The Big Read Financials

RBS bids to escape recovery mode

As the bank faces its ninth straight annual loss, can chief executive Ross McEwan hang on at the helm?

Emma Dunkley and **Martin Arnold** FEBRUARY 19 2017

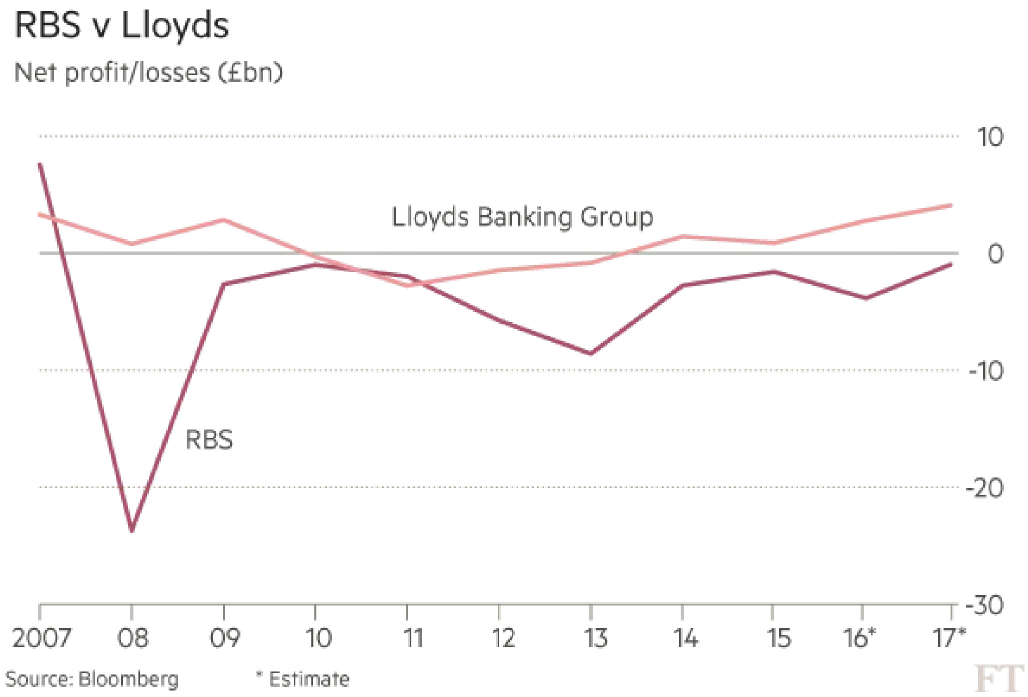
When Ross McEwan boarded a plane from London to Chicago last November, the rugby-mad chief of Royal Bank of Scotland was looking forward to seeing his home nation triumph over Ireland again. But against the odds, the Irish team clinched its first win in more than 100 years against the gritty New Zealand team. The match ended the All Black's 18 game-winning streak and left Mr McEwan crestfallen.

It was a long way to go to watch a stoical but ill-fated confrontation that reflects Mr McEwan's recent corporate experience. In the three and a half years since the 59-year-old became RBS chief executive, he has been battling a long list of legacy scandals and operational shortcomings to salvage the bank that was once the world's biggest by assets, but is now one of the most troubled.

During his time in charge, the bank's shares — the bulk of them owned by the British government — have lost a third of their value. This week, he is braced to announce the bank's ninth consecutive annual loss, which analysts estimate will amount to about £6bn for last year.

RBS's aggregate losses since the 2008 crisis, which triggered the bank's collapse and taxpayer bailout, have ballooned to more than £50bn. Thousands more jobs are due to be slashed and more branches closed in a fresh cost-cutting plan to be revealed alongside the results, aimed at saving £800m this year and a similar amount in 2018, according to analysts.

The bleak picture at RBS contrasts sharply with the fortunes of rival state-backed lender Lloyds Banking Group, which is expected to report a net profit of £2.4bn. While Lloyds, now 5 per cent government-owned after a gradual selldown, could be fully back in private ownership in a few months, with the taxpayer recouping all the £20bn injected into the bank, the situation is very different at RBS. Taxpayers are sitting on paper losses of about £23bn on the government's 72 per cent RBS stake.



Rumours have swirled around the City that the government's patience with Mr McEwan's efforts is running out. Some former colleagues say the RBS boss himself may be getting fed up with the job. "Ross is so pissed off," says a former senior RBS executive who left recently. "I'd be staggered if he was still around in a year's time."

Both suggestions are roundly rejected by RBS — and by Mr McEwan himself. "This is one of the hardest jobs in banking," Mr McEwan says in an interview. "I want to see it through. We've done most of the hard work on this bank. I'm starting to feel actually quite good about 2017. Lots of issues to deal with. But the core [bank] is starting to work."

