DG Finance Committee, BBC PMO, Internal Audit and the programmes.
* Based on our review of DMI and the BBC corporate governance model in place at the time of DMI, we believe that the BBC should introduce a Portfolio Management capability, implemented as part of its current governance structure. Supported by the BBC PMO, the responsibility of Portfolio Management would be to provide oversight, control and authorisation for Capital Expenditure ("Capex") Management of the portfolio of change programmes. This function would monitor progress, interdependencies between programmes and provide assurance that programmes are adhering to the 'BBC Way'. In addition, the function should look at managing the holistic risks of the entire portfolio, including financial, reputational, and delivery risks.

Programme reporting

Programme reporting is central to the effective operation of a programme's governance model. It is essential that the programme sponsor and other stakeholders have accurate and timely information which reflects the current status of the programme and enables them to make informed decisions. Reporting should focus on delivery of the business outcomes and should reflect the programme's key success criteria, deliverables and defined tolerances.

Typical programme reporting includes a combination of:

* Progress reporting, including tracking delivery against key milestones / stage gates, last period's activities and forthcoming activities, dependencies, deliverables, forecasted time to complete, upcoming workload versus resource forecasting.
* Change requests requiring sign-off, including options analysis and associated budget impacts
* Risk management reporting, including key risks and issues that require actions and an overall risk assessment based on cumulative levels of risks from across the programme.
* Financial reporting, including current project run-rates, cumulative programme costs to date against budget as well as a projection of the likely cost to complete.
* Benefits tracking, including tracking of key programme KPIs and forecasted benefits delivery.

Recommendation D

* The BBC should review existing templates and evolve these in line with other recommendations set out in this report to define a standardised reporting framework and templates, which should be mandated on all programmes. The reporting framework should clearly define the level and type of reporting that is appropriate for each layer in the governance structure.

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Programme lifecycle management

Agreeing on a common approach

The BBC does not mandate a common approach to programme lifecycle management or enforce adherence to a common set of standards around Capital Expenditure ("Capex") approval processes and project management. The closest example is the BBC Way, which provides an optional set of guidance for project managers on effective programme management methods. These methods include stage gate delivery, good practice project management guidelines and a number of document templates.

We believe that implementing a standard stage gate framework for programme lifecycle management would provide tangible benefits in programme management and delivery. The adoption of a common lifecycle management approach would provide greater transparency and control of budgeting, spend and forecast through all stages of the lifecycle. A common stage gate process also enables the right controls and checkpoints to be implemented allowing progress to be closely monitored and deviations from plan to be identified and their impacts assessed. This is particularly important for programmes and projects which employ third party vendors operating under their own methodologies, as it enables more consistent, transparent progress reporting across programmes and projects.

Recommendation E

* The BBC Way should be used as the basis for mandating a common project and programme lifecycle management approach. The BBC will need to perform a detailed review of the BBC Way to identify improvements and implement a plan to enhance and embed the approach across the Corporation. Adherence to the common programme lifecycle should be included in the objectives of all programme managers and in contracts with third parties.
* The BBC Way will need to be closely integrated with the suggested Portfolio Management Board and Programme Governance structures to give greater transparency of progress against plan and control of budget.

Programme planning and plan management

Programme plans should be developed as part of programme initiation and have clear linkage to the delivery of technology components, business capabilities, business outcomes and benefits. Programmes should develop a high level plan on a page as part of the Business Case to provide clarity on key milestones. The plan should be aligned to the key stage gates outlined in the BBC Way and baselined as part of a programme's approval process.

Each project should develop mid-level project plans and detailed workstream project plans as part of the preparation for the entry into any new stage gate. Wherever possible, plans should be constructed in line with the BBC's preferred Prince II methodology and include information on activities, milestones, deliverables, resourcing, responsibilities, dependencies and the critical path. Plans should be agreed with each of the key project workstreams and baselined, to enable the programme manager to monitor progress against key milestones and deviations to be tracked. Workstream project plans should be integrated into a mid-level end-to-end programme plan, which in turn should roll up into the programme plan on a page.

Recommendation F

* The BBC should ensure that programme planning is a key component of large scale projects and plans should be aligned to the stage gate process defined in the BBC Way. Programme plans should be periodically reviewed, baselined at the beginning of each stage and aligned to the timelines specified in the overall programme plan. Requests to re-baseline plans should be managed through change control at an Executive Steering Board level and the impact on the Business Case reviewed and approved.

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Risk and issue management

The implementation of risk and issue management, as defined in the BBC Way, can support the BBC in developing a more in-depth, consistent, understanding of its risk profile at both programme and portfolio level and will provide a greater focus on understanding business impacts and mitigation options, developing cumulative risk assessments and providing transparent reporting to key stakeholders.

Recommendation G

* The BBC should ensure that appropriate risk and issues management processes, RAID logs and templates are made available as part of the BBC Way.
* Programmes should undertake a formal risk assessment at the outset to capture risks that need to be managed throughout the life cycle of the programme. This assessment would inform the Business Case, provide the initial base line for the RAID logs and be managed through the formal risk and issues management processes. Periodically a formal review of the risks should be undertaken to ensure that the programme is maintaining adequate focus on the identified risks and has clear plans to mitigate them.

Programme assurance planning

Recommendation H

* An integrated assurance plan should be a mandatory deliverable as part of the initial set-up of a programme and should be monitored periodically to ensure it remains valid as the programme moves through its lifecycle. The plan should outline the key entry and exit criteria for each programme stage, the key assurance activities aligned to the programme plan and the roles and responsibilities of various bodies in providing assurance to the programme.
* Assurance activities should be performed periodically and around key stage gates, with the independent assurance bodies empowered to raise key risks and issues and provide recommendations for their resolution.

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Financial management

Our recommendations on project financial management relate to the approval of the initial Business Case and the on-going management and tracking of spend and forecasting the cost to complete.

Business Case definition and approval

Both corporate and programme governance bodies require accurate and timely Business Case data to make the right investment decisions before a programme is approved or funding is released.

Business Case approval is a key milestone on any programme. The programme sponsor is responsible for agreeing the Business Case with both key business stakeholders and the finance team prior to programme approval.

