

# **Report on the Financial Conduct Authority's further investigative steps in relation to RBS GRG**

June 2019

## How to respond

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## Foreword by Andrew Bailey

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This report provides an extended account of the FCA's investigative work on the RBS Global Restructuring Group (GRG). It follows the announcement of the conclusion of the investigation in July 2018 and that the FCA would not be taking enforcement action as a consequence. The FCA's general approach is to publish information where we take formal action following an enforcement investigation, but otherwise we will not normally make public that we are or are not investigating a particular matter or that we have decided to conclude an investigation without taking further action. It is therefore an unusual step for us to publish such an extended account as this report. We have taken this additional step in recognition of the extraordinary level of public interest in the case of GRG, and thus that it was appropriate for the purposes both of transparency and the accountability of the FCA that we should do so.

The GRG case has raised a number of important public policy issues which have wider relevance. Principal amongst these is the impact of most of the activity of GRG being outside the scope of financial conduct regulation in the UK. Thus, lending to most small and medium sized firms was, and remains, outside the scope of our regulatory powers as defined by Parliament in legislation. The situation has, however, changed since GRG in several important respects. Two stand out: first, the Senior Managers and Certification Regime now defines the responsibilities and accountability of senior managers in authorised firms in a way which applies to all activities they conduct whether they are regulated activities or not. Second, there has been an extension of the scope of the Financial Ombudsman Service in terms of both substantially increasing the coverage to include many more SMEs, and an increase in the amount that can be awarded in such cases by the Ombudsman Service. We have received many requests for help and we have heard some very sad stories about the impact of the financial crisis and subsequent events on small business owners' personal lives. These are welcome developments which should provide more assurance to SMEs.

Turning to GRG itself, the conclusion of the independent review was that there was systemic and widespread inadequate conduct within GRG. Our investigation has found that GRG clearly fell short of the high standards its customers expected. That said, our investigation also concluded that the evidence does not suggest that management sought to treat customers unfairly. This is an important conclusion in an area that has been contentious. It does not mean that the outcomes of actions taken by RBS were always adequate and acceptable. The independent review set out that in many cases they were not. Moreover, RBS failed to place an appropriate weight on its stated objective of turning round businesses in GRG. Again, however, the evidence does not indicate that such outcomes were the stated intent and policy.

The report also sets out two important points that provide context for our conclusions. First, we are required to take into account the conditions at the time of the events. RBS was under unprecedented stress as a consequence of the severe errors made by former management in the years leading up to the financial crisis, the failure of the firm and its receipt of Government support. Management was tasked with dealing with this legacy at a time when general economic conditions had caused a severe downturn and consequent problems for many firms leading to a major increase in the number entering GRG. This context would not excuse failings by management, but we are required to take it into consideration when reaching our conclusions.

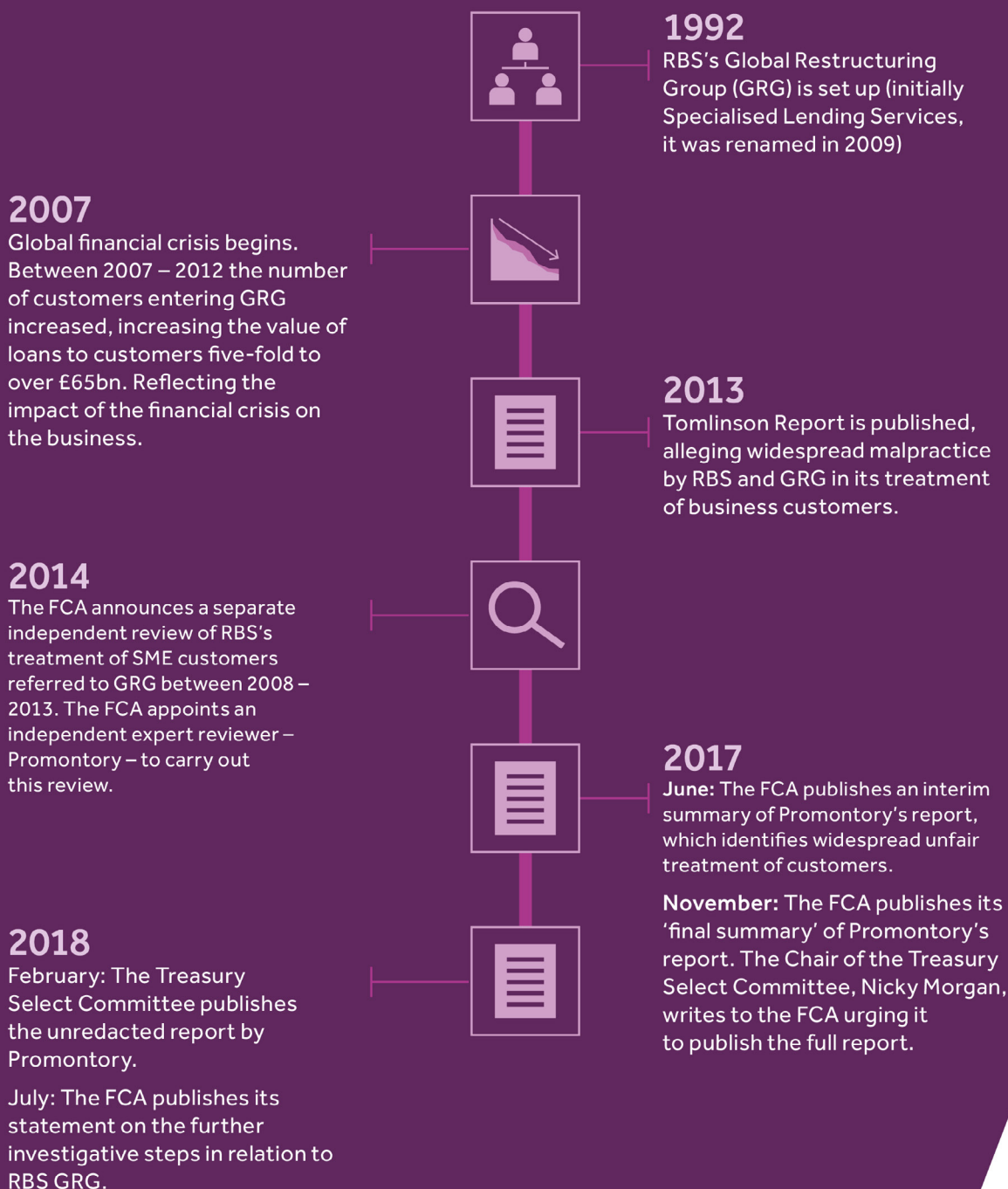
The second important piece of context follows from most of GRG's activity being outside the scope of financial conduct regulation, namely, that the governing law was contract law alone rather than the combination of contract law and FCA rules.

But in spite of the context, and the absence of evidence of deliberate intent to cause harm by management, it is clear that GRG fell short of the high standards its clients expected. RBS has acknowledged this and has established a compensation scheme overseen by a former High Court Judge. Moreover, RBS has provided the FCA with the attestation of a member of the Board that it has taken necessary actions to comply with the recommendations of the independent review. It is essential that these actions continue to be in place because, while in the current economic conditions the demand for turnaround and restructuring services has declined, the economic cycle will at some point experience a sizeable downturn. Despite the issues seen in GRG, there remains a need for banks to provide turnaround services to corporate customers.

Finally, I must acknowledge the distress felt by many of GRG's customers. The firm's relations with its customers were often insensitive, dismissive and sometimes too aggressive; these failings made an already stressful situation worse. I know that many customers of GRG therefore disagree with our decision to not take enforcement action, but I hope that this report will explain why we reached that decision.

## Timeline of events

### RBS and GRG timeline



## Executive summary

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The financial crisis of 2007 - 2010 caused critical problems for many businesses, as well as for financial institutions and public bodies. Many small and medium sized enterprises (SMEs) saw their sources of credit dry up, with lenders often demanding immediate repayment of outstanding commercial loans. As a result, many SMEs found themselves in serious financial trouble, with few or no options to get additional funding and keep their businesses afloat.

SMEs are typically seen by banks as a higher lending risk than companies with larger balance sheets and more varied or established sources of income, which can often provide greater security against the loans. Banks manage the risk that borrowers might default on their loans by putting contractual terms and covenants in place that enable them to protect the money they have lent. Many of the terms of the loan contracts with SMEs are the same as for loans to larger companies, but the negotiating position of a troubled SME is often weaker than that of a troubled large company. This weaker position which SMEs can sometimes find themselves in is due to a number of factors and sometimes outside of their control. When an SME's financial position worsens, for whatever reason, they are usually unlikely to be able to sustain losses for the same length of time as that of a larger company. These losses can sometimes have personal impacts on SME customers, for example, where the owner of an SME has given a personal guarantee and a charge over their home. SME's will also often not have access to the same resources and expertise which large companies might have. This is unfortunately sometimes the nature of being a smaller business owner.

The Royal Bank of Scotland (RBS and the bank) referred many of its struggling SME customers to the part of its business called the Global Restructuring Group (GRG). SME customers made up the minority of GRG's business during the review period - 8% of GRG's total portfolio by value and 35% by volume. GRG's stated purpose was to work with businesses to bring them back to financial health as a going concern wherever possible, while protecting RBS's bottom line. This is often referred to as GRG's 'twin' commercial and turnaround objectives.

SME customers went into GRG expecting that RBS would help their business survive. This was particularly important as, for some of them, their personal finances were bound up with their business. If the business failed they risked losing their homes and savings, as well as their livelihoods.

Once within GRG, some businesses were sold off to pay outstanding loans to RBS. Some customers lost everything.

Some customers of RBS complained to the FCA and others about the way they had been treated. Their allegations included that RBS had deliberately put potentially viable businesses into a worse position so they could be transferred to GRG, deliberately targeted more valuable businesses, and asked for personal financial guarantees when GRG had already decided it would sell or close the business.

### **GRG's activities were largely unregulated**

Regulators can only intervene in areas where Parliament has given them the legal power and scope to act. Commercial lending to RBS's GRG customers was largely unregulated and remains unregulated today. This meant that from the outset we had very little scope to take action against RBS or any individuals who worked for it, even if we found evidence of misconduct.

What we did have the power to do, however, was investigate the activities of GRG. We decided it was right to do this so that we could better understand whether the allegations made about GRG's practices were correct and, if so, consider whether the evidence might give us the ability to take action against anyone responsible, even though we knew the scope would be limited.

### **The independent review of the allegations**

The allegations against GRG were serious. So, as a first step, we used our statutory powers to ask independent experts, Promontory Financial Group (UK) Ltd (Promontory), to carry out a review of how GRG treated its customers during the period 2008 to 2013 (the review period) and whether any poor practices which it identified were widespread and systematic (the independent review).

### ***Areas where the independent review did find evidence***

The independent review identified areas where there were serious and widespread problems in the practices, processes and policies of GRG. It identified a number of instances where it appeared RBS had not treated customers fairly or reasonably, by:

- failing to comply with RBS's own policy for communicating with customers about their transfer to GRG; the standard of much SME customer communication was poor and in some cases misleading
- failing to support SME businesses in a way that was consistent with good turnaround practice
- focusing too much on increasing prices and reducing debt without properly considering the impact of this on the longer-term viability of customers' businesses
- failing to document or explain the rationale behind pricing decisions for customers after they were transferred to GRG
- failing to ensure staff made appropriate and robust valuations, and carrying out internal valuations based on insufficient or inadequate work, especially where GRG based significant decisions on these valuations
- failing to adopt adequate procedures for its relationship with customers and to ensure they were treated fairly
- failing to identify customer complaints and handle them fairly
- failing to handle the conflicts of interest in the West Register model and operation, and
- failing to use adequate safeguards to ensure that the terms of some upside instruments - Equity Participation Agreements (EPA) and Property Participation Fee Agreements (PPFA) - were appropriate

But the independent review did not find that RBS had deliberately made businesses worse off so that it could profit from GRG selling them off. In summary, the review found that:

- RBS did not set out to artificially engineer a position to cause or enable a customer to be transferred to GRG
- SME customers transferred to GRG were showing clear signs of financial difficulty
- there was no widespread practice of identifying customers for transfer for inappropriate reasons, such as their potential value to GRG rather than their level of financial distress
- there was no widespread practice of requesting personal guarantees and/or cash injections when GRG had already decided it would not support these businesses

- there was no widespread practice of RBS making requests for information from customers that were unnecessarily taxing
- there was no widespread practice of RBS acting as a 'Shadow Director', and
- there was no evidence that RBS had formed an intention for West Register to buy assets before transferring the customer to GRG, and no cases identified where West Register's purchase of a property (as opposed to any other purchaser) alone caused a customer to suffer a financial loss

### **Systematic failures**

The independent review found that some aspects of customers' inappropriate treatment were systematic.<sup>1</sup> The independent review took a broad view of what 'intentional strategy' meant in this context. It considered that certain inappropriate treatment was systematic because it resulted from a failure on the part of GRG and RBS to fully recognise and manage the conflicts of interest inherent in GRG's twin objectives and to put in place the appropriate governance and oversight to ensure that GRG struck a reasonable balance between the interests of RBS and that of its SME customers.

## **The FCA investigation**

### ***How we approached the investigation***

The independent review also made findings which indicated that the senior management of GRG were aware, or should have been aware, of some of the issues identified. As a result, we opened an enforcement investigation in order to understand senior management knowledge of the issues in GRG and to further consider if there was any basis for us to take action.

As set out in our Mission, we have wide-ranging powers to investigate potential breaches of our rules, including requiring firms and individuals to provide us with information. When we open an investigation, we have not decided that a firm has committed wrongdoing or that anyone is guilty of misconduct. We investigate the evidence from a neutral perspective and then form a view about whether there has been misconduct we need to take action about.

We start an enforcement investigation as a diagnostic tool. It does not mean a sanction is inevitable or even likely. If the circumstances meet the criteria in the Financial Services and Markets Act 2000 (FSMA), we can appoint investigators to carry out an investigation. The investigators will be able to use different statutory powers depending on the type of investigation.

We investigate to find out what has happened, and many of our final decisions are independently scrutinised by the Regulatory Decisions Committee and by the courts.

We do not usually carry out investigations into unregulated areas of an authorised

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1 The independent review sets out that the Requirement Notice defined 'systematic' as "an intentional and co-ordinated strategy". It stated that 'The definition of the work to be undertaken in Phase One sets some limitations on the extent to which it has been possible to test important aspects of this definition (for example, where inappropriate treatment of customers was known about, authorised and/or sanctioned by management within RBS Group is part of the scope of work for Phase two). However, strategy, and the intention behind it, can be evidenced in a number of ways and is not, in our view, limited to identifying documentation that clearly sets out a particular, and intended, objective. We have reviewed a substantial volume of material. **In certain circumstances the available evidence has led us to form a view that the inevitable and foreseeable consequence of a decision (whether by way of act or omission) was that some other result would ensue.** We have formed the view that, by not addressing that consequence, the Bank must be taken to have intended that it should follow. Accordingly, we have judged certain inappropriate treatment (that, in our view, were the result of policies adopted by GRG or allowed to flourish because of shortcomings in the control frameworks that GRG operated) as systematic.'



firm's business. However, given the independent review's findings relating to senior management awareness, we decided to investigate the oversight and management of GRG by GRG's senior management team and RBS Group Board of directors and executive committee in relation to the matters set out in the independent review.

Our investigation analysed evidence from GRG, RBS more widely and the independent review. We used our statutory powers to require individuals from GRG to attend interviews and answer our questions. We focused on senior people within RBS who were responsible for the management and oversight of GRG during the review period. We considered that, as well as the bank, they were in a position to speak on behalf of GRG about what was happening within GRG at that time.

Our investigation looked at the areas in which the independent review identified the inappropriate treatment of SME customers as being widespread and systematic, and what we found is set out in this report.

The independent review used various terms to refer to management within GRG. These terms were used broadly within the independent review and not as references to a clearly-defined group of identifiable individuals. For example, the independent review used a range of terms including 'GRG Management', 'Senior GRG Staff' and 'Senior managers'. The independent reviewer explained that the review 'did not seek to identify where, when and by whom specific decisions were made, or matters reported to, nor did we seek to 'map' precise individual executive/managerial responsibilities'. We have inferred from this that the independent reviewer did not review the roles of specific individuals and/or whether there were deficiencies in the performance of those roles.

At various points in the report we have referred to what GRG told us. When we use the term GRG in this way, we are referring collectively to the bank and to those people we interviewed.

The purpose of this report is to provide an extended account of our investigative work in relation to GRG. Under FSMA we have the legal basis to do this as guidance for firms and individuals within the financial services industry.

We recognise the demand to name individuals in this report (by, for example, naming the persons who made up 'senior management'). We cannot do so for the reasons set out below.

Much of the information on which the report is based, including that related to individuals, is confidential within the terms of FSMA. We would not therefore ordinarily be permitted by law to publish it. The law does, however, allow us to publish otherwise confidential information as guidance for the future where it is necessary to publish specific information to provide that guidance. It is not necessary to name any individuals to provide the guidance in this report. Therefore, it would not be legally justifiable if we were to do so. This is the primary and sufficient reason for not naming any individuals. Additionally, we have also taken into account specific evidence concerning the personal safety of certain individuals.

When we use the term 'senior management' in this report it should not be interpreted as referring to a defined set of individuals. Instead, we are using the term in the ordinary sense to refer to those who were involved in the management and oversight of GRG in the review period. We consider that focusing on senior management in this way goes

to the heart of what we looked at in our investigation and is consistent with the aims of this report.

### ***What the FCA investigation found***

GRG had twin commercial and turnaround objectives, but staff did not know how to balance them or how to best communicate with customers in financial difficulty. This meant that its communications with customers often created an expectation that their business would be turned around, which could not be met in practice. Staff did not show enough understanding of the extreme emotional stress some of their SME customers were going through, for example those who were losing their home as part of the recovery process.

We expect most regulated firms to abide by a set of principles called 'Treating Customers Fairly' (TCF) when carrying on their regulated activities. RBS decided to introduce TCF within GRG, even though it did not have to, as the business was largely unregulated. That was a proactive and positive step for RBS to take. The challenge was that TCF was not designed to cover commercial lending and in order for it to be effective, RBS needed to think about what TCF meant in the context of GRG's SME customers. In practice, the relationship between RBS and its customers was governed by the terms and conditions of the contracts agreed between them. These types of contracts give the lender certain legal rights when the customer is in default, which if enforced could lead to the sale of a customer's assets. In these circumstances, a lender enforcing their rights causes outcomes that seem unfair to customers, although they are acting within the terms and conditions of the contracts.

GRG brought in various systems and controls. These included new policies and training for relationship managers, and requiring their decisions to be approved by someone more senior, as well as changes to senior staff objectives to include TCF. But RBS was in difficult circumstances. The financial crisis had caused a significant increase in the number of customers coming into GRG, and the changes in systems and controls turned out to not be good enough to keep pace with what was needed.

We also found that GRG's record-keeping was poor, particularly for records of the reasons for business and property valuations and pricing and communications with customers. For regulated firms, we have rules about the nature and quality of record keeping, but those rules did not apply to GRG as the business was largely unregulated.

As will be seen from section 8, it is important to consider GRG's conduct in the relevant context, as we have done so here.

### ***Why we haven't taken action against RBS or individual staff***

The fact that GRG was largely outside our jurisdiction is important. There are no enforceable regulatory rules, for example 'conduct of business' rules, which we can use to hold RBS to account in relation to GRG's treatment of SME customers. The largely unregulated nature of GRG's business also means that, in this case, we cannot take disciplinary action like imposing financial penalties on RBS or individuals.

There was an alternative, which we carefully considered. Where we decide that people are not fit and proper, we can take action to prohibit them from the regulated financial services industry, even where their conduct took place in an unregulated area. A prohibition is different from fining someone. We are not seeking to punish the individual for misconduct, but rather are taking protective action to stop individuals from causing harm in the future. We can take this type of action where we decide,

for example, an individual lacks honesty and integrity, or they lack competence and capability. For a successful prohibition, we must have evidence that the individual is not fit and proper on an ongoing basis.

We found no evidence that any member of senior management was dishonest or lacking in integrity. In particular, we have not found a credible basis to conclude that senior management sought to treat customers unfairly or behaved in any other way that could call their honesty or integrity into question.

We also considered the competence and capability of senior management. While we and the independent review found instances of inappropriate customer treatment within GRG, the absence of regulatory rules against which the performance of senior management within GRG could be measured, in the context of the environment at the time and in all the circumstances, means we do not think a competence and capability case with reasonable prospects of success could be brought. Individuals must be held to account where their behaviour falls below the applicable standards, but to do that, the standards need to be sufficiently clear at the time.

### **What has happened since RBS actions**

We gave RBS the findings of the independent review and discussed them in detail. RBS acknowledged that it could have done better for SME customers in GRG in some areas and has publicly apologised. It has also voluntarily set up a redress (compensation) scheme. This is being overseen by an independent high court judge.

RBS's Chief Executive has provided the FCA with a commitment, known as a 'formal attestation', that RBS and GRG have complied with all the independent review's recommendations that apply to them. Formal attestations are not just a promise, they give us the ability to take action against individuals in certain circumstances, for example if they have tried to deliberately mislead us.

### **Changes to the law**

As a result of problems identified since the financial crisis, new rules about the standards required of staff in financial services have been introduced through the Senior Managers and Certification Regime (SM&CR). Under the Senior Managers Regime, the most senior people performing key roles need our approval before starting their roles. The Certification Regime applies to employees whose role means it's possible for them to cause significant harm to the firm or customers. These people don't need to be approved by us, but firms need to check and certify at least once a year that they are fit and proper to perform the role. The Conduct Rules are high-level standards of behaviour that apply to those within the SM&CR. There are some Conduct Rules that only apply to senior managers.

