FSA reports on failure of RBS

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The Financial Services Authority (FSA) has published its Board's Report into 'The failure of the Royal Bank of Scotland' (RBS).

The Report concludes that RBS's failure amid the systemic crisis ultimately resulted from poor decisions made by the RBS management and Board. But deficiencies in the global capital regime and liquidity regulations made the crisis much more likely. In addition, flaws in the FSA's supervisory approach provided insufficient challenge to RBS.

Specifically, the Report concludes that the failure of RBS can be explained by a combination of six factors:

- significant weaknesses in RBS's capital position, as a result of management decisions and permitted by an inadequate global regulatory capital framework;
- over-reliance on risky short-term wholesale funding, which was permitted by an inadequate approach to the regulation of liquidity;
- concerns and uncertainties about RBS's underlying asset quality, which in turn was subject to little fundamental analysis by the FSA;
- substantial losses in credit trading activities, which eroded market confidence. Both RBS's strategy and the FSA's supervisory approach underestimated how bad losses associated with structured credit might be;
- the ABN AMRO acquisition, on which RBS proceeded without appropriate heed to the risks involved and with inadequate due diligence; and
- an overall systemic crisis in which the banks in worse relative positions were extremely vulnerable to failure.

 RBS was one such bank.

The multiple poor decisions that RBS made suggest, moreover, that there are likely to have been underlying deficiencies in RBS management, governance and culture which made it prone to make poor decisions. The Report, therefore concludes that these underlying deficiencies should be considered as a seventh key factor in explaining RBS's failure.

FSA chairman, Adair Turner, said:

"People want to know why RBS failed and why no-one has been punished. This Report aims to answer those questions. It describes the errors of judgement and execution made by RBS executive management which, in combination, resulted in RBS being one of the banks which failed amid the global crisis. These were decisions for whose commercial consequences the RBS executive and Board were ultimately responsible.

"It describes, however, why the FSA's Enforcement Division concluded that there was not sufficient evidence to bring enforcement action which has a reasonable chance of success in Tribunal or court proceedings.

"The Report also reinforces the conclusion that the global capital standards applied before the crisis were severely deficient and liquidity regulation was totally inadequate. Banks across the world, including RBS, were operating on levels of capital and liquidity that were far too low. These prudential regulations have been changed radically since the crisis, with the internationally agreed Basel III standards.

"Had Basel III been in place at the time, not only would RBS have been unable to launch the bid for ABN AMRO, but it would have been prevented from paying dividends at any time during the Review Period, i.e. from at least 2005 onwards.

"In addition, the Report concludes that the FSA was too focused on conduct regulation at the time and its prudential supervision of major banks was inadequate. The FSA operated a flawed supervisory approach which failed adequately to challenge the judgement and risk assessments of the management of RBS. This approach reflected widely held, but mistaken assumptions about the stability of financial systems and existed against a backdrop of political pressures for a 'light touch' regulatory regime.

"The Report describes a historic approach to supervision, and one that has been radically reformed since 2007. The FSA is a different organisation now. We have more resources, better skills, a more intensive approach and far greater focus on capital, liquidity and asset quality.

"The Government has decided to split the FSA and create two new regulators, a Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA). It has also established a Financial Policy Committee (FPC), with the responsibility to identify and respond to emerging systemic risks. The creation of the PRA, focused exclusively on prudential issues rather than spanning both prudential and conduct concerns, and of the FPC, will ensure that focus on prudential and systemic risks is maintained even when most of the world assumes, as it did before the crisis, that prudential risks are low."

Many of the reforms required in response to the lessons highlighted in this Report have already been implemented. But in addition, Adair Turner proposed two key policy areas where further significant change should be considered. Firstly, he recommends that major bank acquisitions should in future, require explicit regulatory approval. And secondly, he calls for a public debate about changes to rules, laws or remuneration policies which would ensure that bank executives and directors face personal consequences as a result of bank failure.

Adair Turner concluded:

"The fact that no individual has been found legally responsible for the failure begs the question: if action

cannot be taken under existing rules, should not the rules be changed for the future?

"In a market economy, companies take risks on behalf of shareholders and if they make mistakes, it is for shareholders to sanction the management and board by firing them. But banks are different, because excessive risk-taking by banks, for instance through aggressive acquisitions, can result in bank failure, taxpayer losses, and wider economic harm. Their failure is a public concern, not just a concern for shareholders.

"We should, therefore, debate policy options to ensure that bank executives and boards strike a different balance between risk and return than is acceptable in non-bank companies. Two broad ways to achieve this could be considered:

- i. A "strict liability" approach, making it more likely that a bank failure like RBS's would be followed by successful enforcement actions, including fines and bans;
- ii. An automatic incentives-based approach involving either rules which automatically ban senior executives and directors of failed banks from future positions of responsibility, or major changes to remuneration to ensure that a very significant proportion of pay is deferred and forfeited in the event of failure.

"There are important pros and cons of these different ways forward, and complex and important legal issues which would need to be considered. But by one means or another, there is a strong argument for new rules which ensure that bank executives and boards place greater weight on avoiding failure. The options for achieving this merit careful public debate. The FSA has committed to publishing a discussion paper on the options in the New Year."

The <u>full Report into the failure of RBS</u>, the Foreword by Adair

Turner and the Executive Summary are available on the FSA's website.

Commenting on the Financial Services Authority report published today

(Monday) into the collapse of RBS, SNP Westminster Treasury spokesperson Stewart Hosie MP said the findings exposed the systematic

failure of successive UK Governments to provide proper regulation of the banks.

Mr Hosie — a Member of the Treasury Select Committee — said:

"While the executive management at RBS must take responsibility for their disastrous decisions, it is clear from this report that Westminster's catastrophic regulatory and supervisory failures were the co-authors to the banking crisis.

"The admission that there were just six FSA staff engaged in scrutinising the activities of one of the world's largest banks underlines the deficiency of the controls that existed.

"Not only does the FSA report show that the UK Government was not prepared for a financial collapse, but that they ignored the warnings.

For the Shadow Chancellor, the last Labour government's age of irresponsibility is catching up with him.

"The evidence over who is responsible for the economic crisis, and the regulatory failures which contributed to it, all lead directly back to Downing Street. The failure of regulation was 'made in Downing Street'

- numbers 10 and 11.

"There are no shortage of commitments by the previous Prime Minister to put in place 'limited regulation', indeed, Gordon

Brown even pondered whether there should be any regulation at all.

"The financial incompetence of UK authorities, who have presided over the biggest boom and bust in the Western world, is a strong argument for independence, not an argument for the continuation of London mismanagement."