Key stakeholder communities are required to play an active role in the approval of Business Cases. They will need to understand, review and approve the Business Case and consider the:

* Validity of the estimated cost of delivery, including the likely internal resource requirements, sourcing strategy, time lines, risks and issues.
* Alignment of the programme to the BBC's strategic objectives.
* Ability of the programme and the business to deliver the business benefits they have agreed to.
* Programme's ability to deliver the identified outcomes, including any dependencies with other programmes or external factors, the timelines, availability of resources and the achievability of the milestones.

The Business Case should be baselined as part of the programme approval process and reviewed as part of every stage gate review or when significant changes to either the programme's objectives or delivery plan are required.

Recommendation I

* The BBC should review the Business Case approval process and ensure that an appropriate sponsor is responsible for both the Business Case definition and delivering the business benefits.
* The Business Case is a living document that should be reviewed periodically as well as when the BBC's current re-approval limits are hit.

Project financial management

Currently, on approval of a BBC Business Case, the DG Finance Committee delegates responsibility for budgetary control within agreed limits to the Programme Steering Board.

Recommendation J

* Clear guidelines should be in place to enable programmes to estimate cost and track and report spend at a granular level against clearly defined delivery milestones. Monitoring both cost to complete and/or budget burn-down enables the programme manager and governance bodies to track progress against budget and identify over-runs earlier in the process.
* Delegation of authority for programme finances should be aligned to the programme governance structures in place.
* The BBC should consistently implement a formal process for estimating and tracking spend through all stages of the life cycle through to delivery of the expected benefits.
* The BBC should review a programme's financials as part of each major stage gate review. There should be a set of clear guidelines in place to ensure that each programme knows when they should re-baseline their Business Case.

Benefits management and tracking

It is good practice to monitor a programme's ability to deliver against the initial Business Case throughout its duration. Taking a proactive view of business benefit management often helps maintain a programme's focus on delivering business outcomes as well as the ability to deliver to time and budget.

Changes in the programme need to be assessed for their impact on the programme's ability to deliver the defined benefits. The programme should also monitor the influence of any external factors or programmes which could impact the cost, or the realisation of the benefits.

Recommendation K

* Programmes should set up business benefit management and tracking processes as part of initiation and closely link these to the delivery timelines, budget, target KPI's and associated business benefits. Programmes should state how they will adhere to the Trust's published guidelines on Business Case re-approval and set clear criteria for triggering the process to revise and reapprove the Business Case.

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JUNE 2014

POST OFFICE LIMITED MATTERS – DISPUTE RESOLUTION
PRIVILEGED AND CONFIDENTIAL – CLAIMS OVER £500K OR THOSE OF A SENSITIVE NATURE

FILE NAME	CASE HOLDER	BUSINESS UNIT & CONTACT	DESCRIPTION	STATUS	XSP
Horizon claims	POL/RW	Belinda Crowe / Angela van den Bogerd	POL has received various claims from subpostmasters (SPMs) alleging defects in the Horizon system and POL's internal processes. These allegations were initially made in 5 claims brought through solicitors Shoosmiths. Similar allegations have been made by the "Justice for Subpostmasters Alliance" (JFSA) and advanced through SPMs' MPs. Following discussions with James Arbuthnot MP and JFSA, independent investigator Second Sight Support Services Ltd (Second Sight) was appointed in July 2012 to carry out a review into these allegations. On 08.07.13, Second Sight published a Report finding shortcomings in POL's internal training and support to SPMs on the Horizon system, but no systemic problems with Horizon itself.	Following the Second Sight Report, on 27.08.13 POL launched a Mediation Scheme aimed at resolving individual complaints made about Horizon. POL has also been developing and implementing a Business Improvement Program to improve the way POL supports SPMs run their branches. The Scheme has received 150 applications. These are being progressed under the direction of a Working Group comprising retired Court of Appeal Judge Sir Anthony Hooper (as Chair), POL, Second Sight, and JFSA. A sub-committee of the Board has been formed to oversee POL's management of the applications through the Scheme. The sub-committee has agreed that going forward, POL will take a firmer position, informed by its legal position and tighter control over timescales and costs. Consistent with this approach (which has been endorsed by the Board), POL has imposed hard deadlines for some applications, and refused to mediate one case (with support from the Working Group	Bond Dickinson

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				Chair). It is anticipated that the first mediation will take place in the second week of July 2014. POL has also reviewed its approach to the criminal prosecutions it brings against SPMs which use Horizon data and generally, and reviewed past criminal prosecutions which used Horizon data for compliance with the disclosure standards required for prosecutions. To date, no claim has been made against POL in the civil courts, and no appeal has been made against any conviction in the criminal courts, following Second Sight's Report.	
Employment	POL/NM	Colin Stretch	Employment Tribunal has held a sub-postmaster to be an 'employee' at a Preliminary Hearing.	A former SPM has brought a whistleblowing and unfair dismissal claim against POL. On 17.06.14, the Tribunal held that the SPM was an employee of POL between 24.08.12 and 12.07.13, even though she had signed a Temporary Sub-Postmaster (T-SPM) Contract. As an "employee", the SPM can continue with her claim that POL dismissed her for whistleblowing. The Tribunal has not yet determined whether or not the SPM was in fact unfairly dismissed. POL's position (in addition to the SPM not being an employee) is that her T-SPM Contract was properly	Weightmans

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				terminated because of substantial rent arrears. The Tribunal's finding can be confined to the specific facts of this case, in particular to specific pre-contract oral negotiations, without which the Tribunal acknowledges there would be no employment relationship. Nevertheless, we are considering whether to appeal the decision given the significant ramifications for this particular case and the wider network. External Counsel Weightmans believes the Tribunal's decision is wrong and there are reasonable prospects of a successful appeal. Weightmans were however criticised by the Tribunal for not complying with its directions. POL is therefore seeking to instruct alternative Counsel to handle any appeal and the case going forward.	
[redacted]					

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[redacted]

PART (B) – PRINCIPAL CRIMINAL CASES BROUGHT BY POST OFFICE LIMITED

DESCRIPTION	STATUS
Sub postmaster accused of two offences of theft of £175,260 and £9,999.43, and two offences of false accounting regarding the same sums.	A final hearing in the Confiscation Proceedings is scheduled for 06 and 07.11.14. Any further prosecution evidence must be served by 11.07.14.