The aim of the SM&CR is to make individuals more accountable for their conduct and competence, and to ensure that we have the tools to enable us to advance that goal. The Conduct Rules that Senior Managers must comply with will play an important part in driving up standards of conduct by making individuals accountable when performing functions relating to the carrying on of activities (whether regulated or not) by their firm. In appropriate cases, we can fine Senior Managers when they carry on functions in relation to a firm's unregulated activities, in contrast to the regime in place during the review period. We have identified a gap in the ways that SMEs can bring complaints and disputes about financial services. In early 2018, we published a consultation with

proposals for ensuring SMEs can bring cases to the Financial Ombudsman Service, which makes rulings on complaints from consumers against financial services firms. On 16 October 2018, we published near final rules on extending access to the Ombudsman Service to more SMEs. The changes in our approach will mean around 210,000 additional SMEs will have access to the Ombudsman Service. We plan to publish final rules about this later in 2019.

# 1 About this document

We have produced this report in response to public and Parliamentary interest in the results of our investigations into the way GRG treated its SME customers between 2008 – 2013 and the FSA's and FCA's regulatory response and findings.

In light of the history of this matter, the significance of the requirements of transparency and the effective regulation of banks (including where some of their activities are unregulated), this report seeks to explain to the public:

- our view of what caused the issues in GRG between 2008 – 2013
- oversight by senior management of GRG
- our legal powers in relation to GRG and its senior management
- why we have concluded that we do not have a basis for taking action
- what has changed since these events and how this should help improve accountability in authorised firms, and
- further guidance and information around appropriate SME customer treatment

This report also discusses how we approach unregulated conduct within authorised firms, in the context of GRG.

Both the independent review and our own enquiries considered a wide range of issues in GRG and RBS. Some of these are inevitably fairly technical, although we have tried to explain them in this report as clearly as possible.

The Executive Summary provides an overview of the issues and our perspective on those issues.

Section 2 provides a summary of our objectives and explains where, when and how we can use our powers to intervene in financial services.

Sections 3 – 7 give more detailed information about areas for concern that either we, the independent review, or both, looked into, evidence found and the responses of GRG's senior management to this. Each section gives our views on the area of concern.

Section 8 provides an explanation as to the circumstances in which RBS found itself during the review period and areas of management focus at the time.

Section 9 provides our conclusion and discusses the changes to our regulatory remit since the Senior Managers and Certification Regime was introduced.

Annex 1 provides a glossary of definitions.

## 2 Our objectives and jurisdiction

### ***Delivering our objectives***

Parliament has given us a single strategic objective – to ensure that relevant markets function well. Parliament has also given us three operational objectives to advance this strategic objective. These are to:

1. secure an appropriate degree of protection for consumers
2. protect and enhance the integrity of the UK financial system, and
3. promote effective competition in consumers' interests

We have a range of powers and different functions - including authorising and supervising firms, competition and enforcement - to fulfil these objectives.

We use a wide range of enforcement powers to protect consumers and take action against firms and individuals who do not meet our standards. These powers come in part from FSMA and mean we can take a range of civil, criminal and regulatory actions. These include imposing financial penalties and suspending firms and individuals. We can also prosecute firms and individuals who carry out regulated activities without our authorisation.

### ***Firms must be authorised to carry out a regulated activity***

Any firm that carries on a regulated activity in the United Kingdom, or says it does, must be authorised by the FCA or the Prudential Regulation Authority (PRA), unless it is exempt under FSMA. It must apply to us, demonstrating it will satisfy, and continue to satisfy, certain conditions for being authorised (referred to as the 'threshold conditions'). Those conditions include, for example, having the right people and capital in place to carry out its business. After being given this authorisation, these firms are known as authorised firms.

In general terms, a regulated activity is an activity which:

- is specified in the Financial Services and Markets Act 2000 (Regulated Activities Order) 2001 (RAO)
- is carried on 'by way of business', and
- is carried on in relation to one or more investments which are specified investments in the RAO ([PERG 1.2.1G](#))

Some examples of regulated activities which are listed in the RAO are 'accepting deposits' and 'entering into a regulated credit agreement as lender' ([RAO Art60B\(1\)](#)).

Whether an activity is carried on 'by way of business' is a question of judgement that takes into account a number of different factors. Examples include whether the activity is a one-off or ongoing, whether payment is involved, the amounts involved and how much the firm undertakes the activity compared to other unregulated activities it carries out. The nature of the regulated activity carried on is also relevant ([PERG 2.3.3.G](#)).

### ***When our authorisation is not required***

There are circumstances where firms do not need to be authorised by us. The RAO excludes some investments and activities from requiring our authorisation, such as some activities when carried on by an overseas person. Our [Perimeter Guidance Manual](#) gives more details about when a firm or individual needs authorisation.

Further, not all business activities that financial services firms carry on are regulated activities. Many firms will carry out a mix of regulated and unregulated activities as part of their normal business.

During the review period GRG's activities did not involve the carrying on of any regulated activities and so were unregulated activities. They remain unregulated activities today. This means that GRG's activities were, and activities of this type remain, largely outside the jurisdiction of the FCA.

### ***Approving individuals for specific roles***

Before March 2016, under the Approved Persons Regime (APR), we also had to approve individuals in all authorised firms that carried out certain functions at their firms. These functions were known as 'controlled functions'. Examples of these controlled functions include the chief executive function, the money laundering reporting function and the compliance oversight function. Individuals approved by us under the APR were known as approved persons.

One person could hold more than one controlled function but would need to demonstrate how they can meet the standards required for each role. Different businesses required different controlled functions, so not all firms needed to have individuals performing all the controlled function roles.

Since March 2016, SM&CR has replaced the APR for some types of firm and changed the way we regulate people working in financial services.

During the review period, the APR applied.

To get our approval to perform a controlled function, we must be satisfied that a person is fit and proper to perform the controlled functions they have applied for. When we consider someone's fitness and propriety we look at all relevant factors, including their honesty, integrity and reputation, competence and capability and financial soundness. As part of our assessment, the person must demonstrate that they know and meet our regulatory requirements and understand how we apply them. Details of our approach to assessing fitness and propriety are set out in the section of the FCA's Handbook (the Handbook) called Fit and Proper Test for Approved Persons (FIT).

When an individual holds a controlled function under the APR, they must meet at all times the standards set out in our Statements of Principle and Code of Practice for Approved Persons (APER) for the conduct of regulated activities.

### ***Meeting our Principles for Businesses***

Our Principles for Businesses (Principles) apply to every authorised firm, either to part or all of its business, depending on the nature of the business it carries out. There are 11 Principles. Together, they outline the minimum requirements for conduct that an authorised firm must meet.

The Principles are:

<b>1 - Integrity</b>	A firm must conduct its business with integrity.
<b>2 - Skill, care and diligence</b>	A firm must conduct its business with due skill, care and diligence.
<b>3 - Management and control</b>	A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
<b>4 - Financial prudence</b>	A firm must maintain adequate financial resources.
<b>5 - Market conduct</b>	A firm must observe proper standards of market conduct.
<b>6 - Customers' interests</b>	A firm must pay due regard to the interests of its customers and treat them fairly.
<b>7 - Communications with clients</b>	A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.
<b>8 - Conflicts of interest</b>	A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
<b>9 - Customers: relationships of trust</b>	A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.
<b>10 - Clients' assets</b>	A firm must arrange adequate protection for clients' assets when it is responsible for them.
<b>11 - Relations with regulators</b>	A firm must deal with its regulators in an open and cooperative way, and must disclose to the FCA appropriately anything relating to the firm of which that regulator would reasonably expect notice.

During the review period, the Principles applied to the carrying on of:

- regulated activities
- activities that involve dealing in investments as principal, and
- 'ancillary' (related) activities for designated investment business, home finance, regulated credit, insurance mediation and (from 1 November 2009) accepting deposits and activities directly arising from insurance risk transformation

Dealing in investments as principal is essentially buying, selling, subscribing for or underwriting designated investments. GRG's activities did not fall within the definition of dealing in investments as principal.

An ancillary activity is not a regulated activity, but one carried on as part of a regulated activity or offered as being for the purpose of a regulated activity ([FCA Handbook Glossary](#)). GRG's activities were not ancillary activities or regulated activities under the RAO.

If an authorised firm breaches a Principle then, depending on the evidence, we may take action against it. When we decide if an authorised firm has breached a Principle, we consider the standard of conduct required under that specific Principle. In deciding whether to take enforcement action, we also consider whether the firm breached any regulatory rules that applied.



### ***How the Principles apply to unregulated activities***

Lending to commercial organisations is not a regulated activity and, in general, the Principles do not apply to unregulated activities. Principle 6 (Customers' Interests) sets out that a firm must pay due regard to the interests of its customers and treat them fairly. While this seems one of the most relevant Principles when considering how GRG dealt with and treated its SME customers, because Principle 6 does not apply to unregulated activity, it did not apply to GRG.

Principles 3, 4 and 11 can apply to unregulated activities in certain circumstances. Principles 4 (Financial Prudence) and 11 (Relations with Regulators) are not relevant to the issues identified in relation to GRG. Principle 3 (management and control) states that an authorised firm must take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems. Principle 3 only applies to the prudential context of unregulated activities.

During the review period 'prudential context' meant the context in which the activities have, or might reasonably be viewed as likely to have:

- a negative effect on the confidence in the financial system (or after April 2013, the integrity of the UK financial system) or
- a negative effect on the ability of the firm to meet either: the 'fit and proper' test in the 'suitability' threshold condition; or the applicable requirements and standards under the regulatory system relating to the firm's financial resources

### ***Confidence in or the integrity of the UK financial system***

Section 1I of FSMA defines the UK financial system as 'the financial system operating in the United Kingdom'. It includes financial markets and exchanges, regulated activities and other activities connected with financial markets and exchanges. None of these descriptions covers commercial lending. However, given the definition is not exhaustive, we consider that it is reasonable to argue that the market for commercial lending is part of the UK financial system, in the way that 'financial system' is ordinarily meant.

FSMA was amended in April 2013. Before this, there was no definition of what 'confidence' in the UK financial system meant. According to the Oxford English Dictionary the ordinary meanings of 'confidence' include 'a feeling of reliance or certainty'.

Since April 2013, s.1D(2) of FSMA has set out that 'integrity' of the UK financial system includes:

- a. its soundness, stability and resilience
- b. it not being used for a purpose connected with financial crime
- c. it not being affected by behaviour that amounts to market abuse
- d. the orderly operation of the financial markets, and
- e. the transparency of the process for forming prices in those markets

**How unregulated activity can affect market integrity**

In 2014 and 2015, we took 6 enforcement actions involving banks' foreign exchange (FX) trading by applying Principle 3 to unregulated activity in the prudential context. The type of FX trading involved was not a regulated activity, but we found that the 6 banks' failure to properly control the activities of their voice trading businesses in the systemically important FX market undermined confidence in the UK financial system and put its integrity at risk.

These FX cases involved the co-ordinated behaviour of several firms over a number of years.

For Principle 3 to apply in relation to GRG's ability to meet the fit and proper test, GRG's activities would need to be of a significant enough scale (in size or impact) to negatively impact the ability of RBS to carry on regulated activities (such as deposit taking). This was not the case here. GRG's activities during the review period had a significantly damaging impact on RBS's SME customers. However, this impact was not large or widespread enough to have the necessary negative impact on the confidence in or integrity of the UK financial system for us to be able to apply Principle 3 to GRG's unregulated activities.

**Our conduct rules**

During the review period, there were 3 main grounds where we could take action against an individual. These were if the individual:

- breached APER (the Statements of Principles and Code of Practice for Approved Persons) while an approved person
- was knowingly concerned, while an approved person, in an authorised firm breaching a regulatory requirement, or
- is not a 'fit and proper' person to perform functions in relation to a regulated activity carried on by authorised or exempt persons

We consider these further below.

**APER**

APER sets out the standards that we expect individuals who have approval to perform controlled functions in a firm to meet. The Code of Conduct also sets out descriptions of conduct which, in the opinion of the FCA, do or do not comply with APER. If someone breaches one of the principles in APER then we may be able to take enforcement action against them.

During the review period, APER applied to (broadly speaking) the 'performance by an approved person of controlled functions' in relation to their firms' regulated activities. From 1 April 2013, this was expanded to include 'any function' in relation to the carrying on of the firm's regulated activity. This means APER will only apply when an individual is performing a function that relates to their firm carrying on a regulated activity. As GRG's activities were largely unregulated, we are not able to apply APER to individuals within GRG. This is the case even if those individuals were approved persons.

**Being knowingly concerned in breaches**

We may be able to take action against an individual if, while an approved person, they are 'knowingly concerned' in an authorised firm's breach of one of our regulatory requirements. This means (broadly speaking) the individual knew of the facts that constitute the breach and was involved in that breach.

However, as GRG's activities were largely unregulated it was not breaching any relevant requirements and, therefore, no relevant breaches in which an individual could be knowingly concerned took place.

### ***Being fit and proper***

If we decide that someone is not fit and proper to perform functions in relation to regulated activities carried on by an authorised or exempt firm, there are certain powers we might be able to use. These include prohibiting them from performing functions in relation to regulated activities carried on by authorised or exempt firms, or withdrawing any existing approvals.

Prohibitions and withdrawals of approval are often described as 'bans', but they are not intended to punish the individual. They are protective measures designed to stop someone who may pose a threat to our objectives (for example by treating customers unfairly) from performing roles in financial services. This reduces the risk of that person causing future harm, for example by acting without the necessary competence or without honesty or integrity.

At its strongest, a prohibition prevents someone from working in the financial services industry altogether. A prohibition is a public action and, when we publish the information, can have a significant impact on the individual. If an individual does not agree with a prohibition they can appeal our decision through the courts.

When we decide people are not fit and proper, we can take into account conduct that took place in an unregulated area, if it is relevant. We have considered whether there is sufficient evidence to bring a case for prohibiting any of GRG's senior management on the grounds that they are not fit and proper. This involved considering whether they lack honesty and integrity, or competence and capability.

#### **Lack of integrity**

There is no universally agreed definition of integrity, but the courts have given useful guidance about what a lack of integrity might include. While it can involve deliberate or dishonest misconduct, it can also occur if someone acts recklessly or their 'ethical compass' points them in the wrong direction to a significant extent. If we find dishonesty or lack of integrity this is usually sufficient for us to prohibit an individual.

#### **Lack of competence and capability**

Here, the position is more nuanced; competent people make mistakes. In many situations, it would be disproportionate or inappropriate for us to prohibit an individual for a mistake, unless the mistake was particularly serious, or was made repeatedly and/or over a long period of time and never corrected. Where we find no evidence of lack of honesty or integrity, we generally focus on conduct that demonstrates sufficiently serious, repeated, prolonged and/or obvious failures, and measure that conduct against the standards expected of the person at the time and in the circumstances.

Taking all relevant matters into account, and after detailed investigations, we do not consider that bringing a prohibition case against any member of senior management of GRG, in role during the review period, would have reasonable prospects of success.

We found no evidence of dishonesty or lack of integrity, specifically, that senior management sought to treat customers unfairly or were reckless about unfair treatment. The lack of regulatory rules against which GRG could be assessed, in the context of the environment at the time and all the circumstances, means that we do not think we could bring a case for lack of competence and capability in relation to senior management with reasonable prospects of success. Senior management must be held to account where their behaviour falls below the applicable standards, but to do that means the standards have to be clear.

### Other FCA rules that might apply to GRG

The FCA Handbook has a number of regulatory rules about the standards firms must meet when carrying on certain activities. Examples include a range of conduct of business rules, which apply to activities such as:

- deposit taking and designated investment business (BCOBS)
- providing some types of mortgages (MCOB)
- providing insurance services (ICOBS)
- rules relating to systems and controls authorised firms must have in place (SYSC), and
- the minimum threshold conditions a firm must continue to meet to remain authorised (COND)

These rules set out specific obligations on authorised firms when carrying on their regulated business activities, for example how firms should treat their customers and what information they must include in any advertising or give to customers. They also include what information they need to get from the customer when selling specific products. The specific rules that apply will depend on the type of firm, business activities, products or customer.

Because GRG's activities were largely outside our jurisdiction, there are no enforceable regulatory rules or guidance against which we can assess GRG's treatment of its SME customers.

The Handbook also has rules about how firms must deal with certain types of complaint, depending on the type of complaint and who makes it. These rules are set out in the section of the Handbook called Dispute Resolution: Complaints (DISP). Most of the Handbook does not apply to the GRG's activities because these activities are unregulated.

### How rules on handling complaints might apply to GRG

The first part of DISP, which has rules and guidance on treating complainants fairly, does apply to an authorised firm for complaints from 'eligible' complainants. An eligible complainant is a person eligible to have a complaint considered by the Financial Ombudsman Service. One group of eligible complainants are people who count as a 'micro-enterprise' at the time they complained to the firm. A micro-enterprise is any person engaged in an economic activity which employs fewer than 10 people and has a turnover or annual balance sheet of not more than €2 million (FCA Handbook Glossary).

Lending money is generally an activity that falls within the Ombudsman Service's jurisdiction. So a complaint by a micro-enterprise about commercial lending would be

covered by the complaints rules under the first part of DISP. While this would probably not have covered all of GRG's SME customers, it may have covered some of the smallest ones.

Any action we could have taken against GRG for technically breaching this rule would only have applied to this group of GRG customers. It could not have been a wider action for poor treatment of customers. Any action we might have taken would not have affected, positively or negatively, whether an SME micro-enterprise could make a claim to the Ombudsman Service. It would also not have enabled SMEs which did not meet the definition of a micro-enterprise to make claims to the Ombudsman Service.

The independent review identified failings in the way GRG handled complaints. However, this was not the main harm it identified and was not the central criticism of GRG and the way it treated SME customers.

For these reasons, we did not consider that taking action against GRG under DISP would have been the appropriate course of action to take in these circumstances.

### **How the law applied to RBS's actions**

As the activities of GRG were largely outside our jurisdiction, the relationship between RBS and its customers was mainly governed by the terms and conditions of the commercial contract between them. So, while many customers may have felt the steps RBS could take under the law were unfair, they were governed by the terms of the contract and not by our regulatory rules.

#### ***The principle of 'acting in good faith'***

There is no general principle in English contract law that parties must act in good faith towards each other. The parties to a contract can expressly agree to act in good faith and record this in the contract between them, but this is not a requirement. There may be other occasions where courts trying to resolve contractual disputes may find there is, in the particular case before them, an implied duty to act in a particular way, for example, with honesty. However, this will be limited in the way it actually applies and depends on the specific circumstances of the case. The law can also impose a requirement to act in good faith for specific types of contracts (for example s.17 of the Marine Insurance Act 1906).

As a result, there was no general duty in law for RBS to act in the best interests of its SME customers. There was also no general duty for RBS to put the interests of its SME customers before its own commercial interests.

This fact was naturally very difficult for many SMEs to accept. They would be more familiar with the legal and regulatory protections given to retail customers, and not necessarily know that there are fewer protections in a commercial environment. It would also have been challenging for them making their complaints against a large financial services firm that has significant resources and professional advice.

## 3 GRG's objectives and strategy

### Background

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#### GRG's twin objectives

RBS has stated that GRG had two objectives:

- turning customers around and returning them to satisfactory (turnaround objective), and
- generating a return for RBS (commercial objective)

Throughout the review period, GRG described its objectives broadly, as follows:

'GRG's strategic objective is to minimise losses for RBS and to execute effective asset management strategies that demonstrate value add using a variety of innovative and creative solutions. GRG seeks to:

- Add Value to exposure management with the aim of returning accounts to the originating Core Division in a 'satisfactory' condition.
- Maximise debt recoveries/minimise losses in situations where return to satisfactory is not feasible e.g. Connections where insolvency procedures are in place are managed by Recoveries teams.
- Obtain levels of reward commensurate with risks undertaken.'

GRG Management Committee (ManCo) together with the GRG Executive Committee (ExCo) had responsibility for setting the GRG strategy, and senior management said that these were the chosen objectives as they believed they delivered the best result for both RBS and the customer. The rationale provided by senior management was that as long as a customer remained solvent and trading then that customer would, in most cases, be able to pay back their loan and interest to RBS.

Senior management also said that the GRG strategy included being part of the 'leading edge of a rescue culture', leading some of the largest, most complex corporate restructurings. However senior management acknowledged that this strategy was less of a priority when dealing with its SME customers, but also stated that the broad objective to seek to restore customers to the mainstream banking and maintain the relationships was consistent.

From the end of 2009 to 2012 RBS was covered by the Asset Protection Scheme (for more details on the scheme see section 8). This meant that RBS was contractually required to ensure compliance with the scheme's rules.

#### *How GRG and RBS measured the success of its objectives*

A key metric that GRG and RBS relied upon for monitoring whether it was meeting its objectives, was the number of customers that were 'returned to satisfactory', ie customers who were returned to the mainstream bank following a period in GRG. A further metric management relied on was the number of customers who remained in

GRG for a long time. One member of the senior management team described these customers as 'failures' for GRG. This metric allowed senior management to see which SME customers had not been effectively turned around.

### **What the independent review found**

The independent review did not criticise RBS for giving GRG a commercial objective and, in particular, taking steps to protect its capital. But having twin objectives did create, at a minimum, a need to carefully focus GRG's management and day-to-day operation on securing both the commercial objective and good customer outcomes.

In practice, however, the commercial objective was the strategic focus of GRG management during the review period, creating a risk that GRG would take action that was inconsistent with genuine efforts to turn a distressed SME customer around.

### **Transfers to GRG**

RBS's criteria for transferring a customer to GRG were broad. They gave RBS staff significant discretion to decide whether SME customers should be transferred to GRG. The independent review concluded that the transfer criteria could have been simplified but were not, in themselves, inappropriate.