Note: POL's instructions since August 2013 have been that no new summons are to be issued. There are therefore no new live cases being prosecuted. However there have been cases where full and frank admissions have been made which could be prosecuted without the need for independent expert evidence on the Horizon system, and where substantial recovery could have been made if successfully prosecuted. POL has been developing a new policy for criminal prosecutions, with a discussion draft due to be delivered within the next month.

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POST OFFICE LTD EXECUTIVE COMMITTEE

Health & Safety Report

1. Purpose

The purpose of this paper is to:

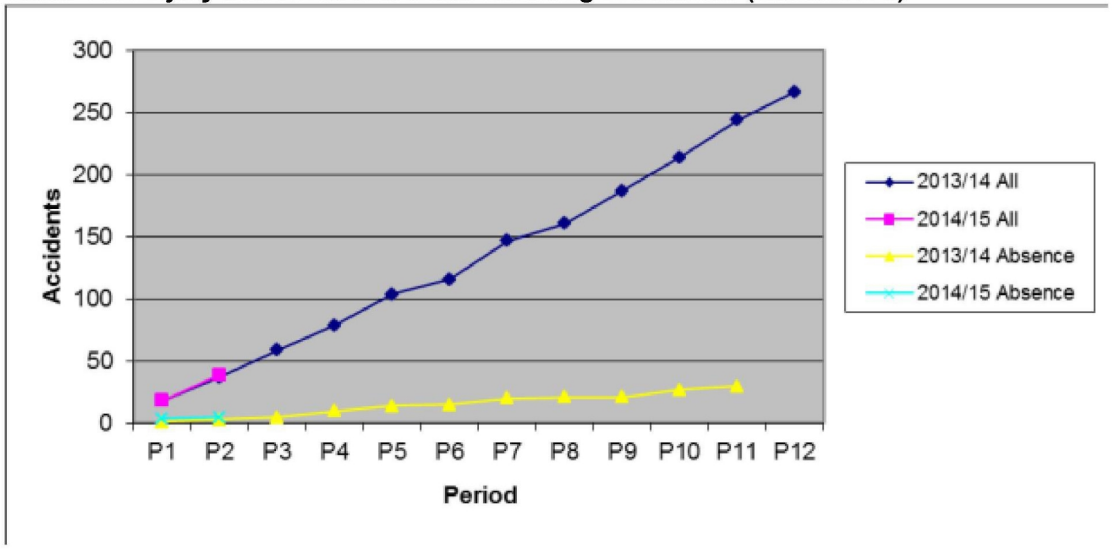
1.1 Provide an update on safety performance.
1.2 Outline risk reduction activities.

2. Current Situation

2.1 The majority of accidents fall into three main categories lifting and handling, stepping and striking and outdoor falls. These are higher frequency events with, in the majority, relatively low severity. The lower frequency types of incident can carry the potential for very high impact, for example, assaults and road traffic collisions.

2.2 All safety KPIs for 2013/14 were met or exceeded. Performance during the first two months of 2014/15 indicates that at this early stage of the year there is no current cause for concern that further reductions by year end are achievable and in line with the 5% year on year reduction target.

Table 1 All Injury accidents and those resulting in absence (Cumulative)



2.3 The number of days lost due to accidents continues on a positive trend and all indications, at this early stage, are that the year on year reduction target of 5% will be achieved. This reduction is predominantly due to the absence of major injuries and indicates that not only is there a favourable trend in the frequency of accidents there is also a favourable trend in a reduction of the severity of those accidents. (Table 2 below refers)

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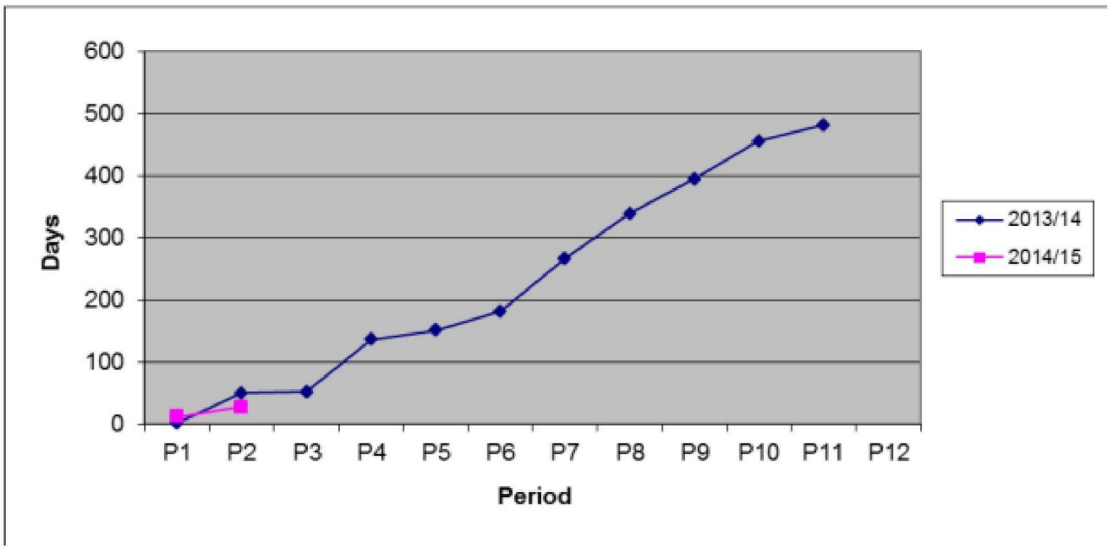
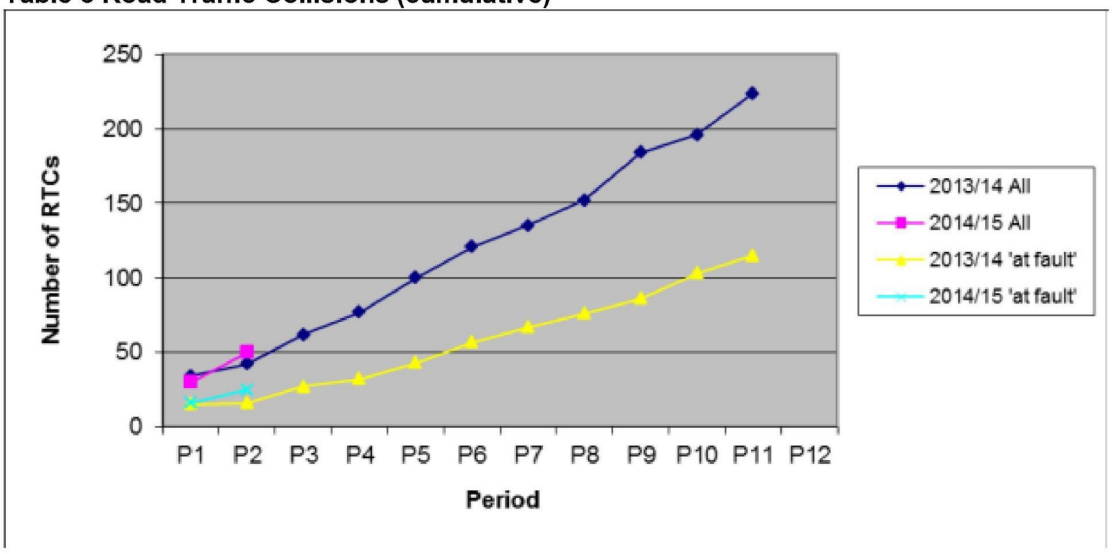
Table 2 Days lost resulting from injury accidents (Cumulative)



2.4 The total number of road traffic collisions (RTCs) for the first two months is up 8 on last year. This continued increase is believed to be related to a more robust approach to the reporting of incidents, no matter how minor, and what appears to be an increase in minor incidents e.g. broken mirrors. The number of incidents where the Post Office driver is 'at fault' is also up compared to last year. (Table 3) Road risk reduction opportunities continue to be the subject of analysis at the Road Risk Forum with a view to identifying improvement activities in addition to those already in place. (3.1 below) Reversing incidents are currently a cause for concern and will be the subject of additional attention. Injuries as a result of road traffic collisions are extremely infrequent. Road traffic collisions account for less than 3% of the overall number of injury accidents, however they have the potential for high impact in terms of injury and loss.

Table 3 Road Traffic Collisions (cumulative)



2.5 Robberies on Post Office Cash and Valuables in Transit (CViT) crews are up one on last year from 7 to 8 for the first 2 months. Physical injuries during

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robberies, of which there have been 2, similar to last year, remain relatively minor in severity. There is a reducing trend in the use of firearms with 1 of the 8 robberies enabled by the presence and/or threat of use of fire arms and on no occasions were the firearms discharged. Support for those affected by robberies is provided by trained trauma supporters and professional support resources available through the occupational health service provision. Risk reduction activities are identified at 3.2. (Appendix 1 – Significant Incidents refers)

2.6 Robberies and attempted robberies on the Post Office network, for the first two months, are higher than last year – 16 compared to 12 – 50% were successful. Despite the increase in incidents injuries sustained during robberies are down from 4 to 1. Robberies take place predominantly at sub post offices leaving Crown branches largely unaffected. Supporting activities have been introduced to continue to mitigate this risk and are identified at 3.2. (Appendix 1 – Significant Incidents refers).

2.7 Burglaries and attempted burglaries (which do not involve personal attack) have increased from 16 to 33 compared to the same 2 month period last year – 5 of the 33 incidents were successful. Risk mitigation activities are included in 3.2.

3. Activities

3.1 Road Risk

Current activities to mitigate road risk are:

- Road risk forum in place to scope and develop road risk reduction initiatives and activities with guidance from insurers risk management division.
- Review of policy and guidance for non-operational drivers e.g. business car drivers
- Analysis and deployment of interventions for reversing incidents
- Eye sight checks for operational drivers are in place
- Technical accident reduction interventions on new vehicles e.g. Reversing aids
- Analysis and evaluation of data (e.g. risk profiles) to determine further accident reduction interventions
- Safety team input and concurrence for vehicle specification and changes
- Safe driver of the year award
- Weekly case conferences to ensure consistent approach to accident investigation, follow up activity and sharing of best practice

3.2 Robbery/Burglary Risk

Current activities to mitigate robbery and burglary risk are:

- Active liaison activities with the police and increased police support activity
- Liaison with Met. Police on the increase in gun enabled robberies
- Introduction of new deterrent technologies e.g. DNA taggant – a solution that contains a unique identifier that is released automatically in the event of a robbery, spraying those involved and enabling identification of the individuals involved in the robberies
- Significant reduction in opportunities for duress type robberies linked to the introduction of single person vehicles
- Increased security support visits to Post Offices in 'hotspot' areas
- Increased use of crime alert communication techniques to Post Offices
- Trialling new point of transfer arrangements to reduce exposure
- Fogging technology

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- Safe time locks
- Increased use of surveillance vehicles
- A three month 'Crime stopper' campaign in the West Midlands has commenced, aimed at reducing cash in transit robberies

3.3 Health and Wellbeing

Current activities to enhance wellbeing

- Programme of visits to all Post Office sites to offer and encourage the use of health check equipment that provides a wide range of indicators on physical wellbeing
- Plans in place to re-visit all Post Office Crown Branches and Supply Chain sites within 18 months
- Health and wellbeing 'Team Talk' modules
- Health and wellbeing poster themed campaigns
- Online wellbeing monitoring tool to support health check initiative
- Roll out of mental health awareness programme

3.4 Safety

The Post Office occupational health and safety management system (OHSMS) is certified by external auditors to the standards required by British Standard OHSAS 18001.

3.5 Asbestos Management

Transfer of the ownership of asbestos management following separation has led to a programme of actions to ensure that up-to-date surveys are available, defined responsibilities post-split are clear and that an asbestos management 'action plan' is in place to ensure that these issues can be managed effectively and in line with legislation. Professional advice and support continues to be available via RMG. Legal Services have been engaged to assess the responsibilities, particularly in relation to the agency network, and to ensure arrangements for on-going management of asbestos are robust and risks mitigated.

4. Residual Risks

4.1 Driving activities have the potential for high impact/loss and therefore remain as a significant residual risk. However, the actions identified in 3.1 above are aimed at mitigating that risk and improving performance.