The independent review found no evidence that there was a general practice of targeting businesses for transfer based on their value to GRG, rather than on their level of distress. Almost all the customers whose cases were reviewed had shown clear signs of financial difficulty before they were transferred to GRG, and required either turnaround action or collection of the debt. In a small number of cases, there was evidence that during the transfer process, GRG had considered whether it would be to GRG's or RBS's advantage to transfer these customers to GRG. However, even in these cases, the transfer could have been justified by other criteria.

The independent review identified that RBS failed to recognise the potential conflict of interest between GRG's twin objectives, and how this affected the transfer of individual SME customers to GRG.

RBS frequently failed to comply with its own policy for telling customers they were going to be transferred to GRG, resulting in poor communications to these customers. These failings resulted in customers being treated inappropriately on a widespread scale.

The independent review additionally made specific conclusions about the transfer procedures operated by Ulster Bank in Northern Ireland.

The independent review found that RBS's failings in the transfer process did not generally cause financial distress for these customers, but could not say this had not been the result in individual cases.

More generally, these failings would have most likely created an environment where many customers did not know where to turn for help or how to respond to the demands RBS was now making. The way that RBS communicated with customers meant they were often given unrealistic expectations: they were led to believe that entry to GRG would help to restore an ailing business that was otherwise viable to health, when for some of them turnaround was not a practical possibility.



### **Staff Objectives**

The independent review noted the tone of and emphasis in senior managers' appraisals which placed financial objectives first and emphasised the need for continuing financial performance.

It also found that there was a failure to establish and oversee appropriate objectives for staff for delivering GRG's twin objectives. This failure was reflected in GRG's culture of 'deal making', which focused on GRG's financial interests. This culture placed little weight on GRG's stated objective of turning businesses around, and even less on treating customers fairly.

### **Turning businesses around**

The independent review found that, in practice, GRG put little emphasis on turning around SME customers, other than wanting them to meet credit policy requirements or move to another financial institution (which the bank referred to as 're-banking'). It found that the focus on returning SME customers to financial health and back to mainstream banking through genuine restructuring was inadequate.

The independent review found that RBS's stated approach to turnaround was appropriate and broadly reflected normal turnaround practice. However, RBS did not widely follow key aspects of the stated policy in practice during the review period.

The independent review identified frequent failures to pay appropriate attention to turnaround considerations, including because of failures to:

- carry out adequate viability assessments
- consider and implement viable medium and longer-term turnaround options, instead of focusing on short-term measures such as rescheduling or renewing an existing credit facility on new terms
- create clear turnaround plans with appropriate objectives and milestones and monitor progress against them
- make adequate use of a broad range of turnaround tools, including appropriate forbearance (postponing the repayment of the debt), and
- consider the impact of RBS's actions, including re-valuing facilities, pressing for debt repayment and withdrawing working capital lending, on SME customers' ability to stay in business

The independent review found that GRG's failure to give sufficient weight to turnaround options for SME customers meant customers were treated inappropriately and that this was widespread and systematic because GRG:

- prioritised its commercial objective at the expense of its turnaround objective
- did not adequately manage and oversee risks to customers and did not treat turnaround as a priority
- did not put appropriate emphasis on turnaround in its staff objectives, instead focusing on raising the price of credit to SME customers because this was more profitable for RBS
- put too much focus on pricing and reducing the amount of debt that customers owed RBS, without proper consideration of the longer-term viability of SME customers' businesses
- inadequately managed the conflicts of interest in its relationship with West Register (see Section 7 - Conflicts of Interest), so that the strategy for managing these



cases was influenced too much by West Register's perceived or actual interests and not enough on customer-led recovery and turnaround, and

- did not put in place adequate or appropriate processes to ensure that turnaround was given enough weight in its day-to-day interactions with SME customers

### **Potential harm to customers**

In terms of potential harm to customers from GRG's failings in its turnaround strategy, the independent review concluded that:

- Delays in transferring customers limited GRG's ability to take meaningful action and reduced the possibility of turning around otherwise viable businesses.
- RBS failed to sufficiently document its processes for deciding whether businesses were viable. One impact of this was that businesses which were clearly not viable carried on being managed by GRG for considerable periods of time, rather than being identified for recovery action early on. RBS remained unclear about the prospects of customers who were potentially viable, and the extent to which, if at all, it should support the business. This created confusion about the options for turnaround, meaning that practical turnaround opportunities that would have benefitted both RBS and the customer could have been missed.
- This failure to rigorously assess turnaround options also led to these turnaround options potentially being missed or overlooked or becoming impractical due to delay. GRG staff instead focused on short term measures such as rescheduling or renewing an existing credit facility on revised terms. This created the risk GRG failed to grasp fundamental issues facing the customer and RBS.
- GRG staff were reluctant to consider customers' counter proposals, some of which were potentially credible, and
- GRG staff were confused about the way in which interest rate hedging products (IRHP) worked and failed to understand the impact that selling income-producing assets to reduce debt would have on their customers' businesses.

### **What we found**

We found that there was a significant tension between GRG's twin commercial and turnaround objectives. GRG was intended to be, and was described as, a turnaround unit – a part of RBS which helped business customers in financial distress, for the mutual benefit of both RBS and the customer. Both the independent review and the FCA have identified that, in practice, GRG did not give as much weight to its turnaround objective as it did its commercial objective, which was not consistent with the impression created for many of its customers by its correspondence with them when they were referred to GRG.

RBS required all SME customers referred to GRG to be assessed by frontline staff to decide whether the customer's business was 'viable' (suitable for turnaround). The independent review found that almost all customers referred to GRG were showing clear signs of financial difficulty. For some of them, turnaround was not a realistic possibility. GRG staff did not appear to fully understand how to balance these two objectives and what this looked like in practice, or how to communicate with customers in financial difficulty.

The way GRG communicated with customers when they were referred to it often created an expectation of turnaround that GRG could not meet, especially given the economic conditions of the financial crisis.

### ***Tension between GRG's objectives and strategies***

During the review period, senior management confirmed they discussed whether there was a conflict or tension between (i) acting commercially and managing assets to get value for the bank and (ii) trying to achieve the turnaround objective. They said they believed there was a duty to RBS's shareholders and the FSA (and then) PRA to manage the bank's capital and commercial results. However, they also believed that the best way to fulfil this 'commercial requirement' was to keep the customer in business, paying back the loan and interest.

However, interviews and documentary evidence reviewed both by the independent review and by us suggest that GRG objectives were in practice not equal, and that minimising losses to the Bank was GRG's primary aim.

### ***Tension between GRG's objectives and strategies created the risk of staff misconduct***

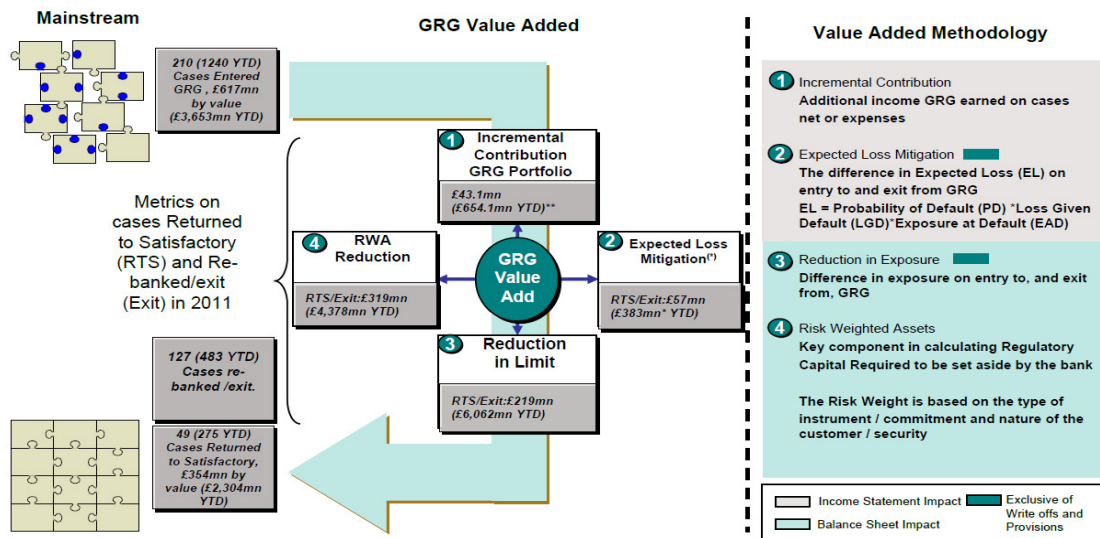
Generally, SMEs' greatest risk at this time - and usually why they were in GRG - was insufficient funds to keep up debt repayments and remain a going concern. However, this is not the same as saying that the underlying business was not viable or at least capable of becoming so. Focusing on how creditworthy the SME customer was and continuing to lend them money could well have been an appropriate response in both RBS's interests and the customer's interests.

Senior management not identifying how tensions between the two objectives were likely to arise and ensure staff were given guidance on how to deal with this ran the risk that staff would not understand how to balance the two objectives in practice. This could have led to poor behaviours if staff believed (for example) that they would get better pay and rewards by focusing on GRG's commercial objective, which risked the consequential poor treatment of customers. The independent review identified this risk arose with GRG's relationship managers, for example.

### ***Management information given to senior management***

Senior management used management information (MI) to understand what was happening on the ground within GRG. They were given this information in monthly MI 'packs'. The main MI pack within GRG was the Management Committee Information Pack (ManCo pack). We reviewed a sample of these and found that they were very high level and limited in detail. The ManCo packs were limited to mainly providing a financial overview of GRG. It is difficult to see how this information was enough for senior management to assess in detail how far customers' interests in turnaround and RBS's interests in minimising losses and making profits were being achieved and balanced.

One member of senior management said of the ManCo Packs: 'the flow of cases in and out was important and what was happening to them, because it is consistent with wanting to get them back to the 'Good Bank' or to restore to health and strength. I mean, that was always the main focus. And stuff that supported what were we doing in terms of protecting RBS's bottom line...'. An example of such information can be seen at Figure 1 below.

**Fig 1: GRG Value Added Metrics for May 2011****GRG Value Added Metrics Explained for May 11**

Information on the number of customers entering and exiting GRG does show that senior management would have had evidence of turning around customers and returning them to the mainstream bank. However, it would have been difficult for senior management relying on this type of MI to understand whether customers were being treated appropriately during their time within GRG, as it lacked sufficient specific information about the treatment of SME customers whilst they were in GRG.

Another form of MI given to senior management was the GRG Executive Committee pack (GRG ExCo Pack). GRG ExCo Packs were given to the GRG ExCo every quarter, and provided a breakdown of GRG's portfolio. As well as financial measures, including portfolio values and case numbers, these packs included 'Value-Added' (VA) information as follows:

- 'VA1: Cumulative Number and Utilisation of cases Returned to Satisfactory'
- 'VA2: Cumulative Number of UK-based Small and Medium-Sized Business Restructured'
- 'VA3: Number of cases with Equity or Property Stakes'
- 'VA4: Loss Avoidance/Mitigation', and
- 'VA5: Usage and Capital Optimisation'

Included in the 'VA2 Cumulative Number of UK-based Small and Medium-Sized Business Restructured' metrics were:

- 'Number of SMEs provided with specialist advice and the value of exposures to which that advice related'
- 'Number of SME restructures', and
- 'Estimate of number of FTE jobs saved in SMEs as a result of GRG's restructuring of SMEs'

While information about SMEs was included in the MI that was passed upwards, it took up less than a single page in a 40-page quarterly report. This amount of information on SME customers would have made it difficult for senior management to gain an accurate picture of how SME customers were being treated while they were within GRG.

We have not seen evidence of any other mechanisms or systems in place to monitor how staff were actually implementing the turnaround and commercial objectives. Beyond the matters above, it does not appear that any measures were in place to oversee and monitor how the tension between the two objectives was being effectively identified and managed.

### What GRG said

GRG explained that:

- GRG's culture was aligned with its objectives and mission statements and 'turning around companies' was at the core of everything GRG did. This included staff being proactive and recognising that not every problem could be solved.
- The strategic objective of turning a company around was to 'recover a company to health, wherever possible and in order for it to return to Group... Those are returned with a long-term mindset... but to return to the Group, it would have had to have moved up credit grades to a level that puts it into... what you would consider a good credit health'.
- 'Turnaround mentality' was the best mentality to have for SMEs. This would sometimes differ from larger corporates as RBS would not be the only party making a decision and each party needed to agree what the best commercial outcome was.
- A customer would not be selected for transfer to GRG because RBS had previously lent to it too generously.
- Customers would not necessarily be transferred to GRG solely for restructuring. Firms which did not need restructuring might be transferred to GRG if they took legal action against RBS. This was because RBS believed GRG staff were better equipped to deal with customers involved in litigation with RBS, although GRG did not think this had ever happened in practice.

### Our View

Given the findings of the independent review and our investigations, we do not think that GRG's culture or practice was aligned with its stated objectives and mission statements when it came to SMEs. Senior management set the objectives and mission statements of GRG, but did not have sufficiently effective means of overseeing how staff complied with them in practice for SME customers.

MI is a key tool for senior management to understand and oversee staff behaviour. Without granular and tailored MI to rely on, senior management were not able to fully understand how its customers were being treated during their time in GRG. We discuss later in section 5 of the report the adequacy of GRG's MI in more detail.

Additionally, if a bank has enough capital and liquidity (funds it is free to use, and not tied up) it is theoretically possible for it to support a customer through turnaround, although potentially this might disadvantage the bank. Both we, and the independent review, found that a process was not put in place to identify when forbearance should be offered considering its own commercial interests and GRG's stated turnaround objective. RBS needed to consider how much capital and liquidity it could use to keep customers going through what could be an extended turnaround period, against having that capital and liquidity for new lending and making sure it met the rules on having adequate capital and liquidity.

RBS should have considered the risk that staff within GRG would pay greater focus to the commercial objective rather than the turnaround objective and taken steps to ensure that customers didn't suffer as a result. In particular, RBS should have ensured that communications to customers clearly set out what they could realistically expect from GRG.

We expect regulated firms to take appropriate steps to identify, prevent and manage conflicts of interest between themselves and a customer, or between two customers. Where a bank sets objectives for some of its activities which have an inherent tension, we expect the bank to take steps to manage that tension.

## 4 Staff conduct and treating customers fairly

### Background

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'Treating Customers Fairly' (TCF) was an initiative the FSA introduced to encourage all firms to make the fair treatment of customers central to their business models and conduct.

The FSA's aim was to see 'a step change in the behaviour of the financial services sector and therefore to deliver improved outcomes for retail consumers'. To encourage this, in 2006 the FSA published the six results it wanted to see TCF achieve:

Outcome 1: Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture

Outcome 2: Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly

Outcome 3: Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale

Outcome 4: Where consumers receive advice, the advice is suitable and takes account of their circumstances

Outcome 5: Consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and as they have been led to expect, and

Outcome 6: Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint

Because GRG was a largely unregulated part of RBS's business, it was not required by any FSA rules to focus on customer treatment. In 2010, however, RBS decided voluntarily to apply the FSA's rules and guidance on TCF to all of its businesses, including to GRG.

### What the independent review found

As our conduct rules could not be applied to unregulated activities, the independent review focused on whether GRG staff complied with RBS's own guidelines and policies for treating customers fairly.

#### *The experience of customers*

The independent review looked at RBS's approach to handling customers. This included how it implemented TCF, particularly when dealing with customers' requests for information and allegations that it had made it difficult for customers to take action.

The independent review found that, for most of the review period, GRG's approach to implementing TCF focused on a narrow range of measures that did not address the key risks to customers in the GRG model. GRG failed to identify key risks to customers caused by its

activities, to develop management information against which it could regularly review these key risks, and to implement systems and controls (including governance) to ensure it controlled and managed these risks appropriately.

The independent review concluded, based on the sample of customers it interviewed and other material it considered, that RBS's relations with its customers were often insensitive, dismissive and sometimes too aggressive. These failings made an already stressful situation worse for customers, creating an environment that was both more antagonistic than necessary and in which mistakes were more likely.

The independent review found that GRG's policy and procedures governing the relationship between relationship managers and SME customers were inadequate. The failure to adopt adequate procedures and to ensure fair treatment of customers caused widespread inappropriate treatment of SME customers throughout the review period.

The independent review found that GRG failed to meet the standards it set itself. That this was not clear to senior management through oversight and the MI they received is further evidence of a lack of adequate systems and controls within GRG. GRG failed to comply with RBS's own policy for communicating with customers about their transfer to GRG.

The independent review found that GRG failed to support SME businesses in line with good turnaround practice.

### **Customer complaints**

Monitoring complaint data and analysing trends can be a good way for firms to identify issues in the way customers are being treated. The independent review found that elements in RBS's complaint-handling policy limited its effectiveness. For much of the review period, the policy had inadequate safeguards to ensure complaints were escalated and the causes identified. The independent review considered that RBS's approach was inadequate and inappropriate in these areas.

The independent review also found failings in the way the policy was implemented. These included the way staff were trained and the negative impact on recognising and reporting complaints which the staff objective of 'zero justifiable complaints' had. This meant that the objective against which a relationship manager's performance would be measured was that of 'zero justifiable complaints'. These objectives also reflected those of a member of senior management, whose performance in relation to customer treatment was measured by the percentage of 'justifiable complaints'. The independent review found that using this concept of 'justifiable' complaints meant that by default some complaints would be deemed 'unjustifiable' by relationship managers.

The independent review concluded that RBS's failures to handle complaints fairly meant inappropriate treatment of customers was widespread and systematic because:

- the focus on 'zero justifiable complaints' and the way staff interpreted this encouraged them not to record and report complaints, meaning the policy of fair treatment of complaints was not followed in practice
- RBS did not put in place adequate safeguards to ensure that it applied its policy in practice and had no meaningful process to check staff were complying with the relevant DISP requirements



- the evidence from cases suggested that GRG often took a dismissive approach to complaints
- management information on complaints was unreliable, and
- GRG did not carry out adequate root cause analysis and so failed to learn the lessons of the complaints that were received

## What we found

### ***RBS's decision to implement TCF in GRG***

We found evidence that GRG did undertake work on TCF. In October 2010 GRG issued specific staff guidance on applying TCF to GRG, including on handling complaints. Before this, the general RBS Group TCF policy had applied.

However, GRG did not implement TCF effectively in practice. TCF was not designed to cover commercial lending. It is part of a broader framework of regulation that did not apply to GRG and includes requirements on conflicts of interest, communications with customers, record-keeping and governance. For TCF to work in GRG, it needed to consider more specifically what it meant for its SME customers.

### ***How TCF was introduced in GRG***

Following the implementation of TCF across RBS, TCF was included in GRG senior management's objectives. One member of senior management also had a 'customer expectations' objective in 2009, and all Business Restructuring Group (BRG) staff had an objective to have 'zero justifiable complaints' throughout the review period. The problem with a 'zero justifiable complaints' objective is that it gave rise to the risk of staff not recording complaints in order to meet the objective.

On 13 October 2010, GRG introduced a 'customer journey', designed to ensure 'customers were treated both fairly and consistently' by GRG staff. RBS gave evidence that it updated staff training materials to include specific references to TCF, as well as producing guidance notes explaining the importance of the TCF principles.

At the beginning of 2011, GRG senior management made an announcement explaining the importance of TCF and its relevance to GRG. The announcement stated:

'Treating Customers Fairly (TCF) is integral to the way that we do business in RBS, and many of you will be familiar with it through previous communications across the Group. TCF is a regulatory requirement of the Financial Services Authority (FSA) designed to ensure that customer outcomes match their understanding and expectations;

Customer service and treating customers fairly must remain at the heart of everything we do. To help provide staff with additional information we are today launching new GRG TCF guidance specifically tailored to GRG. This provides information on the six TCF outcomes and how they relate to our day to day business in GRG; and

At the same time we are also launching revised guidelines on Complaints Handling in GRG. These guidelines lay out a consistent process for dealing with customer complaints across all our businesses. It is important that complaints are dealt with in a robust and consistent manner across the whole of GRG, so I would encourage all staff to read the new guidance and ensure the revised processes are observed.'



In February 2011, a Group Internal Audit 2011 Plan for Non-Core and GRG listed TCF as a key risk for 2011.

In 2010/2011, GRG introduced an annual customer survey, which senior management said was refined as time went on. In July 2013, GRG introduced a 'Customer Charter', setting out staff requirements for dealings with customers. This Charter was introduced as a response to results from the 2012 customer survey about areas of GRG which customers did not understand. Senior management explained they introduced the Charter to explain to customers the services GRG would be delivering so that if GRG 'fell short' of these services then customers could tell them.

In September 2012, following Complaints Handling Assurance Testing and a gap analysis of the Policy Standard, the complaints handling process for GRG UK was changed so that all complaints were recorded centrally in a customer complaints centre.

In October 2013, GRG appointed an accountable executive for conduct risk and complaints, and this executive started attending RBS's conduct risk committee.

### ***The information senior management received about TCF***

Senior management received MI that included the number of full-time jobs in customers' businesses which were saved when turning SMEs around. We have reviewed evidence showing that RBS's Group Board discussed the number of customers which were turned around and the number of customers where RBS ultimately ended its relationship. Senior management believed that these metrics ('turning customers around' and 'customers exited') were key measures of how GRG's fair treatment of its customers and customer turnaround objective were working in practice.

Senior management did not appear to appreciate the risk that an objective of having 'zero justifiable complaints' may encourage staff to not record complaints. One member of senior management believed that the hierarchical 'command and control' structure and management of GRG meant the risk of staff not recording complaints properly was limited.