5. Recommendation

The ExCo is asked to:

5.1 Note the overall safety performance
5.2 Note the risk reduction activities.
5.3 Note the residual risks

Neil Hayward
June 2014

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Appendix 1

Significant Incidents (Period 2)				
Crowns and Network				
Location	**Loss**	**Circumstances**	**Physical Injuries**	**Any further details**
GRO				

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POST OFFICE LIMITED EXECUTIVE COMMITTEE

Cyber Security and Information Assurance

1. Purpose

The purpose of this paper is to:

1.1 Update ExCo on UK and industry Cyber Security initiatives;

1.2 Update ExCo on key Information Security and Assurance Group (ISAG) activities;

1.3 Outline risk reduction activities being implemented at Post Office in Cyber Security;

1.4 Agree onward submission of this paper to the Board.

2. UK and industry Cyber Security initiatives

2.1 Cyber Security Essentials

From 1st October 2014, the Government will require suppliers bidding for certain Government information handling contracts to be Cyber Essentials certified. This initiative was reported on in the previous Cyber Security and Information Assurance ExCo/Board papers, although the scope has only recently been confirmed.

The Government Services team have been alerted to this scheme to ensure that they are aware for any potential Government contracts.

As previously reported the scheme focuses on 5 mitigations, within the context of the previously published '10 Steps to Cyber Security'[1], which raised the need for company Boards and senior executives to take ownership of these risks and embed them into the overall corporate risk strategy.

ISAG have already considered actions that may affect our business should Post Office be required to certify to this scheme.

2.2 Information Commissioners Office Consultation on CCTV Code of Practice

The ICO has launched a consultation on their revised CCTV Code of Practice; the consultation closes in July 2014. The aim of this revision is to reflect the developments in existing technologies that have taken place since the last revision, to discuss the emergence of new surveillance technologies and the issues they present, to explain the impact that new case law has had on the area of surveillance systems and to reflect the wider regulatory environment that exists when using surveillance systems.

Whilst it is not anticipated that the new Code of Practice will have a material impact on what the Post Office already has in place, the Physical Security team have been advised that they should review any CCTV related policies once the final version is published, to ensure it remains in line with the regulator's

[1] 10 Steps to Cyber Security – HMG 2012

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requirements. The Surveillance Camera Commissioner's Code of Practice remains unchanged.

3. Activities/Current Situation

3.1 Master Service Agreement

Both Post Office and Royal Mail Group (RMG) respective ISAG's are currently engaged in a project to ensure that roles and responsibilities of 'contractors' are defined in order to determine access rights to RMG Services and Systems.

ISAG are engaged with HR and IT Service desk on this initiative and it is expected that completion will be by end of June.

Additionally improvements to the Joiners/Movers/Leavers process have been developed to ensure we have more clarity around the permanent/contactor workforce, highlighting any higher risk roles. The improvements have resulted in data access right improvements and a new policy and process for review with HR.

3.2 Management of Information Security Incident Activities

An initiative looking into Incident Management has been setup to review the key process and accountabilities, define scenarios to test the end to end design and report on recommendations to all stakeholders. The review will also identify all risks and issues associated with the running of the service.

An Incident Management process update is now in draft and being reviewed by POL and ATOS for implementation.

3.3 Information Security Incident Position

There are currently 5 active incidents or breaches that ISAG are aware of; out of those, 6 were discussed at the Information Security Committee (5th June 2014) where formal closure was agreed.

All incidents are analysed to ensure lessons learnt are incorporated into BAU operational processes.

At the time of writing this report, all outstanding incidents are assessed as being 'Low' risk to the business.

3.4 Programme/Project Governance

'Self Service Kiosk' (SSK) and 'Mortgage Brain' projects that were referred to in the last Board paper have again been subject to formal risk acceptance and on-going review. The report on SSK is due from our external Penetration testing company, but is expected by 25th June 2014, with the position to take forward agreed by 27th June 2014, taking into consideration project Ivy.

There is only one outstanding issue with Mortgage Brain, which is not thought to be a major concern, whilst the risk is assessed as being 'Medium' the likelihood is 'Low' that the vulnerability would be compromised. The Risk Acceptance Notices have been updated and are with the Project Managers to obtain ExCo sign-off.

3.5 Marketing

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Marketing continues to be an area which needs a higher level of consideration particularly in relation to the use, disclosure and handling of personal data. The Common Digital Platform project provides an opportunity to review their current practices and to ensure appropriate policies and procedures are implemented to reduce the risk of non-compliance to the current UK Data Protection legislation. ISAG have raised some issues with Marketing and will continue to engage with them to provide the necessary support.

The Brands Database will continue to be a high level risk to the business, and this will be raised through the corporate Risk Register, although work is in progress by Marketing to reduce risk through contractual and practical mechanisms. See 3.7 for Business Impact/Privacy Impact.

3.6 HR and Vetting

As part of a project to review the online recruitment process, it has been identified that certain vetting checks are not undertaken by HR as part of the pre-employment screening process, in particular the verification of employment history. This is in breach of a number of the Post Office's client agreements, including DWP and the DVLA. ISAG are in discussions with HR to establish which checks are routinely undertaken and identify where the potential gaps are that will need to be filled. Until this situation is resolved this item will be reflected in the ISAG Risk Register.

3.7 Business Impact Assessment/Privacy Impact Assessments

The programme of engaging with ExCo Directorates has kicked-off, the first meeting has taken place with Martin George – Chief Marketing and Commercial Officer. As expected the most critical area of concern for this area is Customer Data.

Depending on ExCo members diaries, the complete high level report will be available mid-July 2014, which will provide details of critical information, ownership and who the ExCo direct reports are that have responsibility for said critical information. It is hoped that this information, when complete, will be useful to other Post Office business areas to enable a more informed view of information risk across our business and who is the 'owner' of the risk.

The information collected from ExCo members will form the foundation of the data within the new Governance Risk and Compliance Tool. Identified ExCo direct reports will provide the next and deeper level of information which will provide meaningful reports on the information risk levels across the business, and to track and measure these in order to mitigate risk.

3.8 Training and Awareness

The new and combined Information Security and Data Protection e-learning training has commenced across Post Office, including the contractor community. The current completion statistic stands at 92% for e-learning modules.

Non-completers are being identified to their line managers for encouragement to complete the training.

ISAG are engaged with HR representatives to ensure ISAG policies are reflected in colleague induction, communications and HR policies. HR and ISAG will agree dates for outstanding actions over the next 2 weeks.

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The Information Security and Data Protection Training and Awareness campaign will be reviewed at least annually and spot checks will be undertaken to ensure colleagues are adhering to various aspects of the e-learning to ensure that the training is effective.