In order to assess whether GRG was acting consistently with TCF, senior management needed MI that allowed them to confirm whether:

- they were getting an accurate picture of what was going on at GRG's frontline, and
- staff were treating customers fairly

The evidence does not demonstrate that the steps GRG took to implement or embed TCF or to explain to GRG staff what it meant in practice were sufficient. The MI that senior management received gave an incomplete picture of how far the behaviour of frontline staff was consistent with TCF.

Senior management relied on high level MI and on infrequent information, like customer surveys and complaints, which could only give a partial view of what was happening to customers in GRG.

The MI was focused on those firms that were turned around, left GRG and had jobs saved. While this may be relevant to an assessment of TCF, the MI did not consider the overall treatment of all customers, particularly SMEs, or GRG's compliance with policies that might impact TCF.

Further, senior management appear to have relied on complaints MI, and were reassured by the lack of complaints received. However, we have seen evidence that senior management became aware that there was a risk that complaints were not being recorded accurately. One member of senior management also confirmed that a gap analysis exercise identified MI on complaints, including the accuracy and completeness of logging and recording complaints, as a key gap. Additionally, senior management do not appear to have linked the relatively low levels of complaints with the potential motivation for staff not to record complaints by including 'zero justifiable complaints' in staff objectives.

The ManCo MI and complaints MI, which senior management relied on as their primary source of information, were not detailed or accurate enough to have allowed senior management to adequately monitor TCF for its customers.

### ***RBS's communication with customers referred to GRG***

GRG's Policy and Procedures Manual set out the procedures for customer handover. They required that customers were sent a 'pre-handover' letter that explained the reasons for transfer to GRG, introductions to GRG and next steps. The policy also required that all customers were sent a 'post-handover' letter, confirming the position of the customer and setting out next steps. Staff were given letter templates, but the independent review found that, in practice, these letters were 'heavily edited' and not always sent.

A member of senior management acknowledged in interview that, with hindsight, there was general awareness that communication letters were not sent to customers in every case.

BRG was the part of GRG which dealt with smaller firms with debts of between £1m and £20m. Senior management said that BRG's structure was designed to help them communicate appropriately with SME customers. Relationship managers were based in regional offices and so were geographically close to their customers. Once the customer was in GRG the local team leader became responsible for overseeing communications.

There was a risk that the post-handover communications would have given customers, who GRG had assessed as not capable of turnaround, an unrealistic expectation that GRG would save their business. For example, the letter stated that GRG was:

'the area of the Bank that focuses on corporate turnaround...The goal of GRG is corporate turnaround; we focus on identifying risk, addressing corporate distress, crisis management and business stabilisation. Our objective is to return you to mainstream banking once the issues you are facing have been overcome ... Finally I would like to reassure you that the main objective of GRG is corporate turnaround and I look forward to working with you albeit during challenging times'.

### ***How GRG dealt with customer complaints***

Senior management explained that they used customer complaints as another source of information. However, GRG's MI had limited information on whether customers were receiving adequate communications and we know from documentary and interview evidence that complaints were not being accurately logged during the review period. One of the senior management team said that senior management were aware of themes from complaints which included problems with the transparency of the handover process from RBS to GRG and unhappiness with pricing changes.

When dealing with complaints, we expect regulated firms to take reasonable steps to identify recurring themes, as they can potentially indicate a systemic issue ([DISP 1.3.3](#)). We expect the firm to resolve any of these issues if it does find them. We would also expect a regulated firm

to consider, in line with its obligations under Principle 6, whether any customers who had not complained had suffered harm because of the systemic issue and put the matter right. While GRG was not subject to Principle 6, we note that:

- it would have been difficult for GRG to accurately identify recurring themes when it did not log or record complaints accurately, and
- it does not appear that GRG took any steps to address the root causes of systemic issues, or to put right any harm this caused its SME customers

### **Examples of poor culture and senior management knowledge**

We have seen limited examples of documents in GRG that are clearly at odds with ensuring that customers are being treated fairly. One example of these is the 'Dash for Cash' email which circulated within GRG (having been produced outside of it). Such an email indicates a poor approach to customers, albeit in single regional offices. We have not seen evidence that senior management knew about or approved these, or similar, documents.

#### **Team**

#### **Project 'Dash for Cash'**

As discussed at our last Managers meeting there is an imperative to help South and RCB deliver their numbers to support;

- the South/RCB team
- our pride in delivering
- our bonuses

South and RCB are both targeted on a Financial basis (i.e. any fees taken are amortised and they do not feel the full effect). At this time of year therefore the only significant impact that can be made will be in Cash fees (exit/restructuring) and GBM

### **What GRG said**

GRG explained that:

- The culture of GRG during the review period was turning customers around and that ensuring customers stayed in business benefitted not only the customer, but was good from a PR perspective and ensured customers were contributing financially to RBS in the future.
- On the allegations about GRG's culture in the press and public domain, GRG did not believe that it deliberately distressed customers in order to profit from them. GRG also said that it had not known or seen anything which would make it think that was happening.
- RBS would not have benefitted and it would have been 'commercial suicide' for RBS to push SME firms out of business. This was because RBS was the largest provider of finance to SMEs and, from a long-term business perspective, it would have made no sense for RBS to drive SMEs out of business.
- There were policies and procedures for communicating with SME customers and GRG made a greater effort to communicate with SME customers because they potentially had less expertise and resources available to them than larger firms. Additionally, SME customers were 'all bound up in the same entity as it were, and so they tend to be more emotional, occasionally less rational and so more explanation is needed.'
- With hindsight, GRG now knew that letters which should have been sent to SME customers were not always sent.
- BRG's structure was designed to help appropriate customer communication. Relationship managers were based in regional offices and so were geographically near to their customers. Relationship managers were encouraged to have regular meetings with customers. Once

the customer was in GRG then the responsibility for overseeing communications with them was with the local team leaders and regional heads.

- Relationship managers had to use their judgement when communicating with customers and there could not be a 'prescriptive script for every customer.' Because of this, the responsibility for communicating effectively with customers would lie with individual relationship managers, and the first objective should always be returning a customer to the mainstream bank.
- GRG Regional Directors would have been expected to understand what was going on in their own areas and who in their team was responsible for customer communications. 'GRG was designed [sic] that [a Regional Manager or Regional Director] would know his people, he would choose someone who was suitable for a particular type of case, and use his judgement and experience.'
- GRG did not expect higher levels of seniority to get information about what correspondence individual customers were getting.
- Limited MI was produced about customer communications on customers' transfer to GRG. Senior management received MI on numbers of transfers to GRG, but not on the type of communications about transfers or the time between transfer and communication to the customer.
- It did not know if there was a policy about explaining the trigger for transfer to GRG to customers, but thought that it would be 'common sense' that the reason for transfer would be explained to the customer.
- It did not know how senior management knew that staff were complying with policies and procedures on communications with customers, other than by relying on the 'sufficient' layers of management who should be ensuring that it was being done.
- RBS had a 'command and control' structure in place and this was the mechanism used to ensure complaints were handled fairly.
- Customer complaint MI was recorded and would always be looked at. There were very few complaints about GRG, but GRG did not identify how it could ensure that all complaints were being recorded.
- Many of the complaints received about GRG related to operational matters, which the relationship managers would deal with as part of their roles. GRG considered that the complaints were investigated thoroughly, despite the small number of them.
- A gap analysis exercise identified a key gap in MI on complaints, including the accuracy and completeness of logging and recording complaints. This led to staff training and guidance on TCF for complaints and strengthened staff requirements for complaints handling, logging and collecting MI. As a result, accuracy of complaint recording improved in 2011 when GRG began to record complaints centrally. This increased the quality of analysis and regular reporting on complaints.
- GRG was aware of themes in the complaints GRG received which included problems with the transparency of the handover process from RBS to GRG and customer unhappiness with pricing increases.
- GRG's hierarchical structure and culture meant that there was limited risk of complaints not being recorded properly.

## Our view

RBS's intention to implement TCF throughout its business, including unregulated parts of its business, was positive. There is evidence that senior management took steps to encourage the fair treatment of customers within GRG. However, GRG did not imbed TCF effectively in practice. In order to be effective, consideration needed to be given to what TCF meant in practice to GRG's SME customers.

GRG did not always appear to recognise the emotional stress that could be suffered by SME customers in difficult personal circumstances. These customers might not only be losing their business and income but, in some cases, their family home as well. In circumstances like these, we would expect RBS to ensure that there were adequate controls in place to ensure GRG staff were following all policies and procedures so that customers in these situations would be treated as fairly as possible.

### ***Reporting and delegating***

We expect regulated firms to have reporting lines that are clear and appropriate for the nature, scale and complexity of their business (SYSC 3.2.2G). Regulated firms should ensure that delegating tasks from one individual to another is suitable. For example, by ensuring that the person to whom the task has been delegated has the right skills and experience to do the job properly. We expect a firm to supervise and monitor this kind of delegation to ensure the delegate is properly carrying out their role.

In our view, the reporting mechanisms that were in place in GRG to ensure senior management could assess how individuals were doing their job or how issues that could directly affect their customers were being handled did not give senior management a complete picture. This means that senior management risked not identifying and addressing issues that might impact the fair treatment of GRG customers.

### ***Communications with customers***

The way a firm communicates with customers is important, especially customers in difficult financial circumstances like those in GRG. While senior management are not expected to read every letter that is sent, they do need to be satisfied that there are clear policies for communication in place and that checks are conducted to make sure staff are following those policies. Senior management's visibility of customer communications in GRG was limited, impacting their ability to assess the sufficiency of those communications or compliance with GRG policies.

SME firms, through their directors, staff and shareholders (often the same people) have told us how stressful it was being referred to GRG. They have also told us that in many cases there was no effective communication.

### ***Customer complaints***

Senior management gave evidence that GRG received very few complaints. Although we note that senior management identified that there were very few complaints about GRG, they did not explain how they could ensure that staff were recording all complaints or that systemic issues were being identified and addressed.

Customer complaints are a valuable source of information for any business. They help senior management understand what issues are worrying customers, as well as identifying poor practice by staff. GRG senior management understood the importance of customer complaints and the value that analysing them could have. However, the systems they put in place to identify and record these complaints had flaws. These included a requirement for there to be 'zero justifiable complaints' within GRG staff's objectives which created the significant risk that GRG staff would not record complaints properly. This in turn risked reducing the usefulness of complaints as a source of MI, impacting an effective way for senior management to understand how GRG was operating in practice and to understand SME customers' specific concerns.

## 5 RBS's and GRG's risk management, systems and controls

### Background

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#### ***How the financial crisis affected GRG***

The start of the financial crisis affected the way GRG operated. The number of customers referred to GRG increased significantly. The control framework within GRG was evolving over the course of the review period, with senior management introducing some measures that show an awareness that the business needed better systems and controls. However, these changes in systems and controls did not keep pace with what was needed in light of the increase in the volume of customers referred to GRG. This increase, which was a consequence of the financial crisis rather than any strategy on the part of GRG, was a substantial challenge for senior management during the review period.

As a result, while GRG did make some improvements to systems and controls, it now appears that the changes were not enough to give senior management a sufficiently complete picture of GRG's activities.

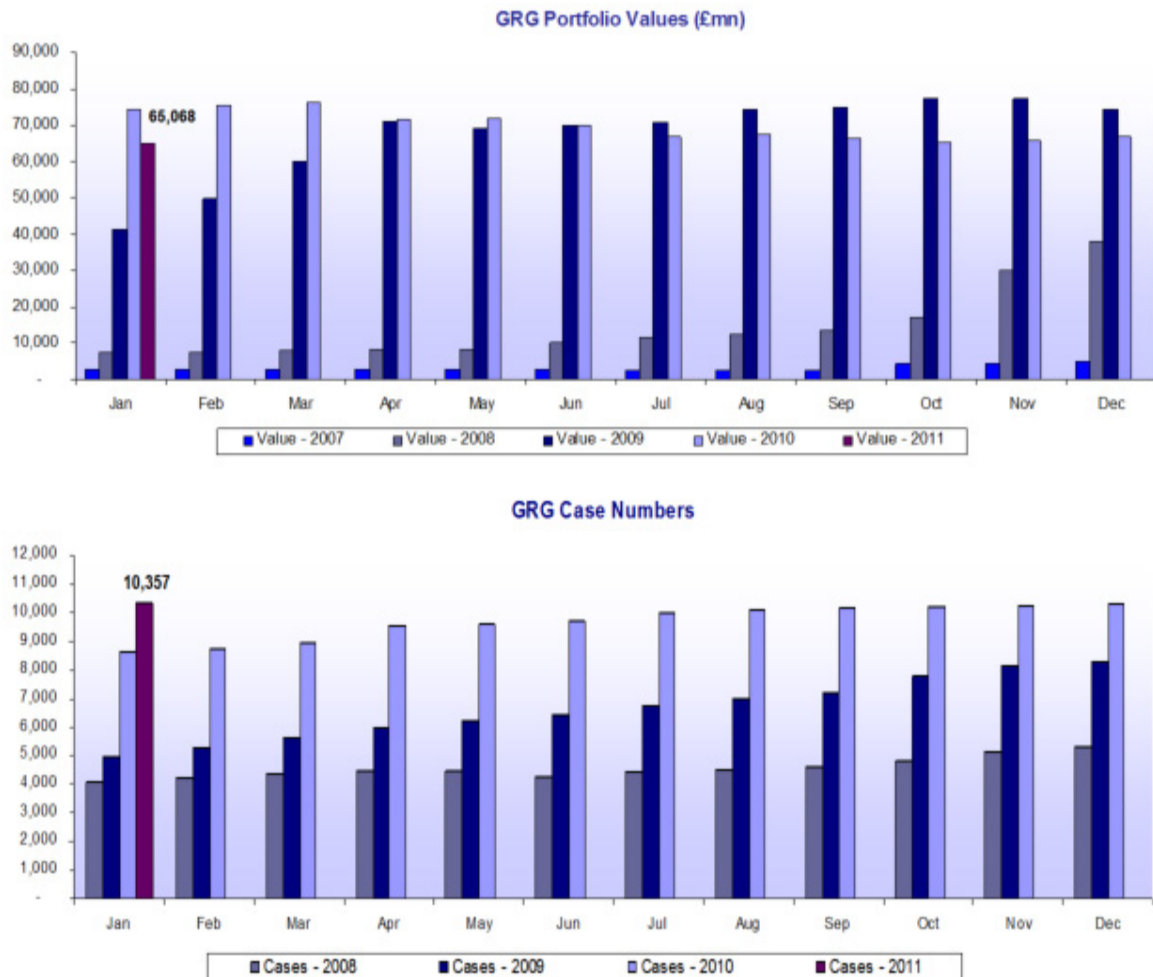
Senior management had competing demands put on their time and the number of SME customers, while growing, made up a minority of GRG's business (8% of GRG's total portfolio by value and 35% by volume). In practice, senior management gave them much less time and focus than larger customers.

#### ***Increasing customer and staff numbers in GRG***

The financial crisis affected many businesses around the world. As a result, GRG grew rapidly, both in customer numbers and in the value of debt under its management.

During the review period, GRG started with a portfolio value of approximately £6bn in Q1 2008. This increased to approximately £60bn in Q1 2009 and to around £76bn in Q1 2010. The number of SME customers in GRG increased from 2,156 to 6,000 in the 12 months from April 2008 to April 2009. GRG represented 8% of GRG's total portfolio by value and 35% by volume over the period 2008 to 2013.



**Fig 2: The increase in GRG customers between 2008 - 2011****GRG Portfolio by Value (£mn) and Volume as of Q1 2011****What the independent review found**

The independent review noted that the longer-term financial impact of the financial crisis created a 'rapid and significant' number of referrals to GRG and 'a challenging ongoing background for the finance of many SME customers and the bank itself. In particular, the bank's appetite for lending to many sectors - including many relevant to the SME customers - was dramatically reduced'.

Because of this, more SME customers defaulted on their loans. Once a customer had defaulted, RBS had triggers which set out when customers would be transferred or referred to GRG from different areas of the bank. From 2009, RBS had a 'Watch' forum where individual customers were monitored prior to transfer to GRG. The decision to then transfer a customer to GRG would be taken jointly between the members of the forum (which included Specialist Relationship Management, Banking and Commercial Credit and GRG). When considering whether or not to transfer a customer, the forum used transfer criteria against which an assessment would be made. Some of those transfer criteria were mandatory (meaning that staff had no discretion and the customers had to be transferred to GRG), while others were subject to a discussion with GRG staff about whether it was appropriate to transfer them.

**Fig 3: RBS Mandatory referral, discussion and transfer to GRG criteria**

Mandatory transfer to GRG	Mandatory transfer to/discussion with GRG
<ul style="list-style-type: none"> <li>• PD is 24 or greater with no justifiable override appropriate</li> <li>• Need to record Stressed Loss</li> <li>• Customer litigates against the Bank</li> <li>• Accountants investigation (IBR) required</li> <li>• Current/proposed insolvency or other action against customer or management – Includes any Phoenix proposal</li> <li>• Fraud by owner or management, incl cross-firing (unless otherwise instructed by GS&amp;F)</li> <li>• Debt has to be restructured outside of normal senior debt parameters</li> </ul>	<ul style="list-style-type: none"> <li>• Any other bank initiated request for external accountants' involvement where PD is 18 or greater</li> <li>• Default any other funding lines with RBSG/other banks</li> <li>• Withdrawal of licence/registration etc. from main trading business</li> <li>• Breakdown of customer relationship or any proposed exit strategy</li> <li>• Regular/significant unpaid items that threatens the future of the business</li> <li>• Sustained losses/cash absorption that seriously compromises serviceability</li> <li>• Property investment exposure with unacceptable LTV/DSC profile</li> <li>• 2 consecutive years operating losses where customer is unable to service borrowings</li> <li>• Two or more consecutive (uncovered) loan arrears</li> <li>• A change/strengthening of customer's management team at the Bank's insistence and more specifically if there is the introduction of interim specialists to assist the management team</li> </ul>

The increase in customers being referred to GRG meant it needed a rapid increase in staffing at all levels. GRG also needed to develop the systems and controls which could deal with the new (and increasing) volume of customers.

### **Governance and Oversight**

The independent review identified that the potential for inappropriate action by GRG to harm customers was significant, and a number of its customers were vulnerable. This called for a framework of systems and controls to enable it to identify, manage and mitigate risks to its customers. In the absence of appropriate governance and oversight there was an increased risk that issues of concern (eg failures to comply with policies) would not be identified and so the opportunity to remedy them would be missed.

The independent review raised a number of concerns in connection with GRG's systems and controls:

- the existing procedures for frontline oversight of relationship managers were inappropriate and unlikely to have been sufficient to ensure GRG managed the risks appropriately
- RBS provided limited second or third line oversight of GRG activities across the review period, particularly of customer-treatment issues
- GRG did not identify or define key risks to customers and these ongoing risks were not monitored or managed
- there was not enough appropriate management information to enable senior management to have clear oversight of the risks to customers
- GRG did not carry out assurance work on key risks, apart from some work on complaints
- RBS decided to roll out TCF across the whole Group, and it was not appropriately implemented in GRG, and



- there was insufficient bespoke training of GRG relationship managers on viability and turnaround issues but, more importantly, also a failure to follow the processes in GRG policy and in RBS's oversight which allowed this to continue throughout the review period

## What we found

### *Overview of GRG's systems and controls*

The control framework within GRG was evolving over the course of the review period, with senior management introducing some measures that show an awareness that the business needed better systems and controls. These changes did not keep pace with what was needed in light of the substantial increase in the volume of customers referred to GRG. However, that increase, which was a consequence of the financial crisis rather than any strategy on the part of GRG, was a substantial challenge for senior management during the review period.

In overview:

- Senior management gave evidence that, before GRG's growth, there was a 'deliberate decision taken by a wide cross section of the bank's senior management not to establish a second line of defence (the 'lines of defence' are explained in further detail on page 42) in the first instance, as it was felt that, in order to give the quick responses required in restructuring, a 'four eyes' system of escalating credit decisions was more effective for customers...the system proved effective and there were no indicators to give rise to concern, neither was there evidence of an increased risk of loss'.
- With GRG's rapid expansion, the previous control environment - set up for a small unit - was no longer adequate.
- In 2010, senior management approved the decision to continue without a second line of defence and accepted the risks of doing so, while working towards putting one in place.
- Senior management sought to recruit sufficiently experienced senior staff but it was difficult to recruit staff in the financial crisis.

Throughout the review period, GRG did not have a dedicated second line of defence in relation to SME customers. Senior management were aware of the risks this created and steps to embed a second line were being taken, with an initial focus on larger customers who comprised the majority of RBS's portfolio. In the interim, in place of a second line of defence, senior management relied on:

- the 'one up' system to manage credit risk, where staff could not authorise their own credit proposals but required more senior review
- the Strategy and Credit Reviews (SCRs), which were designed to give a view of both credit issues and a holistic consideration of the results for customers and turnaround, and
- day-to-day oversight and review by senior and experienced staff in local offices

One member of senior management said that they believed these processes at the time ensured decisions were properly assessed and reviewed, and that they were always followed. However, it is difficult to understand how, in the absence of a fully-functioning second line of defence overseeing customers' cases, senior management could have such a high degree of assurance and confidence.

The second line of defence was implemented in phases, with the initial focus on customers with larger amounts of debt. It was not fully implemented for customers owing under £20m until 2013, at which point its focus remained on credit risk as opposed to broader conduct risk.

### ***The three lines of defence model***

The 'three lines of defence' is a common risk management and compliance model designed to ensure a firm has adequate systems of internal control and risk management. A three lines model would usually involve:

#### ***The first line of defence***

This typically consists of sufficiently experienced management and internal controls to oversee and manage risk and compliance for frontline staff. The first line of defence is usually part of the frontline operational area that takes risks on behalf of a firm. Examples of controls include having effective policies and procedures, training, guidance and experienced frontline managers.