This type of training is 'good practice' across all industries and is a mandatory requirement for our information security certifications (Payment Card Industry and Information Security Standards').

3.9 Resourcing and Recruitment in ISAG

ISAG are currently recruiting into 6 roles; 4 new roles and 2 replacement roles.

The new Data Protection Officer – Kim Thomson is now in post. Kim is highly experienced and comes to us from Financial Services and a Big 4 Consultancy.

The advertised vacancies are for 1 Data Protection Manager, 1 Senior Information Security Risk Manager, 2 Information Security Compliance Managers, and 2 Information Security Technical Architects. These are all specialist roles requiring professional qualifications and accreditations in Information Security.

4. Request

4.1 ExCo is asked to note:

- The updates provided in this paper.
- The next and subsequent papers will be submitted at two month intervals.

Julie George/Lesley Sewell
23rd[h] June 2014

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POST OFFICE LTD BOARD

Colleague Offers – Noting Paper

1. Purpose

The purpose of this paper is to:

1.1 Update the Board on the status of colleague offers.

2. Background

2.1 Colleague advocacy of Post Office products is a key enabler for on-going sales success, with 'customer offer' (confidence in products) one of the 3 key drivers of Subpostmaster engagement, as referenced in the January 2014 Board Paper 'Update on Subpostmaster Engagement Metrics'.

2.2 Consistent with a belief in the service profit chain, there is a commitment to increase colleague engagement by improving the offers available to colleagues relating to Post Office products and services.

2.3 To enhance colleague engagement and strengthen direct relationships between employer and employee, there is also an opportunity to better demonstrate the total reward proposition which includes colleague offers.

2.4 In recent Engagement Surveys the willingness for employees to recommend Post Office products and services fell from 78% in Spring 2013 to 65% in Oct 2013 (v's UK retail norm of 70%). This downward trend needs to be reversed.

2.5 Current colleague offers are largely limited to Financial Services products with the take-up volumes of Post Office products being relatively low. During the financial year 13/14 there were just under 6,000 colleague sales with 4,500 of these in Travel Insurance, an offer that is also open to Royal Mail colleagues.

2.6 Since the launch of free Broadband over 2,000 existing colleague customers have switched to the new offer, and a further 400 colleagues have submitted new applications.

2.7 In the context of colleague offers, colleagues are defined as 'Post Office employees, Subpostmasters and their employees that work directly on Post Office business'. Offers will be made available to Royal Mail staff on an individual product basis.

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3. Improving our colleague offers to drive advocacy

3.1 All product teams are undergoing a review of their existing colleague offers and fulfilment processes in order to introduce new improved colleague offers. To enhance and maintain the reputation of colleague offers it is essential that they are compelling to colleagues. The list of current offers, as well as proposed and new offers is in table 1.

Table 1: Post Office Ltd Colleague Offers

Product	Current	Proposed/ New	Live date
Mails	No offer	Discounted rates	Product team undergoing commercial & fulfilment review
Retail	5 - 15% discount	15%	LIVE MAY
Travel Money	No offer	Discounted rates on 7 currencies	LIVE MAY
Travel Insurance	25% off annual, 15% off single	No change	LIVE
Telecoms		FREE BROADBAND	LIVE - March 24th
Credit Card	21 MONTHS % ON BALANCE TRANSFERS (v's 18 month customer offer)	No change	LIVE
Mortgages	No offer	£500 cashback	LIVE date to be confirmed by end of May
Life Insurance\ Over 50s Life Cover	£50 cashback	£100 cashback	Product team reviewing commercial viability
Motorcycle Insurance	10% annual discount	No change	LIVE
Car Insurance	10% discount year 1 + FREE Breakdown Cover	No change	LIVE
Home Insurance	25% discount year 1	No change	LIVE

3.2 Colleague offers are currently taken up through a variety of offer codes or a pay number through existing channels. Work is underway to make this a consistent process and therefore simpler for colleagues. In addition a colleague convenient method of applying discounts to transaction products such as mails and travel money is being scoped.

4. Colleague Communications

4.1 An enhanced communications plan (table 2 overleaf) has commenced to ensure that all colleagues, in all parts of the business are aware of the colleague offers. Previously offers have been communicated through a static page on the intranet and ad-hoc initiatives. Now the communications activity is split into 2 categories:

- Quarterly reminders of all colleague offers in circulation.
- Launch of specific offers giving single-minded coverage and focus on 'hero' offers e.g. FREE Broadband, £500 Mortgage cashback.*

*Available only via Mortgage Specialists in branch.

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4.2 These are communicated via all existing channels such as the Mypostofficeofficeplus intranet site, whilst Subspace Online provides access to Subpostmasters. These activities are complimented by 'one-offs' such as desk drops and leaflets.

4.3 Further work is underway to dramatically enhance the communication of colleague offers in order to significantly increase take-up levels, given the importance of colleague advocacy.

4.4 The disappointing take-up to date of the 'free broadband' offer demonstrates the urgency of understanding why colleagues have not responded more positively. Work is underway to understand this in detail and respond accordingly.

Table 2: Colleague offer communications plan

	March	April	May	June	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	March
Current colleague offers													
Current Travel Offers													
FREE Broadband													
Retail 15%													
Travel Money Card													

Current offers
Audience: ALL colleagues
Media used:
SPMRs & colleagues: Subspace online, offer booklet, Subspace.
Crown: mypostofficeplus.co.uk, offer booklet, wow,
HQ: mypostofficeplus.co.uk, offer booklet

New offers
Audience: ALL colleagues
Media used:
SPMRs & colleagues: Subspace online, offer leaflet, Subspace, branch focus
Crown: mypostofficeplus.co.uk, offer leaflet, wow, teamtalk, branch focus, in vision
HQ: mypostofficeplus.co.uk, offer leaflet, in vision, banners

5. Commercial Impact

5.1 The principle behind all colleague offers is that they are to breakeven for the business within each Product P&L, with communications costs accommodated within existing Marketing and Communications budgets; each offer will be evaluated by the Finance team. The total cost of communications during the year is not expected to exceed £20,000.

5.2 The commercial benefit arises from increased colleague product take-up resulting in enhanced advocacy, creating an increased propensity amongst colleagues to recommend and sell Post Office products and services.