#### ***The second line of defence***

This is usually a risk management and compliance function, although it can include other areas, such as IT and HR. The responsibility of the second line of defence is to oversee, and assess whether, the first line of defence controls are working effectively and that staff are using them appropriately. A second line of defence is usually independent of the staff in the first line of defence, but need not be independent of the wider business unit they are overseeing. Some independence is important to ensure that staff in the second line of defence are not motivated by pay to turn a blind eye or be improperly influenced.

#### ***The third line of defence***

This is typically provided by an independent internal audit function. The third line would be entirely independent of the first and second lines to ensure they are operating effectively and should not report directly to the management of the business unit they are assessing.

### ***Risks that RBS identified***

Throughout the review period, RBS identified and acknowledged the risk that GRG's resource and infrastructure required improvement to keep up with its rapid growth. RBS acknowledged that improvements were required throughout 2009 to 2011 and made some improvements:

'RBS Risk Management considers there to have been a positive improvement in risk profile in GRG during 2010. While the most significant improvement is in credit risk there have been improvements in control environment and risk awareness. These should be considered though in light of the improvements that were needed in control environment and infrastructure albeit some aspects were exacerbated by the rapid growth and people in 2009'.

One member of senior management gave evidence that they were aware at the time that GRG needed a completely different control environment and better information systems to keep up with the unexpected growth.

In May 2010, the GRG Divisional Risk & Audit Committee (DRAC) identified 'resourcing' as a 'Top Key & Emerging Risk issue'. In particular, GRG noted the growth in workload in GRG was resulting in a significant increase in staff. GRG recorded that relationship management teams had significant workloads in an extremely challenging environment and were struggling. It also noted that, at this time, a significant proportion of staff were relatively inexperienced. In 2010, GRG flagged this as a risk which could expose RBS to reputational or financial damage.

Throughout the review period, GRG tried to increase staff levels to meet the new workload demands. It did this by bringing in staff from other parts of RBS and secondees from external firms. Senior management said that they knew that GRG's staffing levels needed to increase to keep up with its growth, but they found it difficult to find senior staff, noting the stigma attached to RBS at the time of the financial crisis as well as pay restraints.

GRG also identified as a risk that it required sufficient resource to train staff and ensure they were adequately supervised. Senior management said that one of the ways they satisfied themselves that they were managing this risk was the fact that inexperienced staff could not approve granting of new money to customers.

Instead, GRG used a 'one-up' process to ensure only more senior staff could authorise credit decisions about customers. Only a small group of the most experienced staff could do this, with the intention that credit decisions about customers always had oversight and control.

### **Overview of GRG's approach from 2008**

#### **Limits in the second line of defence**

GRG operated without a dedicated second line of defence, which was recorded as a risk and accepted by RBS Group until June 2011. Senior management gave evidence that they accepted this risk until the right person was put in the role to oversee governance arrangements for the second line of defence. However, GRG's control framework was nonetheless evolving during the review period, with senior management introducing some measures that show they were aware that the business needed better systems and controls in light of the substantial growth in volumes of referrals it was experiencing.

In terms of SME customers specifically, GRG did not have a dedicated second line of defence during the review period. Senior management knew the risks this created and were taking steps to embed a second line, initially focusing on larger customers who made up the majority of RBS's portfolio. In place of a dedicated second line for SME customers, a panel of experienced GRG staff carried out a periodic 'strategic credit review' of each customer file. GRG's structure also required that relationship managers' credit decisions were approved by more senior staff (the 'one-up' process). This meant relationship managers dealing with a customer should not have been able to make the credit decision for that customer without oversight.

Regional heads for each office carried out formal oversight of the 'one-up' process for SME firms as part of SCRs of a customer. The decision of the senior staff who signed off decisions in the 'one-up' process was seen as the primary control to evaluate how appropriate a strategy and pricing was for a customer, as they were more experienced members of GRG staff.

Senior management said that another form of oversight in GRG was the weekly meeting between senior management and the heads of GRG's different departments, known as the 'weekly heads' meeting. As GRG grew in 2010, senior management formalised this and created the GRG ManCo. GRG ManCo would escalate issues to the GRG ExCo, which in turn reported to RBS Group. Senior management explained that GRG ManCo, in conjunction with GRG ExCo, had responsibility for setting the strategy for GRG.

GRG ManCo would review all new cases over £2m and senior management said it was a forum where issues such as TCF, pricing and valuations were discussed. The meeting minutes of GRG ManCo during the review period show that such issues were discussed and escalated to GRG ExCo.

Senior management would also receive MI as part of the monthly packs presented as part of the ManCo. They explained that these ManCo packs included the 'granular' and 'individual

office level information for various teams'. However, when we reviewed the ManCo packs, we found only limited evidence of the detail that would give senior management enough information about what was happening on the frontline. See Figure 1 for an example of the data senior management received.

The MI given to senior management was high level and mainly focused on financial figures, with limited information about SME customers to give senior management an accurate picture of how customers were being treated during their time within GRG. Figure 4 below indicates the information which senior management would have had to rely upon to get a picture of GRG's SME customers.

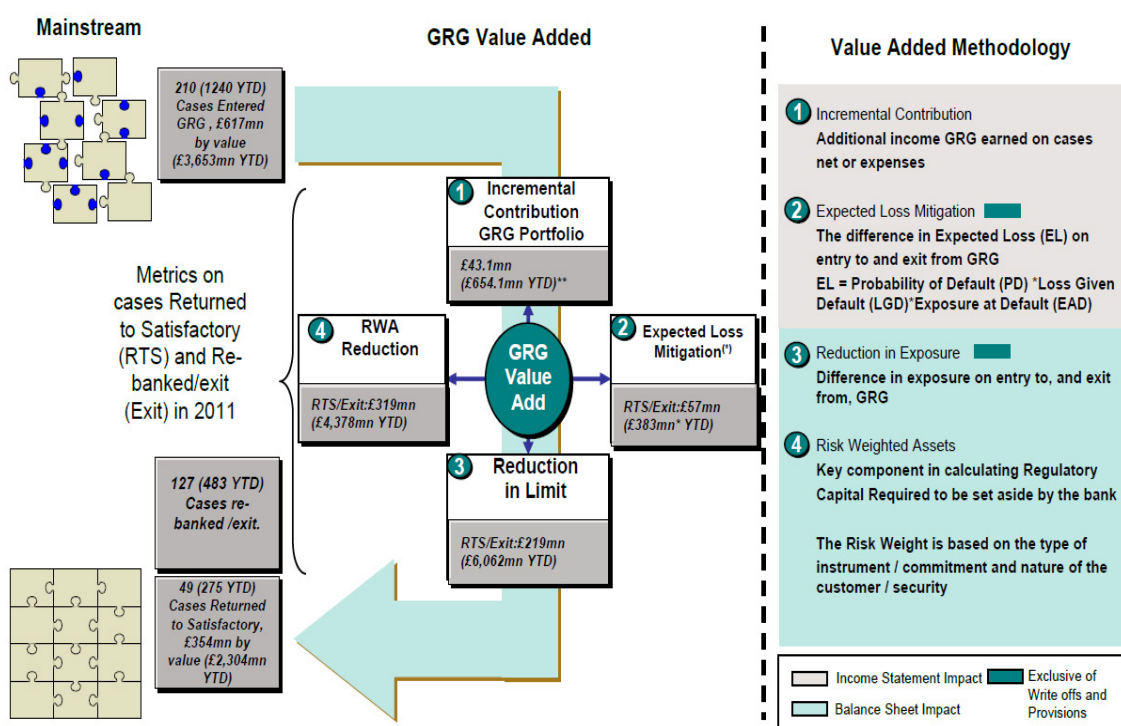
**Fig 4: Extracts from GRG ManCo management information – June 2011**

Headcount for the month increased to 1,116 (1,250 incl. secondees) from 1,095 (1,221 incl. secondees) in May.

The portfolio size decreased to £67.8bn (May £68.2bn). Main drivers for this were repayments on balances outstanding of £1.8bn and cases being returned to satisfactory of £0.8bn. Offsetting this were new cases to come under GRG management totalling £1.3bn (Ulster accounting for £0.4bn). Other balance movements were largely driven by EUR and USD currency rate fluctuations for the period.

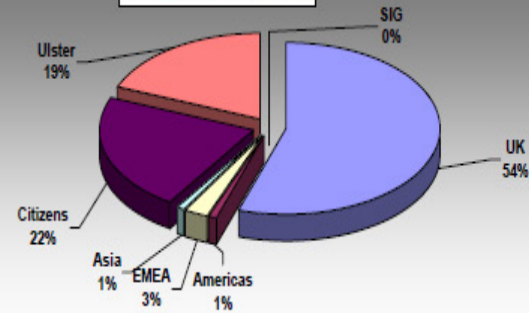
Case numbers increased to 11,884 from 11,605 May.

## GRG Value Added Metrics Explained for May 11

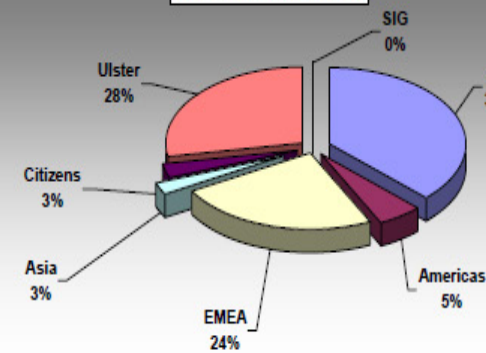


# GRG Portfolio Analysis

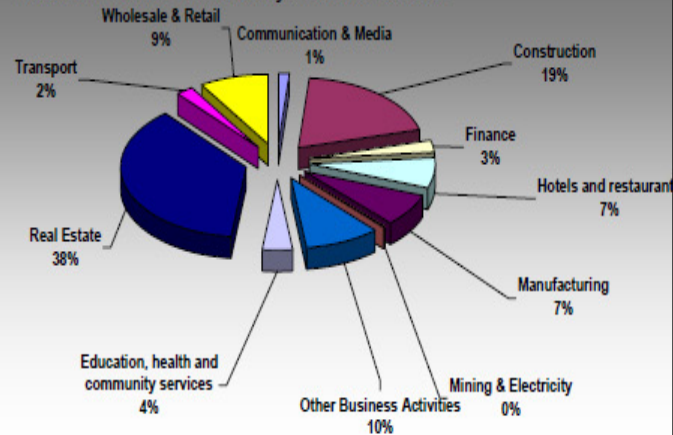
GRG Case Numbers



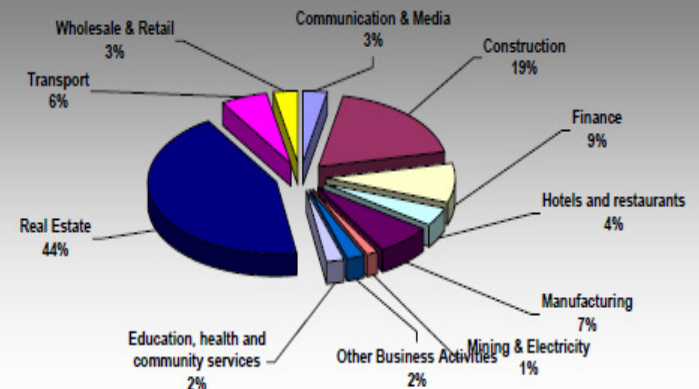
GRG Portfolio Value



RBS/GBM Case Numbers by Industrial Sector



Case Values by Industrial Sector



Note - Sector Analysis does not include Citizens - Ulster is now included.



Global Restructuring Group  
Portfolio - Business Restructuring Group (BRG)

June 2011

Case Numbers

	Birmingham	Bristol	Cambridge	Edinburgh	Leeds	London	Manchester	SMU 600	Total
	Month Actual	Month Actual	Month Actual	Month Actual	Month Actual	Month Actual	Month Actual	Month Actual	Month Actual
Brought Forward	263	122	97	263	101	553	278	1,994	3,671
New Cases	9	8	3	16	5	28	10	102	181
GRG Internal transfers - In	0	0	0	1	0	3	2	3	9
GRG Internal transfers - out	(1)	0	(1)	(2)	(6)	(6)	(2)	(9)	(27)
Transfer from / (to) Telford	0	0	0	(2)	0	(1)	(1)	(19)	(23)
Cases Closed	(3)	(1)	0	(3)	(1)	(5)	(3)	(27)	(43)
Re-banked	0	0	(2)	0	0	0	(1)	0	(3)
Returned to Satisfactory	(3)	0	0	(3)	0	(6)	(1)	(32)	(45)
	266	129	97	270	99	566	282	2,012	3,720
Shadow Cases (Include RBSIF)	0	0	0	0	0	0	0	0	0
Total No. of Cases Incid Shadow	266	129	97	270	99	566	282	2,012	3,720
% Case numbers by BRG area	7%	3%	3%	7%	3%	15%	8%	54%	100%

	Birmingham	Bristol	Cambridge	Edinburgh	Leeds	London	Manchester	SMU 600	Total
	YTD Actual	YTD Actual	YTD Actual	YTD Actual	YTD Actual	YTD Actual	YTD Actual	YTD Actual	YTD Actual
Brought Forward	370	120	95	246	140	618	486	2,476	4,551
New Cases	47	35	22	63	27	142	48	596	980
GRG Internal transfers - In	10	5	2	2	6	19	8	12	64
GRG Internal transfers - out	(120)	(21)	(16)	(21)	(63)	(163)	(220)	(581)	(1,205)
Transfer from / (to) Telford	(7)	(3)	0	(3)	0	(5)	(10)	(130)	(158)
Cases Closed	(16)	(3)	(1)	(9)	(7)	(17)	(11)	(185)	(249)
Re-banked	(1)	0	(2)	0	(2)	(2)	(3)	(4)	(14)
Returned to Satisfactory	(18)	(4)	(3)	(8)	(2)	(26)	(16)	(172)	(249)
	286	129	97	270	99	566	282	2,012	3,720
Shadow Cases (Include RBSIF)	0	0	0	0	0	0	0	0	0
Total No. of Cases Incid Shadow	286	129	97	270	99	566	282	2,012	3,720
% Case numbers by BRG area	7%	3%	3%	7%	3%	15%	8%	54%	100%

Case Values £'000

	Birmingham	Bristol	Cambridge	Edinburgh	Leeds	London	Manchester	SMU 600	Total
	Month Actual	Month Actual	Month Actual	Month Actual	Month Actual	Month Actual	Month Actual	Month Actual	Month Actual
Brought Forward	514,284	255,506	220,654	813,269	182,765	1,457,295	543,475	714,567	4,801,813
New Cases	23,992	5,700	5,967	44,775	9,072	39,832	9,255	37,494	175,087
New Money	120	730	0	1,722	0	0	345	894	3,711
GRG Internal transfers - In	0	0	0	469	0	11,889	1,649	957	14,965
GRG Internal transfers - out	(11,362)	0	(2,329)	(10,521)	(6,194)	(10,799)	(931)	(3,657)	(45,793)
Transfer from / (to) Telford	0	0	0	(246)	0	(40)	(175)	(2,758)	(3,223)
Debt Written off	0	0	0	0	0	(672)	0	0	(672)
Debt Repaid	(3,396)	(2,756)	(5,873)	(8,111)	(1,358)	(25,842)	(15,298)	(17,749)	(80,383)
Returned to Satisfactory	(1,042)	0	0	(58)	0	(1,260)	(331)	(2,847)	(5,538)
Movements in OD / RCF / FX / Other	360	(3,052)	(1,487)	(8,389)	(737)	707	(889)	(9,400)	(22,925)
	622,867	266,087	218,832	832,909	183,548	1,471,110	636,997	717,601	4,838,042
Shadow Cases (Include RBSIF)	0	0	0	0	0	0	0	0	0
Total Value of Cases Incid Shadow	622,867	266,087	218,832	832,909	183,548	1,471,110	636,997	717,601	4,838,042
% Case values by BRG area	11%	5%	4%	17%	4%	30%	13%	15%	100%

	Birmingham	Bristol	Cambridge	Edinburgh	Leeds	London	Manchester	SMU 600	Total
	YTD Actual	YTD Actual	YTD Actual	YTD Actual	YTD Actual	YTD Actual	YTD Actual	YTD Actual	YTD Actual
Brought Forward	675,362	265,746	241,397	789,766	228,008	1,704,039	969,876	898,167	5,772,360
New Cases	112,541	53,058	64,013	179,505	52,652	290,197	89,806	231,473	1,073,246
New Money	936	9,942	4,846	20,749	272	932	720	3,360	41,756
GRG Internal transfers - In	24,741	7,935	4,907	4,292	10,271	76,703	9,881	4,776	143,507
GRG Internal transfers - out	(243,222)	(49,531)	(59,862)	(59,933)	(86,475)	(459,116)	(377,276)	(208,690)	(1,544,105)
Transfer from / (to) Telford	(683)	(477)	0	(445)	0	(318)	(604)	(14,851)	(17,377)
Debt Written off	(6,596)	0	0	(3,376)	(319)	(868)	(3,760)	(71)	(14,990)
Debt Repaid	(43,763)	(33,078)	(31,720)	(98,404)	(19,865)	(122,145)	(50,984)	(91,622)	(491,581)
Returned to Satisfactory	(7,245)	(3,127)	(13,646)	(7,265)	(252)	(46,877)	(23,109)	(15,452)	(116,974)
Movements in OD / RCF / FX / Other	10,885	5,619	6,998	8,020	(745)	28,563	22,447	(89,589)	(7,800)
	622,867	266,087	218,832	832,909	183,548	1,471,110	636,997	717,601	4,838,042
Shadow Cases (Include RBSIF)	0	0	0	0	0	0	0	0	0
Total Value of Cases Incid Shadow	622,867	266,087	218,832	832,909	183,548	1,471,110	636,997	717,601	4,838,042
% Case values by BRG area	11%	5%	4%	17%	4%	30%	13%	15%	100%

As these examples show, senior management did receive some MI about companies entering and exiting GRG. The MI packs also discussed individual cases, including SME customers. This information would have given senior management some level of understanding of customer treatment. However, these individual cases are referred to in some packs as 'success stories' or 'deals done' and do not appear to give senior management information about any known issues. As discussed in section 4 above, the MI was focused on those firms that were turned around, left GRG and had jobs saved. While this may be part of an assessment of TCF, the MI did not consider the overall treatment of all customers, particularly SMEs, or GRG's compliance with policies (such as those that might impact TCF).

### ***Third line of defence***

Group Internal Audit (GIA) acted as a third line of defence examining policies, procedures and processes as well as training. GIA reports were circulated to senior management and provided evidence that regional GRG offices would raise issues with GIA where appropriate.

A member of the senior management team gave evidence that GIA would carry out regular audits of regional offices, and check that staff were complying with policies and procedures. Other senior management said they had regular discussions with senior staff from GIA, Human Resources and Quality Assurance who could provide up to date information on the skills and performance of frontline staff and those authorised to approve proposed pricing structures.

The independent review found that 'GIA provided some oversight of GRG activity across the review period and undertook audits into different topics of relevance within GRG. Many of these reports were specifically in relation to GRG Ireland and were not relevant to the operation of GRG in the United Kingdom. We have reviewed the reports provided to us and saw no evidence that GIA undertook any assessment of issues that specifically related to how GRG was treating its customers'.

### ***GRG's implementation of a second line of defence***

GRG's implementation of the second line of defence was phased.

In 2011, RBS appointed a Chief Risk Officer for GRG and GRG also established its own independent risk function - the GRG Risk team. Before this date GRG had used RBS Group Risk for its risk and compliance matters. GRG reported into the DRAC, which in turn reported risk matters up into the RBS Board Risk Committee. We have seen documentary evidence that senior management gave presentations to the RBS Group Board twice during the review period. During these presentations, senior management discussed topics such as the number of customers entering and exiting GRG, capital management and resourcing.

The process for implementing a full three lines of defence model in GRG - and therefore its earlier absence - was noted by:

- Group Internal Audit in Q1 2011
- the Board Risk Committee in November 2011
- the Group Audit Committee and Board Risk Committee in October 2012, and
- the Board Risk Committee again in November 2013 - this document also notes the size of assets the second line of defence was considering

Senior management appear to have relied upon GIA's assessment of GRG's practices as a layer of compliance checking.

In January 2012, GRG created a credit team as a second line of defence. This second line of defence started with a review of credit capability that only looked at customers with more than £20m of debt. It looked at approximately 150 cases a month where RBS had lent £20m+.

This covered approximately 70% of GRG customers (by number), which excluded SMEs from second line of defence reviews. Senior management explained that the focus of the credit team was to look at credit risk not conduct risk, and so did not consider the fair treatment of customers.

After this second line of defence was introduced in GRG, SCRs continued to review cases of £20m or less. It was not until 2013 that GRG introduced this second line of defence in BRG for customers, including SME customers, with exposures below £20m. Senior management considered that, in the interim, the SCRs provided a level of risk management for SME customers.

In practice, there was no independent oversight of frontline staff (ie oversight by staff who were not part of the frontline) until the credit risk team was put into place in 2013.

### ***The role of Strategy and Credit Reviews (SCRs)***

GRG's infrastructure and second line of defence required improvements due to its rapid expansion. Until the introduction of a second line of defence in GRG, senior management relied on SCRs to provide a level of checking and reviewing of customer cases. SCRs were reviews held for all GRG customer cases. They were made up of a panel of three experienced staff members from GRG, who would assess the status of the strategy set in relation to the customer.

SCRs would often be chaired by some members of GRG senior management.