5.3 There is a strong belief that colleague advocacy also enables improved customer service which in turn is a strong driver of profit.

5.4 As part of product development process all colleague offers are screened to ensure there are no tax issues for either the Post Office or colleagues taking advantage of the offers.

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6. Key Risks

6.1 The key risk is the abuse of colleague offers by 'non-colleagues'. This is currently mitigated by the need for promotion codes and pay numbers when applying. A potential solution is through an employee card that is currently being scoped. Sales will be closely monitored to mitigate this risk.

7. Recommendations

7.1 The Board is asked to:

- Note the update on the status of colleague offers.

Martin George & Neil Hayward
April 2014

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Current Actions and Decisions Log

ExCo Meeting 23 April - Actions and Decisions

23/04/23	Action 7	Explore the opportunity using the Alarm response centre to provide care for customers; possibly as part of the home insurance market. Update 08/11/13: Alarm monitoring – discussions can take place once contracts have been signed with the selected vendor for the provision of Grapevine and alarm monitoring services as part of the separation from RMG. This is likely to be April 2014. Update 16/06/14 - Due to delays by RM in the provision of FM and Grapevine services we won't be in a position to award contracts until 8 July 2014 this year. Following that date we can commence discussions with the alarms provider about an extension of the service.	HC/MM (PB)	August

ExCo Meeting 19 November - Actions and Decisions

19/11/04	Action 4	Update on Horizon Conclude legal advice on obtaining documents from SS. Update: Chris Aujard has formally written to SS requesting disclosure. We are waiting for their formal response.	CA	

ExCo Meeting 13 February - Actions and Decisions

13/02/03	Action 2	Project Sparrow (Business Improvement Process) Report back to ExCo on the effectiveness of HORice pilot.	AVDB	July 3 ExCo
13/02/06	Action 5	Project Sparrow (Business Improvement Process) Discussion on future ExCo agenda on the cash ownership and business model for the network. Update: Added to July ExCo agenda	AL	July 3
13/02/08	Action 2	Project Sparrow (Prosecutions Policy) Introduce a new management metric to measure the	AVDB	July 3

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		Business – losses Support – spmr engagement Programme – efficiency cost Possibly covering To report to ExCo every quarter		

ExCo Meeting 18 February - Actions and Decisions

18/02/06	Action 1	Transformation Board Communicate to SLT the new Governance structure and their role in holding ExCo to account. Update 13/06/14: RZW is progressing this action.	AL/AT/MD	End June In progress

ExCo meeting 13 March – Actions and Decisions

13/03/19	Action 6	Corporate Governance CA to share the internal audit plan with ExCo.	CA	End of March
13/03/44	Action 1	BPMA Request from BPMA to ask colleagues if they would like to contribute to the funds being sought to deliver the Mail rail project. Update 13/06/14: MD in progress	PV/MD	In progress

ExCo meeting 18 March – Actions and Decisions

18/03/08	Action 8	Finance Report – Government Contracts Circulate to ExCo a table showing Government contract coming up for renewal in 2014/2015 and the likely effect on the plan.	MG	April ExCo

ExCo meeting 15 April – Actions and Decisions

15/04/20	Action 2	Network Board papers Mike Granville to provide a paper to look at the effect of the run up to	MD/Mike Granville	In progress

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		the last election on the Business and the influence of manifestos. Update 13/06/14: Mike Granville and Jane Hill preparing a paper.		
15/04/32	Action 1	Policies Future policy papers to give more content to the policies and how they will be communicated.	CA	

ExCo meeting 22 April – Actions and Decisions

22/04/06	Action 4	Transformation Committee Layla Wildon to provide a framework for programme assurance and recommendation for use by sponsors.	CA	

ExCo meeting 8 May – Actions and Decisions

08/05/01	Action 1	Strategic Risk Produce a communications plan to explain the strategic risks to the SLT and Business – highlighting how the business is managing the risk through mitigation actions. Updated 13/06/14: In progress.	CA/MD	End of June In progress
08/05/03	Action 3	Strategic Risk – Industrial Relations Ensure business changes and events are fed into the IRSG early enough to enable engagement with unions and staff.	All	Ongoing
08/05/04	Action 4	Strategic Risk – Industrial Relations Risk owners to consider how they will report back to ExCo and feed this into their risk document.	Risk owners	
08/05/06	Action 6	Strategic Risk – Industrial Relations ExCo to consider the impacts on IR of work being carried out in their functions and flag to Alison Thompson via HR business partners.	All	End of May
08/05/07	Action 7	Strategic Risk – People and Capability ExCo to provide a note to Neil to highlight any capability gaps in their teams.	All	End May
08/05/08	Action 8	Strategic Risk – People and Capability Contracts for contractors to include a long enough notice period for business protection.	NH	End of May

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08/05/11	Action 10	Strategic Risk – Operating Model ExCo members to check who are their reps on the Information Security Committee and ensure they have the right people representing them and they attend. Update 25/06/14: Peter Goodman is Finance Rep.	All	End of May
08/05/13	Action 12	Strategic Risk – Financial Services Set agenda time on a future ExCo for a deep dive into Financial Services after the June Board away day. To include, risks, dependencies and links within the business.	NK/AL	Sept/Oct
08/05/14	Action 13	Strategic Risk- Risk Appetite Feedback to Dave Mason any comments on the Risk Appetite paper. Dave to update and set up an ExCo session on risk appetite after the June Board away day.	ExCo/DM	July
08/05/15	Action 14	Strategic Risk – Contingency Risk Paula to discuss the contingency with Chris D to decide how the ExCo take the lack of contingency risk forward.	PV/CD	
08/05/16	Action 15	Strategic Risk – Contingency Risk Chris Day to share the finance stress testing of the plan with the ExCo, to ensure contingencies are identified for the big programmes.	CD	
08/05/21	Action 1	Update on Industrial Relations Next couple of months session on IR at the ExCo	NH/AL	
08/05/22	Action 2	Update on Industrial Relations Neil to send out a briefing note the ExCo on HO managers pay and time lines for communications and how this aligns to Business Transformation change.	NH	End of May
08/05/25	Action 1	Colleague Offers paper Representatives from Internal Comms team/Marketing team/HR team to meet to consider how we operationalize the colleague offers to feed back to the Commercial Committee. Updated 11/06/14 – A meeting is being organised between Marketing and HR to get this action completed.	FH/MG	Ongoing
08/05/31	Action 4	Data Centre Procurement (pre ARC) Adnan to produce a draft learning sheet to use within the business.	CA	In progress