SCRs were meant to ensure that the strategies which relationship managers decided upon for GRG customers, including SME customers, were properly assessed and reviewed. SCRs did not formally approve the strategies relationship managers put in place, because SCR reviews were retrospective. Instead, they were meant to ensure progress was being made with each customer and to provide advice and guidance. The SCRs were staffed by individuals who were independent of the decision-making about a customer, in order to maintain effective independent oversight.

Senior management believed that the staff sitting on SCRs were sufficiently experienced and knowledgeable, including about SME customers, to properly assess relationship managers' decisions and recommendations.

SCRs took place between every 3 months to a year, depending on the customer's size and nature of the risks associated with that customer. Customers with an exposure of less than £2m were required to be reviewed at least once a year and all customers with an exposure of more than £2m were required to be reviewed within a 90-day cycle.

There is little evidence that an SCR review would result in a change to strategy that was already underway. The minutes of SCRs were brief, recorded little challenge and provided no evidence that available turnaround options for a customer were substantially debated or challenged. The independent review also identified that SCRs could be held as infrequently as once a year for those with smaller exposures. SCRs would generally record background information about the customer, the reasons they were transferred to GRG, and RBS's strategy to either restructure or repay and reduce the debt.

There were limits to this approach. SCRs were held infrequently,<sup>2</sup> had limited information about the customer on the file and do not appear from the available evidence to have often

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<sup>2</sup> Those customers with exposures under £2m on the basis that they were only subject to an SCR annually.



changed the strategy underway. Further, we have seen no evidence of any formal requirement about what issues SCR meetings would consider, apart from credit risk.

### What GRG said

GRG explained that the main risk to customers was credit risk and the 'one up' system was in place to manage this risk. When asked about the risks present in GRG (in the context of discussing the recruitment of skilled members of staff) GRG did not appear to consider that unfair customer treatment was another risk which needed to be managed but instead identified credit risk as the main risk to customers.

RBS and GRG said that:

- The SCRs were considered an important GRG process to ensure that every 'live' case was subject to a regular formal assessment by a panel of senior GRG staff. Within BRG an SCR was required to assess a customer within 30 days of its transfer to GRG; and
- SCRs focused mainly on strategy and usually discussed in more detail any pricing or charges which 'appeared out of line with expectations for the circumstances in question'.

### Our view

GRG grew unexpectedly and rapidly in size/scale, which meant that its previous systems and controls were no longer suitable. This meant that GRG had to make substantial changes to its systems and controls and recruit additional staff, which it recognised. However, inevitably this takes time. GRG had to do this in circumstances where the stigma attached to the bank and pay restrictions, at the time, impacted the speed and ability to recruit the staff it needed. This impacted the speed with which it could design and introduce the new systems and controls.

Throughout the period 2010 to 2013, the main focus from a risk perspective was credit risk, rather than conduct risk. When the second line of defence was implemented in January 2012, the focus was still on credit risk, rather than the fair treatment of customers.

The independent review made specific criticisms of SCRs. We agree that there were clear limitations to SCRs in terms of overseeing frontline staff. The minutes of SCRs the independent review assessed were brief, recorded little challenge and provided no evidence that available turnaround options for a customer were substantially debated or challenged. There is therefore little evidence that in practice an SCR review would result in a change to the strategy that was already in place. The independent review also identified that SCRs could be held as rarely as once a year. SCRs would generally record background information about the customer, the reasons they were transferred to GRG, and RBS's strategy to either restructure or repay and reduce the debt.

The ability of a firm to be able to produce good MI depends to a large extent on it having good systems and controls in place. Without adequate systems and controls, the firm cannot collect relevant, detailed and accurate information in order to produce meaningful and useful MI. The weaknesses in the systems and controls at GRG during the review period meant that the MI senior management received did not provide them with sufficient detail to be able to identify poor treatment of customers if it occurred.

Senior management at GRG were aware of the weaknesses in the systems and controls in place at the time and had identified the risk that these systems and controls were not keeping pace with the growth of the business. It was the responsibility of senior management to take steps to consider whether the MI was good enough in this context and, if not, to take steps to improve it.

Senior management were working to improve the systems and controls in GRG, which we consider was a necessary and positive step. However, they were having to play catch-up in a business that was growing exponentially and very quickly. This growth was a consequence of the financial crisis rather than any strategy on the part of GRG. Therefore, while senior management were taking appropriate steps in relation to improving systems and controls in GRG, the speed in which they could make the necessary changes was being impacted by factors largely outside of their control.

For GRG, MI regarding the treatment of customers was limited only to the 'value add' sections of the GRG ExCo packs. The information did not allow those receiving it to form a view on a number of potentially important matters, such as the number of customer complaints or compliance with GRG's policies and procedures. The lack of information was in part due to the absence of a second line of defence and other weaknesses in the systems and controls. However, we do acknowledge that the addition/inclusion of these 'value add metrics' were an improvement on the prior customer MI and as such is an indication that senior management were seeking to improve the MI as GRG's systems were being enhanced over the review period.

GRG's second line of defence did not appear to be considering conduct risk and the adequacy of GRG's systems and controls to tackle it. We found no evidence of other systems and controls in GRG focused specifically on conduct risk during the review period.

We expect regulated firms to take conduct risk seriously and ensure they have the right systems and controls to tackle it.

## 6 Lending, pricing and valuations of customers' assets

### Background

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GRG's authority to charge fees and its pricing structures came from RBS's contract with the customer. The terms of this contract could be varied as part of GRG's restructuring proposals.

Every contract between RBS and an SME customer would have differences that were specific to that customer. We have not reviewed every contract between RBS and its SME customers. However, we note that some of the contracts we did review included clauses that allowed RBS to immediately 'call in' the loan, in full, if an 'event of default' occurred. Events of default include, for example:

- the customer failing to pay any amount due under the contract on or by its due date
- a significant drop in the value of the security, which was usually one or more properties, and
- any other circumstances which may reasonably lead RBS to believe that its interest in the security might be prejudiced or the customer might not meet their obligations under the contract

As commercial lending falls outside our jurisdiction, we take no view on how reasonable these clauses are but note that they are common terms for commercial loans.

We also note that both RBS and the SME customer were party to the contract and therefore both agreed to be bound by its terms. RBS could immediately 'call in' the entire loan, plus interest, and demand repayment. Instead of immediately doing this, which may have led directly to the SME becoming insolvent, RBS chose to transfer many SME and non-SME customers to GRG.

As well as this right, if the customer defaulted, RBS could charge extra interest and the costs of communicating with the customer. RBS could also charge customers in default for any management or administrative costs and had the right to set off any sums owed under the loan against any funds the customer held at RBS.

Given RBS's contractual rights if a customer defaulted, it would have been possible for RBS to apply significant pressure, within the terms agreed by the customer, to agree new charges and terms within GRG.

### What the independent review found

The independent review found that GRG put too much focus on increasing prices and reducing debt, without properly considering the longer-term survival of customers. It also found that GRG failed to document or explain the rationale behind the decisions it made on the prices it charged customers following their transfer to GRG.

### ***The position of customers on referral***

The independent review used the term 'facilities' for any contractual arrangement under the terms of which RBS lent customers money or otherwise extended credit to them. That might include loans that customers had to repay after a fixed period, perhaps three or five years, overdrafts, short-term loans or an invoice discounting facility available through RBS Invoice Financing.

The independent review found that almost all customers which entered GRG were already exhibiting clear signs of financial difficulty. In many cases, this also meant the customers had already defaulted on at least one of their facilities, or were in breach of one of the terms of their original credit agreements. The fact that a customer was in breach of the terms of the facility (or that the facility had expired) gave GRG a lot of leeway with the terms of the contract.

The independent review found that it was a feature of some of the cases reviewed that RBS had taken steps to reduce the level of facilities offered to the customer. The Bank also sometimes asked for additional personal guarantees as further security against the customer's credit facility.

### ***Valuations***

The independent review noted that the main purpose of valuations was to assess whether lending was still within RBS's policy and risk appetite and how this affected its capital reporting. But, in practice, RBS used valuations in ways that covered a lot of other issues which were potentially important for customers, including:

- the decision to transfer customers to GRG
- its initial assessment of customers' viability
- assessing and developing restructuring or renewal proposals for lending that had expired
- deciding the prices customers would be charged, and
- testing if customers were meeting the financial terms of their lending agreements and deciding if they needed customers to provide additional security, such as personal guarantees or security over property

The valuations that were used by RBS were either carried out by external third-party valuations firms or were internal valuations carried out by RBS staff, who were qualified valuers. Internal valuations were used provided the internal valuer was independent of the business unit which required it. The independent review did not regard this policy in relation to the use of external or internal valuations as inappropriate.

The independent review found that there were many failures in valuations. These included failing to oversee and ensure that frontline staff made robust valuations in a way that supported the objectives of a turnaround unit. It also found a failure to carry out adequate work when making those valuations and in documenting the basis for them, particularly those that had a material impact on the approach taken to customers, such as whether a customer was in breach of the terms of its loan.

The independent review did not find any evidence that GRG's valuation practice or methodology systematically under-valued assets. It also did not find that RBS manipulated valuations so that it could transfer customers to GRG or for any other purpose. However, RBS often did not include evidence for its internal valuations that supported how they had been made. The independent review found that RBS should have taken more care to ensure that it reduced the risk that internal valuations were unsupported by evidence.

The independent review concluded, based on the sample of customers it interviewed and other material it considered, that the use of internal valuations based on insufficient and/or inadequate work amounted to widespread inappropriate treatment of customers.

### **Property assets**

There were many cases in the independent review sample that involved some form of residential or commercial property development. In these cases, the property loan was short-term and designed to be paid back once the customer had completed and sold the development.

The independent review concluded that it was not reasonable to expect RBS to continue to finance assets that had little realistic prospect of recovering value within a reasonable period of time.

However, the independent review found that the position in individual cases was not always so clear. Property assets often turned from straightforward developments for sale into letting businesses. In these cases, there was at least some potential to fund interest, if not capital, repayments due under term loans. The independent review considered whether it was fair and reasonable in individual cases not to renew facilities, or whether it was more appropriate to renew facilities for a limited period so that assets could be sold in an orderly way in the mutual interest of RBS and the customer.

Changes that RBS made to the available credit facilities to trading businesses, particularly overdrafts, increased the risk they could potentially significantly affect these businesses' ability to operate.

### **Lending (facilities)**

The independent review noted that GRG had no specific policy on postponing debt repayments (known as 'forbearance') until after the end of the review period, although it did introduce reporting mechanisms in June 2013 to capture the level of forbearance it extended.

The independent review found that RBS did not act unreasonably in seeking to reduce facility levels in most of the cases it dealt with. It also found that many, SME customers transferred to GRG were in breach of the facilities granted in the years leading up to 2008 on terms which appeared in hindsight to have been generous.

However, having decided that it no longer wished to lend to categories of customers, RBS should have considered good turnaround practice and its TCF objectives in line with its own intentions to apply TCF across the whole business. It should have carefully considered how to do this in an appropriate way which minimised the negative effects on these customers as much as possible.

Instead, the independent review found that GRG had pursued its commercial objective with too little consideration of the impact of its decisions on its customers. As a result, the way GRG made decisions about existing facilities was inappropriate. The overriding objective for facilities was to reduce RBS's exposure, and GRG's loan extensions to customers were typically short-term and often on terms that generated additional income for GRG.

The independent review did find cases where RBS had exercised forbearance. But it also found RBS had treated customers inappropriately because it had failed to exercise

forbearance when it would have been fair and reasonable to do so. This was often linked to RBS's failure to undertake any meaningful assessment of a customer's viability or turnaround options, together with an overriding objective to reduce the debt and increase prices where possible. The independent review found widespread failure by RBS to exercise forbearance when this would have been appropriate.

### **Pricing**

The independent review assessed the way that GRG increased the contractual prices its customers had to pay for credit, increasing fees and the margin that RBS charged on facilities, and how it renegotiated other financial terms. GRG could seek to change prices, including by charging additional fees, if the customer breached certain terms in its original contract with RBS, and the customer would often be unable to refuse the proposed change in price.

The term 'pricing' means one, or any combination, of:

- Increases to the margin paid on the loan.
- GRG's administration fees to cover RBS's increased costs for employing extra staff to deal with cases in financial difficulty (management fees).
- Upfront fees when granting 'new' money (often called arrangement fees).
- Fees that are deferred until the loan is repaid (usually described as an exit fee).
- Sums customers had to pay when an upside instrument ends.
- Risk fee following default. A risk fee is an extra fee charged to reflect RBS's increased risk from carrying on supporting a customer who has defaulted on its payments. The rationale for charging this fee was that the lending had fallen outside the terms of the contract originally agreed with RBS, and RBS needed to ensure it was paid for its continued support at a level of risk it would not normally accept.
- Waiver fees – these fees are fees paid to RBS for agreeing to waive a customer's default. The rationale was that RBS had provided the customer with a benefit by waiving its legal rights.
- 'Payment in kind' fees. These apply if a customer cannot pay the interest on their debt, and instead asks for interest to be rolled up or added to the debt. RBS charged fees for doing this.
- Non-utilisation/commitment fees. These were fees payable to RBS to compensate it for holding funds that were available but not actually drawn.
- Excess fees/unauthorised overdraft fees. These apply when a customer's current account balance is either (a) overdrawn, with no formal overdraft agreement in place, or (b) goes over the agreed overdraft facility limits.

The independent review found that it was reasonable for RBS to take into account the need to match the risks with the reward it wanted in return, but that, given this was a turnaround division, with a stated objective of turning around struggling businesses, RBS needed to be particularly careful.

This focus on matching risk and reward in the short term meant GRG customers would have to pay significant additional charges and the independent review found that simply demanding more money from businesses that were already financially struggling was unrealistic.

GRG failed to give its relationship managers more detailed guidance on how they should use lenience in applying these extra charges. The independent review found evidence that staff focus was simply on how to increase prices and make more money from customers which were already struggling.

### ***Inappropriate treatment of customers through pricing***

The independent review found customers were treated inappropriately on pricing in 118 of the review sample cases (57%), mainly because of GRG's failure to record the reasons it was increasing pricing and/or failing to properly explain the reasons to customers.

The independent review found that, overall, there was too much focus on increasing prices, without properly considering the longer-term survival of customers' businesses. This focus meant customers were treated inappropriately on a widespread scale.

The independent review also found that these failures amounted to systematic inappropriate customer treatment because:

- GRG prioritised its commercial objective at the expense of its turnaround objective.
- GRG's overall management and oversight of risks to its customers was inadequate. It did not treat turnaround or risks to customers as a priority to balance against the focus on income generation.
- GRG's management information focused on pricing related data, not risks to its customers.
- GRG's staff objectives focused on pricing, and did not put enough emphasis on other objectives such as treating customers fairly.
- GRG staff objectives in practice, material on case files and in some local staff communications suggested a culture in at least some parts of GRG of deal making. This put little value on the interests of customers, as its main focus was generating income and creating 'upsides'.
- there were significant deficiencies in the policy framework for pricing practices before March 2011 and, after this, GRG did not widely follow legal guidance;
- GRG failed to put in place adequate or appropriate processes in its day-to-day work with SME customers to ensure that its pricing changes were appropriate, bearing in mind its objectives as a turnaround unit;
- There was a failure to provide more detailed guidance to GRG staff about how to use the significant levels of choice they had under GRG's pricing policy.
- The review found no evidence of GRG balancing pricing increases with other factors when dealing with SME customers (for example in SCRs). The evidence actually showed that the focus was on income generation,
- GRG's controls over pricing practices were generally inadequate.

## **What we found**

### ***GRG's approach to pricing***

GRG set its pricing on a risk/reward basis. RBS stated that:

'GRG manages the riskiest and most capital-intensive assets in the Bank. In return for providing ongoing support to customers that fall outside normal Risk Appetite, GRG seeks to obtain a return commensurate with the risk being undertaken.

Where the value of the business and/or its assets (the collateral) has fallen significantly due to changing market conditions and/or there are adverse changes in business performance, the Bank is taking non-senior risk and has to hold significantly more capital to reflect the increased risk.

The customer has the opportunity to source or provide additional capital and/or collateral to bring the lending facility within normal senior lending risk appetite parameters.'



Once a customer had transferred to it, GRG had a range of options for 'case treatment and strategies', for example as Figure 5 shows:

**Fig 5: GRG Customer Treatment Options**

Treatment options		Example criteria for selection	Example actions
Terms reset	Minor modification to financing	<ul style="list-style-type: none"> <li>Covenant breach / technical default but business is viable as a going concern with no liquidity concerns</li> </ul>	<ul style="list-style-type: none"> <li>Modify interest rate, reset covenant and charge client a restructuring fee</li> </ul>
	Refinance business	<ul style="list-style-type: none"> <li>Business likely to RTS in short to medium term, strong management and low risk for bank (e.g., good collateral)</li> </ul>	<ul style="list-style-type: none"> <li>Inject additional capital into client (debt or equity)</li> </ul>
Refinance	Refinance loans externally	<ul style="list-style-type: none"> <li>Business appears viable in the medium term, but appropriate structure / terms cannot be agreed or risk preference is exit</li> </ul>	<ul style="list-style-type: none"> <li>Find third party financing for client, e.g., invoice discounting, sale and leaseback</li> </ul>
	Restructure debt	<ul style="list-style-type: none"> <li>Capable management but short and medium term liquidity concerns, with long term potential upside (with Bank to share in upside if appropriate)</li> </ul>	<ul style="list-style-type: none"> <li>Major rescheduling (e.g. change maturity or payment holiday), re-pricing or collateral changes (e.g., additional collateral, cross collateral)</li> </ul>
Restructure	Debt to Equity	<ul style="list-style-type: none"> <li>Upside and high turn around potential, but significant short and medium term concerns</li> </ul>	<ul style="list-style-type: none"> <li>Convert proportion of debt into equity and actively turn around, incl. new management, (in-house or 3<sup>rd</sup> party) and sell in the future</li> </ul>
	Restructure asset	<ul style="list-style-type: none"> <li>Short term liquidity problems, viable core business enabling leverage reduction to sustain debt capacity</li> <li>"Sellable" collateral</li> </ul>	<ul style="list-style-type: none"> <li>Work with client to facilitate changes and extract cash from business, e.g., partial asset disposal</li> <li>Realise recovery through sale of company</li> </ul>
Exit relationship	Dispose of loan	<ul style="list-style-type: none"> <li>Poor ratios, limited future upside but buyers exist</li> </ul>	<ul style="list-style-type: none"> <li>Sell loan, e.g., to distressed debt trading house</li> <li>Exit client relationship</li> </ul>
	Foreclosure / liquidate	<ul style="list-style-type: none"> <li>Poor ratios, troubled management, poor fundamentals, very limited upside and no potential buyers</li> </ul>	<ul style="list-style-type: none"> <li>Liquidate client</li> <li>Focus on maximising value from collateral</li> </ul>

Once within GRG, and before a customer could be given financial support, a relationship manager had a lot of discretion in setting fees and pricing structures. GRG did provide some boundaries within which relationship managers could structure pricing, for example:

<b>Senior debt</b>	This applied where the customer's debt was within an acceptable financial ratio and they could repay capital over an acceptable period. It was the amount of debt RBS could lend to a customer in line with RBS's Credit Policy. Before 2013 senior debt was priced up to a maximum of 10%.
<b>Mezzanine</b>	This is where a customer was able to pay the interest on their debt but unable to repay capital from existing profit or cash flow over an acceptable period. Mezzanine debt was typically priced between 10% to 20%.
<b>Equity</b>	This is the highest risk debt and would usually be provided by shareholders, rather than GRG, with an expected return of 20% to 30%.

### **Oversight of pricing**

In interview, one member of senior management said that relationship managers agreed pricing and SCRs endorsed it within broad parameters and based on risk. Senior management said that the SCR would therefore have reviewed and endorsed the pricing documented in the SCR proposal paper. Another member of senior management said that the decision of the 'one-up' staff member was the main control to assess if the pricing was appropriate. However, from our investigations it is not clear where or when in the 'one up process' or SCR process pricing for customers was checked and appropriately approved. SCRs provided a retrospective review of



actions, usually after a pricing strategy had already been set for the customer. The minutes of SCRs we reviewed were brief, recorded little challenge and failed to provide evidence that there was substantial debate or challenge about a customer's available turnaround options.

Cases we looked at included statements of fees and pricing on the SCR papers, such as:

'£65k arrangement & £28k exit fee

PPFA £300k /6% whichever is greater split per remaining units (IRR 17% including fees & interest margin)'

However, some of these statements were not accompanied by documentary evidence or reasons behind pricing discussions. This will have impacted the extent to which GRG could ensure adequate oversight of decisions and be able to carry out some form of check and challenge.

### Valuations

RBS's draft policy required valuations to be supported by workings and costing for comparable options. This draft policy, which does not appear to have ever been finalised (and RBS could not confirm if it had been), was changed in January 2011 when RBS required 'certain key information' to be presented in a Strategic Valuation Paper. That RBS is unclear whether there was a finalised policy suggests there was a lack of adequate systems and controls to ensure robust valuations were being made and reported to SCRs.

SCR minutes show that valuations were discussed but underlying details, including the basis for calculation, were not. For example, SCRs would include statements such as 'Property Management Unit valued property at £X', 'Recent valuations by Property Advisory Unit reflect the following values ...' or 'Secundee valuer has provided feedback'. However, no further details were provided. As a result, it was not possible to see clearly what (if anything) was typically discussed about valuations or the treatment of customers at SCRs, or how an SCR could gain a meaningful view of the approach to pricing or customer treatment.

The lack of detailed SCR minutes meant that neither we nor the independent review could judge whether a valuation had been reached fairly or how and why a particular figure was used. The limitations of the SCR minutes would have also had an impact on the ability of GRG to carry out effective compliance checking or oversight on customer files. With limited information on the files, a compliance function would have been unable to effectively review customers' files and ensure customers were being treated in line with RBS policies.