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08/05/32	Action 1	TFL – Audit protocol guidance CA to update the paper and recirculate. Each Director responsible for large contracts would approach legal team to ensure correct protocols are followed before anything else is done. Noted: DR will brief out BTr programme team. UPDATED PAPER SENT OUT BY CA ON 26 JUNE 14	All ExCo	
08/05/33	Action 2	TFL – Audit protocol guidance All new contracts to consciously consider audit rights in new contracts.	CA	
08/05/34	Action 3	TFL – Audit protocol guidance Put the policy on the intranet and ensure it is well communicated. Updated 13/06/14: MD meeting CA to progress	CA/MD	In progress
08/05/36	Action 5	TFL – Audit protocol guidance Internal Audit to recommend best practice for assurance activity for the large programmes.	CA	
08/05/37	Action 6	TFL – Audit protocol guidance Decide on the best approach to ensure the intranet is effective with the possible use of a super administrator. Updated 13/06/14: MD to discuss at 1:1 with NH to progress.	MD/NH	In progress
08/05/40	Action 3	Business Transformation ExCo members to discuss individual initiatives and projects with David Ryan to ensure conscious decisions are made and where possible no regrets.	ALL	

ExCo Meeting 4 June 2014 - Actions and Decisions

04/06/04	Action 3	Review ExCo agendas to challenge whether items are proper to ExCo	AL	End June
04/06/09	Decision 1	Systems Access and Data Security ExCo supported the decision to send the MSA letter to RMG.		

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ExCo Meeting 9 June 2014 - Actions and Decisions

09/06/01	Action 1	Risk & Compliance Piece of communication needed to explain risk management and risk protocols particularly as we move into Business Transformation. Updated 25/06/14: MD and CA met to progress further	MD/CA	End June
09/06/01	Decision 1	Risk & Compliance Business owner to have final sight of the paper and be invited into the room when their projects are discussed at ExCo.	CA	
09/06/01	Decision 2	Risk & Compliance ALL ExCo to receive all Sub Committee papers for information	AL	
09/06/01	Action 2	Risk & Compliance Retable Xanadu report at the next R&CC meeting after conversation with LS & MG (report to cover the whole process and any ongoing risks).	MG/LS/CA	Next R&CC
09/06/01	Action 1	Commercial Committee Circulate the Ivy information to be used at the Board Awayday	MG	10 Aug
09/06/01	Action 2	Commercial Committee Commercial Committee to circulate agendas, paper and minutes/ actions to the whole ExCo. (Agendas to include: 1 – Short term commercial actions 2 – Longer term 3 or 4 projects)	MG	
09/06/01	Action 1	AOB Slot on Performance Meeting Agenda to cover all ExCo Committee verbal updates.	AL	
09/06/01	Action 2	AOB Communicate the outcome of the Board Away day to the SLT Top 400 as part of TeamTalk Live on 24 July (include hard hitting messages, transparency, what does it mean for people). Updated 13/06/14: MD to discuss at 1:1 with NH to progress.	MD/NH	In progress
09/06/01	Action 3	AOB Ways of Working paper for Business Transformation to be circulated to the ExCo. David to feedback to individual ExCo on their team's	DR	

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		responsibilities		
09/06/01	Action 4	AOB ExCo to check with their representatives on the Transformation steering group that they are comfortable with their role and the time commitment.	All	
09/06/01	Action 7	AOB ExCo offsite before the Board Away day next year.	AL	

ExCo Meeting 16 June 2014 - Actions and Decisions

16/06/01	Action1	Board Away Day Feed into Paula by Thursday thoughts on the 14 priorities circulated.	Those at away day	19 June
16/06/02	Action 2	Board Away Day By end of week owners lay out key principles which sit below the 14 focus areas.	MD/ME/NH/MG/KG/ NK	20 June
16/06/03	Action 3	Board Away day Those not at Away day will meet Paula for debrief and feed into the 14 priorities.	PV/ME/LS/NK/MD/ CA	18 June
16/06/04	Action 1	July 4 – SLT meeting Need to explain what 'get out of the way' means for SLT and governance changes on July 4th.	ME/AL/MD	
16/06/05	Action 2	July 4 – SLT meeting Digital session at July 4th session and share advertising.	AL/MG/MD	
16/06/06	Action 3	July 4 – SLT meeting Share advertising with ExCo next Monday	MG/MD	23 June
16/06/08	Decision 1	July 4 – SLT meeting Monday 10 – 11am no agenda, no papers then optional ½ hour for specific items may not need all ExCo.		
16/06/09	Action 1	DVLA contract Need to look at DVLA contract to understand the liability risks and how we will take forward. Email out to ExCo to explain what has happened and governance included.	LS/CA	

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16/06/11	Decision 1	Supply Chain Board paper Replace directorate with team		
16/06/12	Action 1	Finsbury Dials Harry to come back to the ExCo with the plan.	AL/HC	Coming to 8 Jul ExCo
16/06/13	Decision 1	Finsbury Dials ExCo to own the move to Finsbury Dials, the culture, the layout etc.		
16/06/14	Action 1	Sparrow Chris A to do an update note to the ExCo and the Board	CA	17 June
16/06/16	Action 2	Performance Need to be clear about 14/15 initiatives and where in the Business they will be delivered to get to the pre-McKinsey baseline. Allocate stretch cost reduction targets into the business. Note to the ExCo to clarify. Update: DR to confirm Business Transformation baseline with CD and update ExCo.	DR/CD	To be completed before next Performance Meeting.
16/06/17	Action 3	Performance Consider mails segregation and possible approaches to mitigate the £6m risk.	MG	
16/06/18	Action 4	Performance Pick up narrative at the Commercial Committee to decide how the metrics narrative document is to be populated.	Com Com	
16/06/19	Action 5	Performance Neil H to discuss the metrics People with his team to understand the actions in place to drive the people results. To come back to a Monday morning ExCo.	NH	
16/06/20	Action 6	Performance Circulate summary of income actions plans to the ExCo – after Commercial Committee debate.	MG/KG/NK	