### Oversight of valuations

Senior management believed that GRG's structure meant there was a joined-up approach to supervision from the top down to the customer, and that all levels of that structure were staffed appropriately with qualified individuals who adopted an 'open management' style, which senior management adopted themselves.

Senior management relied on the quality of the staff under them. But they do not appear to have put formal mechanisms in place to ensure that matters were being dealt with appropriately other than the 'holistic review' which SCR's provided. We note some senior management sat on SCRs and so had some exposure to what was happening in practice.

Having suitably experienced and qualified staff making and overseeing decisions is a key part of ensuring that a firm is taking appropriate decisions. However, in this case we note that the frequency of the SCRs varied according to the size of the SME customer's debt. Those with a smaller – from RBS's perspective – debt might only be reviewed once a year. This reduced the level of oversight by senior staff over these cases.

Relationship managers actively considered the value of assets, such as houses, which could be the basis for a personal guarantee for the loan. One case we looked at included statements such as:

'Additional security by way of Personal Guarantee for £290,000 from Managing Director/customer which is unsupported – Matrimonial home is valued at £3.75m with mortgage of £2m and therefore may be a fair prospect of recovery'

GRG did not appear to recognise the emotional stress that could be suffered by SME customers in difficult personal circumstances. These customers might not only be losing their business and income but, in some cases, their family home as well. In circumstances like these, we would expect RBS to ensure that there were adequate controls in place to ensure GRG staff were following all policies and procedures so that customer in these situations would be treated fairly.

## What GRG said

### Pricing

GRG explained that:

- Pricing was agreed by relationship managers and endorsed by SCRs within broad limits that were based on risk. Pricing decisions were made on a risk/reward basis. If GRG considered the risk of a firm to be higher, then the pricing would be higher.
- The SCR would therefore have reviewed the pricing and documented it in the SCR proposal paper. Senior management also said that only people who the head of GRG had directly delegated authority to could approve pricing structures.
- Although SCRs were advisory, senior management could not recall an occasion when the advice of an SCR about pricing was not accepted. If this had happened, the next SCR would have been able to identify it from the minutes of the previous SCR.
- Fees and pricing were not discussed at the RBS Group Board level. They were dealt with at the operational levels of GRG because they required specialist knowledge of individual companies.
- Because pricing was discussed and considered at SCRs, and some members of senior management sat on SCRs, as senior GRG managers they would have known about the nature, type and methodology of pricing.
- From complaint themes, GRG was aware that some customers were dissatisfied with pricing changes.
- Relationship managers had training, notes and guidance on pricing but it was a 'bespoke service' and they would make judgements about the risk, what was required and the probability of success.
- GRG could not recall if pricing was discussed at GRG ExCo meetings, but thought that pricing would, and should, have been discussed at the GRG ManCo.
- Relationship managers should have, and did, tell customers the reasons for pricing. However, they acknowledged that, as relationship managers were very experienced at pricing a restructure, and customers were probably going through their first restructuring, the communication on pricing might not be particularly clear to customers.

## Valuations

In overview, GRG explained that:

- Internal valuations could be used by 'everyone's agreement'. This meant that if the relationship manager and the customer could agree on the internal valuation, then GRG would use that valuation instead of an independent valuation.
- If a customer had run out of money and had no foreseeable way of servicing its debt, the valuation was in those circumstances 'academic'.
- If a significant decision (a decision which could affect the loan-to-value ratio of the lending) was being taken about a customer's property, the customer would get an independent valuation.
- In terms of how GRG might use an internal property valuation, there was not 'a definitive decision affecting the customer in terms of what they would be lent or how they would be treated would be made on the back of that [an internal valuation]... it would be indicative, and of course sometimes the indicative could be different by a factor of 10 from what the customer believed the property might be worth.'
- If GRG and a customer disagreed about the valuation, then RBS would get its own independent valuation so that it could take a view on the customer's valuation.
- Valuations might depend on the instructions GRG gave to the valuer, particularly the timescale the customer may have to find a buyer.
- There could be complaints if there were fundamental differences in opinion about a property valuation, eg 'There was the odd complaint about the valuation of property, around the issue of "Your desktop valuation, your surveyor's valuation is different from my personal opinion or my surveyor's valuation". And then there would be an attempt at a meeting of the minds, which may or may not be achieved'.
- Customer's expectations of what a property is worth may not reflect the market at the time of sale; 'certainly aware of there being differences in opinion between what customers thought it was worth, which was usually based on the inflated price they'd paid at the top of the market in '06 or '07 and they would be very disappointed to hear that possibly it had dropped by 60, 70%, and so they would be kind of starting off their purchase price and expecting, in time honoured fashion, it must have gone up because it was property. So, as I say, anything that was a decision based on the valuation would require an external valuation'.
- It had never heard of a case where a customer had been pressured to accept an internal GRG valuation.
- Internal valuations could be used to decide the value of Property Participation Fee Agreements (PPFAs) but this would only be done to be pragmatic and helpful to a customer who wanted to move quickly. It would not be the usual process that relationship managers were meant to follow.
- Property valuation was an area which the GRG ManCo and ExCo looked at and were keen to remain as free of criticism as possible, however senior management/GRG also thought that this was an area where that was probably impossible.

## Our view

### Pricing

We do not consider that GRG's overall approach to pricing was inappropriate in itself. It is reasonable for a restructuring unit to adapt its approach to pricing to the circumstances of every customer. It is also reasonable that the bank is appropriately rewarded for the degree of risk it takes – every SME entering GRG was different and so each pricing strategy was different.

However, as each pricing strategy was unique to the relevant SME, it was important to have effective oversight and record keeping of the pricing agreed by the relationship manager. There appears to have been limited management focus on the pricing strategies and approaches that relationship managers used for SME customers.

In many cases the main and often only asset that SME customers had was their home or commercial property. Getting an accurate valuation for this property was fundamental to being able to assess if the customer's business could survive and whether the customer was in breach of the terms of its credit agreement and/or mortgages. It would also feed into the pricing strategies GRG imposed on customers using a risk/reward approach.

Given the limited information available on the files we have seen for SCRs, and because it is unclear if GRG ExCo discussed pricing, it is unclear how senior management assured themselves that risk and reward were appropriately balanced in SME pricing strategies. In some cases, SME customers would have had the choice either to accept the pricing GRG imposed on them or have to cease trading and appoint administrators. In situations like this, and particularly when GRG was requiring directors or shareholders to make personal guarantees, it was particularly important that SME customers understood why and how certain fee structures were applied so they could make an informed decision about the future of their businesses.

### **Valuations**

In many cases GRG used an independent third-party surveyor to value property. However, where GRG used its own internal valuers, we could find no evidence of the basis and assumptions for deciding valuations in customer files, or that SCRs considered these.

Using internal valuations is not inappropriate, particularly when the customer asked GRG to carry out its own valuation to save the cost of an independent valuation. However, for an SME customer whose main asset was their home or business property, we cannot see how GRG could ensure there was oversight and control over valuations if the details of each valuation were not recorded clearly on the customer file.

The review period was an extremely unpredictable time for the commercial property market. This meant it was often difficult to work out what the accurate value of a property was. Given this volatility and how crucial property valuations were to many SME customers, we are surprised by the lack of detail on customer files about how GRG calculated the value of properties.

## 7 Conflicts of Interest involving West Register

### Background

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GRG used third parties, and businesses under its management – West Register and Strategic Investment Group (SIG) – to work with struggling customers and advise them.

For most of the review period, West Register had two purposes. One was to maximise recovery for RBS by avoiding forced sales, where prices achieved are usually lower. The other was to hold assets and sell them at a later date ('when market conditions are more opportune') when RBS would benefit from any increase in value.

Many SME customers believed their businesses were deliberately 'run down' by GRG or that they were given misleading advice so that GRG could acquire these assets cheaply for RBS. Some customers felt they were deliberately kept in GRG for longer than necessary and not returned as viable businesses to mainstream RBS banking when they should have been.

### Independent review findings

#### *Third parties*

GRG used third-party firms widely, for example lawyers on security reviews and valuation firms to provide professional opinions on the value of assets and independent business reviews.

The independent review did not find any cases where third-party firms told customers to take specific steps that harmed them or where it was inappropriate to use third-party firms to conduct specific pieces of work.

#### *Customers returned to mainstream banking*

The independent review considered how appropriate relevant policies and practices were for customers exiting GRG and exiting to RBS mainstream banking.

In general, customers who should have been transferred back to the mainstream bank were transferred. The independent review found that the fact that customers remained in GRG for an extended period was not in itself inappropriate nor was it inappropriate that customers did not find it easy to exit GRG. However, the independent review found that the transfer process that GRG used and explained to customers could potentially lead to confusions about the steps customers needed to take to leave GRG. It also found that the bank's failure to appropriately manage the expectations of customers was likely to lead to a perception that it was impossible to leave GRG successfully.

#### *West Register and SIG*

West Register was made up of a number of legally separate businesses. While these were all limited companies, they were managed by GRG and carried out turnaround business.

The independent review considered West Register's role in acquiring the property of GRG customers. It also separately looked at its role as owner of the interest in properties it acquired from GRG customers by using upside instruments and SIG's role in negotiating these instruments.

The independent review found that, on balance, having a mechanism to acquire assets in this way was not, in itself, inappropriate or unfair to customers. But when setting it up and designing its governance, policies and procedures, RBS needed to take the greatest care to protect all parties, including itself, against any conflicts of interest inherent in this type of arrangement (as well as perceived conflicts to which such arrangements inevitably give rise).

The review concluded that the overall relationship between GRG and West Register was inappropriate. The independent review found that this relationship created a number of conflicts of interest that initial guidance from RBS did not resolve and that were still only partly covered in its guidance of November 2013.

The governance structure that should have identified those underlying conflicts was inadequate and inappropriate. Governance was also concentrated in the same hands that were looking to the future profitability of the Bank in general and of GRG in particular.

The inappropriate relationship was made worse by the closeness between West Register and GRG at every level. There was inadequate separation of West Register's operational functions and the controls that ought to have acted as a balance to them.

The failings the independent review found resulted in the inappropriate treatment of customers. It found that because the bank created an environment where conflicts of interest were inadequately managed, not enough attention was given to the options for turning businesses around and whether the strategy for handling cases was influenced by West Register's interests, regardless of whether West Register ended up acquiring the property. The independent review found that the inappropriate treatment of customers was also systematic for the following reasons:

- Setting up GRG with a 'profit motive' required careful oversight, but GRG did not appear to recognise either the real or perceived conflicts of interest that were an inevitable part of the structure it developed. It also did not put in place adequate or appropriate controls to manage those conflicts during the period covered by the review.
- GRG actively encouraged GRG staff handling SME cases and West Register to share information. This created an environment where West Register could and sometimes did become involved in the strategy for handling SME cases before administration/insolvency.
- There was a failure to establish an arm's length relationship between GRG and West Register. This was illustrated by the 'double hatting' of various roles and teams not being sufficiently separated. This added to the risks of inappropriate information sharing or influence over strategy.
- Overall there was a weak governance framework for West Register's actions towards customers, particularly inadequate controls for information sharing between GRG and West Register.
- The focus on West Register as a potential and profitable solution to cases for RBS created an environment where West Register could become the 'easy option' for GRG staff, instead of more considered options. This further weakened GRG's focus on genuine turnaround.

### ***The role of 'Upside Instruments'***

The independent review criticised GRG's overarching attitude towards Upside Instruments, which were generally managed by SIG. They were important parts of the GRG strategy and emphasised in staff objectives at all levels. While they had a valid role in the toolkit of a turnaround unit, the focus GRG gave them was disproportionate and inappropriate.

The independent review's main concern about PPFA's was that RBS did not explain its rationale for calculating the return as compensation for its increased risk to customers. Some customers were also given a comparatively short time to decide whether to accept a PPFA. GRG's explanation to customers about how the agreement operated in practice could also have been more detailed.

The independent review concluded that EPAs are inherently more complex financial instruments than PPFA's. An EPA typically required changes to an SME customer's structure and complex legal documents, was open-ended, and had no clear mechanism for deciding the value of a customer's assets when the agreement ended. The independent review concluded that GRG and SIG failed to use adequate safeguards to ensure that the EPAs' terms were appropriate.

The independent review found that the close association between SIG and GRG's relationship managers created conflicts of interest that were not managed effectively or appropriately. GRG shared equity 'prospects' when considering the strategy for handling distressed cases with SIG at an early stage, at least in the early part of the review period. This created a risk that SIG's commercial priorities would overly influence the strategy and encourage GRG's relationship managers to deliver 'upsides' for RBS. The independent review found that this could and did result in customers entering EPAs that were inappropriate for their needs, and GRG staff not looking at options for more traditional turnaround of these businesses.

The independent review found that the use of EPAs caused inappropriate customer treatment which was widespread. Although the number of SME customers with EPAs was relatively small, they created significant problems for these customers. GRG should have seen EPAs as the exception, and only a suitable option for the largest customers. They were too complex and generally inappropriate for the vast majority of SMEs.

The independent review also found the inappropriate treatment of customers caused by the focus on EPAs was systematic because:

- GRG heavily emphasised the importance of getting upsides – in staff objectives, management information and training and in its pricing policies.
- GRG did not put adequate controls in place to define the circumstances in which EPAs would be used or their terms, and
- GRG did not recognise the inherent conflicts of interest in the SIG/EPA approach. Given the limited restrictions on GRG and SIG sharing information, there was a risk that GRG's strategy for handling SME cases would be influenced by SIG's interests and the expectations of future 'upsides'.

### ***How the independent review calculated the extent of harm to SME customers***

The independent review found that no more than 1 in 10 customers entering GRG during the review period had returned to mainstream banking within that period. Around 15% had repaid their facilities or left RBS. Around a third of customers entering



GRG during the review period ended up insolvent, although in many cases this happened after the end of the review period and mainly due to the financial problems they were already suffering when they transferred to GRG.

As explained to the Treasury Select Committee in correspondence on 28 November 2017, the independent review used a sample size of 207 customer cases. This was made up of a representative sample of 178 customer's cases and a further 29 cases considered by the Tomlinson Report.

To form a view about the likely extent of financial distress that GRG's inappropriate actions may have caused, the independent review put each of the 178 SME customer cases in the representative sample in one of the following groups:

Group 1 - Business clearly would not survive (be viable) - 61

Group 2 - No inappropriate actions identified - 9

Group 3 - Inappropriate actions not likely to result in material financial distress - 89

Group 4 - Inappropriate actions likely resulted in material financial distress - 19

The independent review's conclusions on the representative sample were:

- 34% of the SME customers could clearly not have survived.
- 92% of the remaining, potentially viable, cases had suffered some inappropriate actions in the way RBS handled their case.
- About 16% of the potentially viable customer cases (11% of all cases) experienced inappropriate actions by RBS that, in all the circumstances of the case, were likely to have resulted in material financial distress, more than they would have suffered otherwise. However, the independent review also noted that there were rarely clear-cut causal links between RBS's actions and specific consequences. Negative outcomes were more likely for trading businesses and less likely for businesses involving property, and
- All but one of the potentially viable customer cases had suffered some inappropriate action. Of the potentially viable group, inappropriate actions were likely to have caused actual financial distress in 28%, more than they would have suffered otherwise.

The independent review also looked at the potential harm caused to customers. It found that causes of actual financial distress to customers included:

- sudden - or at least too fast – requirements to reduce customers' credit facility levels
- increases in prices that paid too little attention to the customer's circumstances and cash flow
- upside instruments that, in the circumstances, appeared to be unreasonable, and
- generally failing to consider wider options for turning businesses around and to identify and implement appropriate available alternatives



## What GRG said

GRG explained that:

### *Customers' long term viability*

- GRG's primary objective was to turn businesses around so they were viable for the long term. Turning a business around was better both for RBS and the customer, as it kept the customer in business, meant RBS could fully recoup losses and built long term customer loyalty.
- The broad objective was to be at the 'leading edge of rescue culture' and restore customers to an acceptable credit position, aligned with the aim to 'seek to restore customers to the mainstream banking and maintain the relationships' and that the broad objective to seek to restore customers to mainstream banking and maintain the relationships was consistent.
- The credit departments of RBS's commercial bank carried out one-off exercises to look at customers which had returned to the mainstream bank and see how they were performing three years on.

### *Conflicts of interest*

Initially, risks from potential conflicts of interest were dealt with using Chinese Walls between West Register and the GRG relationship managers. Senior management were considered to be above these walls. This approach was approved by RBS and known to RBS Group.

There was a 'perceived risk' of unfair dealing, and senior management asked a City law firm for advice on appropriate Chinese walls. GRG implemented everything that the law firm recommended.

GRG would always sell property assets to the capable purchaser offering the highest price. West Register would bid on a property only once, unless the property was removed from the market or fundamentally changed in nature or type; GRG 'didn't want to buy these properties and West Register was a great way of actually keeping the market reasonably honest. So if a property had sort of anything about it, you could market it, West Register could bid, if someone wanted it and they paid more, that was great, they got it.'

Properties were openly marketed in almost every case. This was particularly important after getting the City law firm's advice.

It could not recall discussions about West Register at the RBS Group Board or Board sub-committees: 'No, I mean, if I come back again to the Group Board level.... you're looking at an operating company somewhere several layers down in the organisation that is sitting within a specific area of which there are, or would have been, well, hundreds and hundreds across the Group as a whole. I don't recall that one...being picked out for particular discussion. It might have been discussed in one of the meetings.'

The reason for why it would want to get equity in an unlisted private company was to try to rescue some value for RBS, if the customer could be turned around: 'I think it comes back to the core objective. It preserves the entity, it stops it from failing. Because remember, by doing it this way, you produce a stronger beast with a stronger balance sheet than if you just put it in as a loan, and you have a company for the longer term that is going to go on trading.... in terms of ever realising your investment, you're probably going to do that either by selling it back to the entrepreneur at some stage or selling it in parallel with him when he sells.'

GRG ExCo did not consider the risks from specific EPAs in detail. GRG ExCo would have received aggregated information about what GRG was doing in relation to EPA's. GRG ManCo considered the risks of conflicts of interest, acknowledging the need to keep the administration of the equity separate from the lending. It also acknowledged that some of the SME customers were too small to have an appointment made by GRG for a representative to sit on their company boards. Most appointments to a company board by GRG would be to larger companies and these appointments would have been made outside of GRG so that the representative/management of the equity was separate with Chinese Walls in place.

A customer could not complete an EPA without taking independent legal advice. GRG also said that SME customers would always have enough time to properly consider entering into an EPA, which they said would be '14 days as a minimum'. In particular, 'I mean clearly you can't say to someone, 'Sign this or I'm going to put you into insolvency'. So there had to be a reasonable period for them to think about it, to consult their [sic] and, you know, frankly, you don't want to be involved in an equity investment with someone who's really unhappy, and that's going to cause you endless problems going forwards.'

### Our view

The risks of conflicts of interest between West Register and GRG were clear, and GRG and senior management had identified them. When marketing and selling property for an SME in financial distress, particularly during the financial crisis, it was not unreasonable for West Register to be a bidder, and so provide a 'floor price' for assets to ensure that they were not sold for much less than they were worth.

Senior management tried to put in place some controls to manage the conflicts of interest and support West Register in providing a floor price. The risk of a conflict actually happening and causing harm would be significantly reduced by a sale on the open market.

However, both we and the independent review saw evidence of West Register staff commenting on the proposed valuations of property before an open market sale was completed. This suggests that West Register had access to information about the property before the wider market did, which meant there was a risk that it could seek to influence the price the property was put on the market for.

This is unlikely to have resulted in the property being sold for a reduced value in an open market sale with appropriate marketing. However, it does suggest a closeness between West Register and GRG staff that was not managed effectively and which could have become a conflict of interest with the potential to harm customers.

## 8 Background to GRG and context during the review period

In assessing the behaviour and actions of both firms and individuals we take into account the context within which they were operating. For example, senior management will often face competing priorities that need to be balanced alongside one another. They may also need to prioritise one issue over another. Assessing whether the right balance has been struck or the prioritisation was correct necessarily requires a degree of judgement.

Factors that we have taken into account when assessing senior management's conduct include:

**The nature and scope of each of the senior manager's role** - whether GRG was the main focus of their role or if they had other responsibilities beyond GRG. This is relevant to our assessment of whether senior management prioritised their time and focus reasonably.

**GRG's rapid and unexpected growth** - both in the value of customers' assets managed and in customer numbers, due to the start of the financial crisis, particularly in the period 2008 to 2010. This is relevant when assessing the adequacy of GRG's systems and controls over time, and the steps senior management took to mitigate any risks they identified.

**GRG's ability to recruit specialist staff quickly enough** - particularly compliance and risk staff to deal with GRG's growth. Senior management stated that 'Having regard to the extraordinary scale, nature and complexity of the risk management and restructuring challenge that confronted RBS in 2008/2009 and growth of GRG in the immediately ensuing years it was necessary to have in place and appoint suitable and experienced personnel in as timely a manner as was practicable given the solvency crisis which RBS then faced, the rapidly evolving circumstances and the real difficulties in finding and recruiting appropriately qualified personnel at that time'. We consider senior management's assertion to be a reasonable one and do not have a basis to contradict or challenge it. This is relevant when assessing the adequacy of GRG's response to the need to improve its systems and controls and human resources.

**How far senior management's roles required them to focus on and prioritise other issues** - other issues may have taken senior management's focus away from how customers were being treated. These are discussed further below, but in summary include:

- Meeting the Asset Protection Scheme's (APS) terms from December 2009 to October 2012. At worst, failing to do so could have meant RBS would lose APS protection, causing significant capital risk to RBS and the UK financial system, and
- The Government's rescue of RBS in 2008 due to its capital position. The Group Board made capital the priority area of focus across all of RBS. Staff were required to consider capital in their strategic choices for customer assets.

It is also important to recognise that RBS, through GRG's activities, did not generally owe fiduciary duties (a legal obligation to act in another's best interest) to its customer. The relationship was instead a contractual borrower-lender relationship. We note that GRG told customers that one of its objectives was turnaround and the expectation this was likely to have created for customers. This is relevant to our assessment of what 'fair treatment'

looked like for GRG customers and whether senior management had enough day-to-day oversight of how GRG was treating customers.

We also note that in June 2011, the FSA carried out a visit to GRG. The visit was to look at GRG's credit decisions and provisioning and not its customer treatment. After the visit the FSA gave senior management feedback on what it had found, together with a list of actions it suggested GRG should implement. The FSA's review focused on GRG's credit provisioning (estimates of potential losses because of credit risk) following the financial crisis. It made several comments based on what it saw during the visit. Those that are relevant for the purposes of this report, include:

- that GRG had 'increased workload resulting from the significant growth of the GRG portfolio in recent years'
- the overall assessment, for credit decisions and provisioning, that GRG was fit for purpose, with senior and relationship manager personnel being appropriately skilled and experienced, and
- that a key risk was that 'the governance framework of GRG has not kept pace with the rapid growth of GRG's business'

The FSA wrote to senior management telling them they should not rely upon the findings of their visit to have identified all GRG's weaknesses or failures of systems and controls. The letter reminded senior management that responsibility remained with the Board of Directors and senior management of RBS.

### **Other demands on GRG senior management**

We set out below in more detail the competing priorities which senior management were required to balance in addition to their general day to day oversight of GRG during the review period.

#### ***RBS and the Asset Protection Scheme***

In December 2009, RBS entered the APS. Under the APS, the Government provided protection to RBS's higher risk assets. RBS was required to follow the APS's rules. If it did not, it would have meant RBS would have to leave the APS which would expose RBS to significant risk to its capital. The APS covered approximately 57% of GRG assets by value and meant that these assets came under the scheme rules. One of senior management's main priorities during this time was to implement and comply with the APS's rules. The APS was administered and overseen by the Asset Protection Agency (APA), who in turn reported into the Treasury.

One member of the senior management team said RBS recognised that it was critical to comply with the APS to prevent RBS becoming insolvent and to avoid a potentially critical loss of market confidence.

One member of senior management said that they spent a significant portion of their time dealing with APA issues and attending meetings, both with the APA itself and internal RBS meetings preparing materials for the APA.

The APS had 'step in' rights, which meant it could take over the management of assets. This would have likely harmed RBS's reputation. According to both RBS and senior management the APS required RBS to prioritise its implementation. Senior management told us their priority was to ensure RBS successfully complied with and implemented the APS scheme rules.

To achieve the APS objectives and ensure it complied with the APS rules, RBS built a parallel oversight, compliance and reporting system. Senior management explained that the most senior levels of RBS told them that the priority focus was on implementing this system to ensure RBS complied with the APS rules.

Senior management said that this also contributed to pressures on staff through the period that RBS was in the APS due to the scale of requirements from the APS, and the need to train the entire business.

The Asset Management Objective (AMO) of the APS was 'to maximise recovery and minimise loss', which senior management believed was broadly the same as GRG's objectives. However, one member of senior management had a different view of how the AMO and GRG's objectives lined up. They believed that the fundamental objective of GRG was to rescue the customers and to protect RBS's bottom line.

This member of senior management attended meetings with the APA and said that the APA was not 'particularly interested' in protecting customers and that a lot of time was spent arguing with it. On SME customers, the same member of senior management said 'they [the APA] would have loved us to just flog a bunch of those SME customers for next to nothing and walk away. Which we wouldn't do because we genuinely wanted to fix their problems'. However, this member of the senior management team did not believe that the APA put SME customers in a worse position.

The evidence shows that, during a meeting with APA, a member of senior management stated that the goal for a Non-APS customer and an APS customer should be aligned, ie to minimise losses and maximise recoveries. A member of APA's senior management responded that the APS objective of maximising the net present value should be considered the most important one. Senior management confirmed in interview that they made no differentiation in the strategies between APS customers and Non-APS customers because the overall aim of GRG was to return a customer to strength.

### ***The need to focus on capital reduction***

RBS has given evidence that, as at 12 June 2012, GRG managed between 25-30% of the Group's capital. Senior management stated that at one point during the review period, RBS was significantly focused on GRG because it had 'almost half of...RBS's capital tied up.' During the review period, RBS's main focus was 'on operating in a manner that enabled the Bank to survive and work towards a return to standalone strength', in particular by ensuring RBS could meet the regulators' more rigorous capital adequacy and stress tests. The CEO's Strategic Plan of 2013 and strategic initiatives reflected this, including the creation of the Non-Core Division of RBS.

In 2011, one member of senior management was set an objective to implement a capital reporting framework throughout GRG and to roll out training about capital metrics to increase staff awareness of the impact of decisions on capital. This was because of the higher capital requirements that regulators had brought in following the financial crisis.

Senior management's view was that, in most cases, the best way to protect RBS's capital was to get a customer back into a condition where they were safe to lend money to again. This would reduce, or manage, the risk of loss to RBS and also mean that customers could continue trading.

RBS's focus on capital continued throughout 2012, and GRG trained 700 relationship managers on capital management as part of an ongoing training programme. The MI sent to GRG ExCo also reflected this continuing focus on capital. An early 2012 meeting of GRG ExCo noted that the 'new enhanced MI that provides more clarity around notional RWA and capital deduct. The forum collectively agreed that the improved MI was useful and that capital will continue to form a large part of the Group's focus over the coming months.'

RBS Group Board also discussed the capital managed in GRG. The discussion included how staff were taking capital into account when they made decisions about SME customers' assets and telling the Group Board that 350 GRG staff had been trained on the capital model.

Senior management gave evidence that there was pressure on RBS for GRG to release capital, but said that it was not done at the expense of a good turnaround. Senior management explained that the pressure for capital reduction in the 'SME world' came from the APA and stated that the APA were focused on capital reduction. One member of the senior management team gave evidence that, between 2008 to 2010, RBS's focus on capital reduction was not so great that GRG would force SME customers out of business to reduce Risk Weighted Assets (RWA). Their view was that SME customers made up such a small proportion of GRG's total assets during that time that spending time driving SME customers out of business 'just did not stack up'. Senior management said that GRG focused on its largest customers.

During this period, the management of the Non-Core Division of RBS placed significant focus on expected outcomes and timings about when the value of assets could be realised or repayments made.

One member of senior management said: 'a significant amount of my time was focused on the large real estate and large corporate loan exposures ... as these represented the most significant credit risk to the bank and were an area of considerable focus both from the APA and the banking divisions (including Non-Core), due to the capital and balance sheet impact of credit deterioration and/or the scale of actual or potential losses arising on these loans, individually and collectively'.

### ***Recruitment of specialist staff***

In line with the rapid growth of GRG, RBS needed to increase the number of suitably experienced staff to manage the increased workload. Senior management said that they found this difficult, because RBS had a stigma at the time that meant attracting staff was difficult, along with limitations on what it could pay people.

We recognise the challenge which GRG faced when it grew unexpectedly and rapidly in size and scale, with its previous systems and controls no longer suitable. While senior management recognised the need to recruit additional staff, the challenges they faced meant this was not easily or quickly achieved. Senior management were trying to keep up with these challenges and growth. We acknowledge that throughout the period, GRG was trying to increase resourcing to meet the demands it was facing so it brought in people from both inside and outside RBS (ie secondees) as a way to address resourcing issues.

## 9 Conclusion

Recognising the significant public interest in this matter we have aimed, in this report, to set out the evidence we found in relation to the treatment of SME customers within RBS GRG during the review period. We have also explained the limits on the FCA's jurisdiction to take disciplinary action against RBS or any individuals, and our consideration of whether any individuals were lacking in fitness and propriety.

Publishing this report is an exceptional step and something we would not ordinarily do. We have done so on this occasion because we think, in light of the history of this matter, the significance of the requirements of transparency and the effective regulation of banks (including where some of their activities are unregulated), there is a clear public interest in providing as much information about GRG as possible. There is also a clear public interest in discussing how we approach unregulated conduct within authorised firms.

GRG was a largely unregulated part of RBS. However, when serious concerns were raised about the treatment of customers the FSA, and later the FCA, took steps to consider if there was any basis to take action. We appointed Promontory to conduct an independent review and produce a detailed report setting out its understanding of events. When that independent review raised particular concerns about senior management's understanding and awareness of customer treatment, we appointed our own enforcement investigators to examine the issues. We use investigations as a diagnostic tool. We do not begin an investigation on the basis that we will be able to secure punishment. We do it to ensure we understand the full picture of events, and we then decide if it is possible and appropriate to take action.

While senior management introduced changes to the control framework of GRG, it was an evolving picture. The financial crisis saw a significant increase in the number of customers referred to GRG. Despite this, the changes to the systems and controls did not keep pace with what was needed in light of that increase and there is clearly evidence of poor behaviour within GRG.

Because most of GRG's activities were outside our jurisdiction, we are not able to impose a financial penalty on RBS or any senior management. We also considered if any senior management lack fitness and propriety, such that they should be prohibited from the financial services industry.

We did not find evidence that senior management acted dishonestly or with a lack of integrity. We have also considered whether the way senior management performed their roles showed a lack of competence and capability, taking into account all the relevant circumstances. A challenge in this respect was the absence of regulatory rules against which the performance of senior management could be measured. To say an individual's behaviour falls below the expected standard, that standard needs to be clear. Because our rules did not apply to GRG there is not a clear standard here. While those directly affected might think the conduct of senior management was deficient in GRG, we do not believe we would have reasonable prospects of bringing successful prohibition proceedings against any member of senior management.

Although we are not able to take action against RBS or any individuals in this situation, we have worked with the bank to ensure it puts things right for its customers. RBS



voluntarily established a compensation scheme for affected customers. The CEO of RBS has also provided an attestation that the bank has complied with the independent review's recommendations. We have also input into changes to the law, for example extending access to the Financial Ombudsman Service for more SMEs. We also hope that the situation will be different going forward, with the implementation of the SM&CR.

## The position now

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The SM&CR replaced the APR for banks, building societies, credit unions and dual-regulated (regulated by the FCA and PRA) investment firms in March 2016. It has now been extended to insurers and later this year will be extended to a wider group of FCA-regulated firms. The SM&CR has changed the way people working in banks and some financial services firms are regulated.

The aim of the SM&CR is to reduce harm to consumers and strengthen market integrity by creating a system that enables firms and regulators to hold people to account. As part of this, the SM&CR aims to encourage staff to take personal responsibility for their actions, improve conduct at all levels and make sure firms and staff clearly understand and can show who does what.<sup>3</sup>

### *How the SM&CR works*

The most senior people performing key roles in a firm need our approval before they can start that role. The FCA Handbook sets out which roles are defined as senior manager roles, known as Senior Management Functions (SMF). Each SMF has a specific set of responsibilities.

The basic principle of the SM&CR is about accountability and responsibility. A senior manager has to take responsibility for the activities under their control. Likewise, they should be accountable for that responsibility.

Senior managers can hold more than one SMF at the same time with our agreement. This would be much less likely in a big firm. Amongst others, the SMF roles include that of chief executive (responsible for the conduct of the whole of the business or regulated activities within it), and of money laundering reporting officer (who is responsible for overseeing that the firm is complying with our rules on systems and controls against money laundering).

Firms must also allocate specific prescribed responsibilities to individual senior managers. For example, being responsible for the policies and procedures for tackling the risk that the firm might be used for financial crime. Requiring a firm to allocate these prescribed responsibilities helps ensure that SMF holders are accountable for the key conduct and prudential risks that a firm faces.

Every SMF holder must have a statement of responsibility, which clearly sets out their roles and responsibilities. Some firms must have a responsibilities map, which sets out the firm's management and governance arrangements. The responsibilities map must include details on who has overall responsibility for the firm's activities, business areas and management functions and how responsibilities have been allocated.

The Certification Regime applies to staff whose roles mean they could potentially cause significant harm to the firm or consumers. People performing these roles do not need our

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3 The senior Management and Certification Regime: Guide for FCA solo-regulated firms - July 2018 see page 6



approval before they start their job. However, firms need to check and confirm that these people are fit and proper to perform their role at least once a year, taking into account factors including their level of competence, qualifications and training. An example of a certification function is someone who gives advice to consumers, such as a financial adviser or investment manager.

The Conduct Rules are a new set of rules we can enforce that set out the minimum standards of good personal conduct against which we can hold people to account. The Conduct Rules apply directly to all staff at relevant authorised firms, and aim to improve standards of individual behaviour in the financial services industry.<sup>4</sup> There are two sets of Conduct Rules:

- the Individual Conduct Rules which apply to all staff including SMF holders (but excluding staff solely performing support roles, such as cleaning, catering and reception staff)
- the Senior Manager Conduct Rules that only apply to SMF holders.

The Conduct Rules apply to the conduct of an individual in relation to their performance of functions relating to the carrying on of activities (whether or not regulated activities) by the firm.

### ***Would the SM&CR change what we could do about GRG?***

If the SM&CR had been in force during the review period, we would have had a clearer understanding from the start of which individuals held which specific responsibilities for RBS and GRG's activities.

One of the challenges of taking action before the SM&CR was implemented was the difficulty in identifying who specifically was accountable and responsible for the business area where the breaches occurred. Even if the individual was identified, it was not always clear what they were responsible or accountable for within the business area. The statements of responsibility required by the SM&CR solves this. If a firm fails to put in place an appropriate statement of responsibilities for SMF holders, we can act both against the firm, and against the SMF holder accountable for the SM&CR within the firm.

It is difficult for us to set out a definitive set of criteria that say when we would have reasonable prospects of success for holding individuals to account, simply because this will depend on the circumstances and facts of each case. Subject to that important point:

- We would have had jurisdiction under the SM&CR, if there was sufficient evidence, to take action against RBS senior management for breaches of the Conduct Rules, despite GRG's activities being largely unregulated.
- The SM&CR would not have enabled us to take action against RBS. This is because the SM&CR relates to individuals within firms; it does not alter our jurisdiction in respect of the firm itself.

We cannot say whether we would have been able to bring successful cases against RBS senior management had the SM&CR been in force during the review period. This would involve applying a new regime to a historic set of facts and it would not be appropriate for us to make a hypothetical judgement. The SM&CR cannot be applied retrospectively to conduct that happened before it was implemented in March 2016.

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4 The senior Management and Certification Regime: Guide for FCA solo-regulated firms - July 2018 see page 43

## Annex 1

### Glossary

<b>AMO</b>	Asset Management Objective	The objective of the APS, which is to maximise the expected Net Present Value of the Protected Assets, including by minimising losses and potential losses and maximising recoveries and potential recoveries in respect thereof.
<b>APA</b>	Asset Protection Agency	An executive agency of the Government created in 2009 to implement the APS.
<b>APS</b>	Asset Protection Scheme	A Government insurance scheme created in 2009 during the financial crisis to protect banks against exceptional losses.
<b>BRG</b>	Business Restructuring Group	Relationship and credit management of businesses in GRG from £1million to £20million RBS group aggregate exposure.
<b>B&amp;C Credit</b>	Banking and Commercial Credit	The area of RBS which would provide banking services to small and medium sized businesses with turnover up to £25 million.
<b>DSC</b>	Debt Service Coverage	The measure of the cash flow available to pay current debt obligations.
<b>Chinese Wall</b>		A business term describing an information barrier within the bank that was erected to prevent exchanges or communication where there was a conflict of interest.
<b>Clifford Chance Review</b>		The report of Clifford Chance LLP, published on 11 April 2014, following its review of the allegations set out in the Tomlinson Report.
<b>CSS</b>	Customer Satisfaction Survey	An independent satisfaction survey, undertaken annually by Ipsos MORI, on a random sample of 500 GRG customers.
<b>DRAC</b>	Divisional Risk and Audit Committee	The RBS Non-Core Division and GRG risk and audit committee.
<b>EPA</b>	Equity Participation Agreement	Acquiring equity in a business, explained in more detail in Chapter 5.2 of the independent review report (Strategic Investment Group).
<b>GAC</b>	Group Audit Committee	Responsible for assisting the Board in disclosure of financial affairs as well as reviewing accounting and financial reporting. It also reviews regulatory compliance and RBS's systems of internal controls and monitoring including internal audit, risk management and external audit.
<b>GIA</b>	Group Internal Audit	RBS Group's Internal Audit department.
<b>GRC</b>	Group Risk Committee	The Group Risk sub-committee of the RBS Group Board.

<b>GRG</b>	Global Restructuring Group	Undertakes active management of RBS's problem lending portfolio.
<b>GRG ExCo</b>	GRG Executive Committee	Responsible for establishing the strategy and strategic objectives for GRG, including the setting of risk appetite; ensuring GRG is appropriately led and managed, in line with its sanctioned strategy and debating and authorising significant business and functional matters.
<b>GRG ManCo</b>	GRG Management Committee	Responsible for ensuring the overall strategy of the GRG ExCo is being delivered, including people resourcing and retention.
<b>GS&amp;F</b>	Group Security & Fraud	The area responsible for group security and fraud.
<b>IBR</b>	Independent Business Review	A business review carried out by an independent professional accountancy firm.
<b>IRR</b>	Internal Rate of Return	An internal calculation of the rate of return on loans.
<b>Invoice discounting facility</b>		This is where RBS would lend to a business an amount of money equal to that owed to the business by its suppliers, in return for a percentage.
<b>LTV</b>	Loan-to-value	A percentage figure derived by dividing a loan amount by the value of the asset(s) against which it is secured.
<b>MI</b>	Management Information	Information provided to the management of an organisation giving specific details of its business/in connection with the activities undertaken by its staff and with customers.
<b>NCD</b>	Non-Core Division	The NCD was created to manage £258bn of assets that were no longer core to RBS strategy and the continuing operations of the Group. The purpose of the NCD was to run-down or exit these assets over a 5-year period (by the end of 2013). NCD was to be the primary driver for reducing the Group's overall risk exposure, the intention being to aid the reduction of the Group's balance sheet by up to 20% and to rebalance the Group's risk exposure by exiting more capital-intensive assets and assets no longer deemed core to RBS strategy.
<b>PD</b>	Probability of Default	The likelihood of a customer failing to trade satisfactorily and to service financial obligations. It is calculated from the Risk Rating questions within the Risk Rating Screen and Audited Financial information.
<b>PPFA</b>	Property Participation Fee Agreement	A deferred variable fee arrangement whereby customers agree to pay a fee in the future calculated by reference to increase in the underlying property value.

<b>RBS</b>	Royal Bank of Scotland	The Royal Bank of Scotland Plc.
<b>REAM</b>	Real Estate Asset Management	See West Register.
<b>Restructuring</b>		The name of GRG from 1 December 2014.
<b>RM</b>	Relationship Manager	A Bank employee who manages (primarily) a customer's lending relationship but will also be accountable for other elements of the relationship, for example Anti-Money Laundering regulations.
<b>RTS</b>	Return to Satisfactory	The return of a case to a Banking and Commercial Relationship Manager where the lending meets current Banking and Commercial lending criteria (or otherwise agreed) and is trading satisfactorily.
<b>RWA</b>	Risk Weighted Assets	A measurement of credit risk, market risk and operational risk that helps to establish minimum capital requirements.
<b>SCR</b>	Strategy & Credit Review	Committees of senior and experienced GRG RMs and directors that review exposures periodically.
<b>SIG</b>	Strategic Investment Group	A separate unit within GRG which provides advice and support on negotiating and managing Upside Instruments in respect of lending which falls outside RBS's normal risk profile.
<b>SME</b>	Small & Medium Enterprises	All customers who were directly or indirectly transferred to and/or managed by GRG during the review period with debt levels of between £1million and £20million, and where that transfer and/or management was carried on from an establishment in the United Kingdom.
<b>SMF</b>	Senior Management Function	A function defined in section 59ZA FSMA (Senior Management Functions) which means, in relation to the carrying on of a regulated activity by an authorised person, any function if (a) the function will require the person performing it to be responsible for managing one or more aspects of the firm's affairs, so far as relating to the activity and (b) those aspects involve, or might involve, a risk of serious consequences (i) for the firm or (ii) for business or other interests in the United Kingdom (Glossary of the FCA Handbook).
<b>Skilled Person</b>		Promontory Financial Group (UK) Limited appointed by the FCA under s166 FSMA on 20 May 2014
<b>SRM</b>	Specialist Relationship Management	This unit provides a specialist credit focused relationship expertise to B&C Banking and Lombard. It was part of B&C not GRG.

<b>Tomlinson Report</b>	'Banks' Lending Practices: Treatment of Businesses in Distress' published on 25 November 2013.
<b>Upside Instrument</b>	See EPA and PPFA.
<b>West Register</b>	The vehicle used by RBS to acquire property assets from distressed situations; mandated to consider purchasing any property asset where the property loan is distressed, and where the property is being offered for sale. Now known as REAM (Real Estate Asset Management).

We have developed the policy in this Consultation Paper in the context of the existing UK and EU regulatory framework. The Government has made clear that it will continue to implement and apply EU law until the UK has left the EU. We will keep the proposals under review to assess whether any amendments may be required in the event of changes in the UK regulatory framework in the future.

We make all responses to formal consultation available for public inspection unless the respondent requests otherwise. We will not regard a standard confidentiality statement in an email message as a request for non-disclosure.

Despite this, we may be asked to disclose a confidential response under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Rights Tribunal.

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