RBS still faces a crushing mortgage mis-selling penalty, forecast to be as high as $13bn, from US authorities. Record-low interest rates are squeezing its profit margins. Those, and other headwinds, mean any hope of profitability has been abandoned for 2017. But more existential questions loom. Can RBS, in its current form, ever become a prosperous institution? And is Mr McEwan the man to get it there?

"This is such a demanding job — when you see him you realise there is only so long anyone can take it," says a top 10 shareholder.

Stephen Hester, then the CEO of RBS, leaves the bank's London headquarters after announcing a record £24bn loss for 2008 © PA

Long shadow of the crisis

The RBS chief was dealt a tough hand when he took on the role in late 2013.

Many of the bank's problems stem from former RBS boss Fred Goodwin and his aggressive expansion, which started with a hostile takeover battle for NatWest at the turn of the millennium.

But it was the disastrous £49bn acquisition of ABN Amro in 2007 that proved RBS's undoing. The Dutch bank had vast exposure to mortgage-backed securities, totalling nearly €40bn. When US subprime mortgage borrowers began defaulting en masse in 2007, it decimated the value of these securities.

RBS had grown larger than any rival with more than £2.4tn of assets — as big as the German economy in 2008. But its rapid expansion led to its downfall, requiring the biggest ever rescue at £45.5bn. It is still the biggest bailed out lender that remains majority owned by a government.

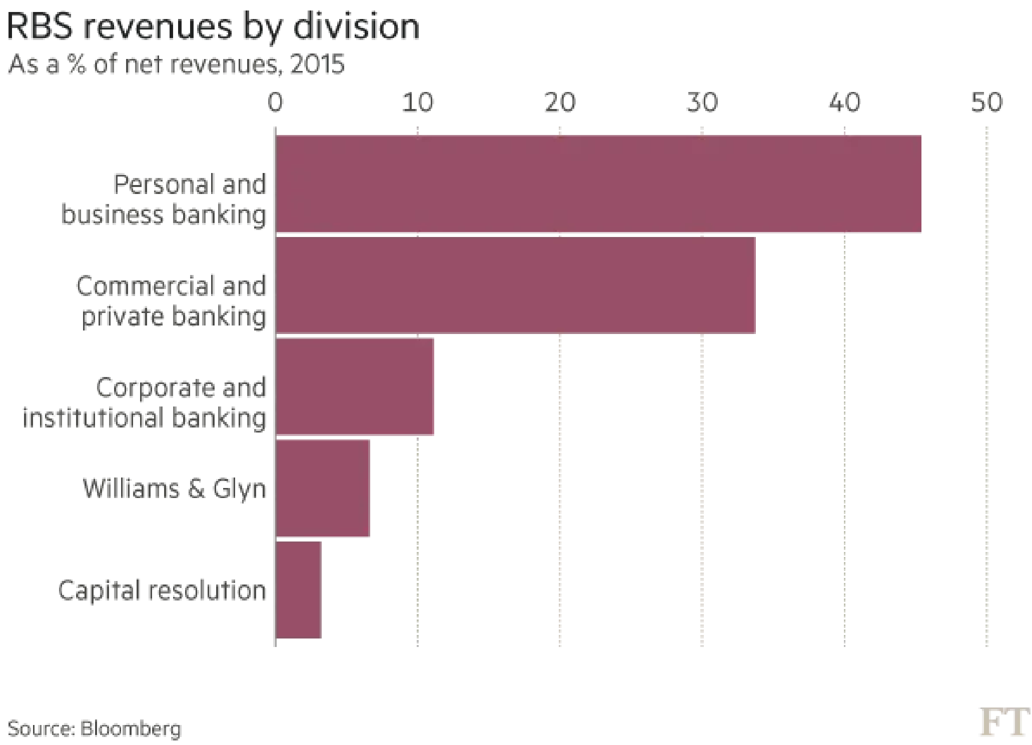

Former chief executive Fred Goodwin in August 2007, pictured after shareholders approved the deal to take over ABN Amro in 2007 © Reuters

The Goodwin era still haunts RBS. Board members say they often spend 70 per cent of meetings discussing legacy issues, according to the top 10 shareholder. The widespread mis-selling of mortgage-backed securities from 2005-07 has left RBS facing an imminent penalty from US authorities. It is the single largest obstacle facing Mr McEwan, although the timing of a settlement is largely out of his control.

Last month, RBS added $3.8bn to the $4.5bn it had already set aside to cover the potential cost, but warned it might still have to earmark "substantial" amounts for the looming penalty.

The top 10 shareholder said: "All the litigation issues have eaten away at the excess capital. So there is no capital for dividends or to invest in the business."

The other large problem for Mr McEwan has been the requirement to sell Williams & Glyn, a bank that RBS has attempted to form from 306 of its branches, as an EU condition of RBS's bailout. After a failed sale to Spain's Banco Santander in 2012 and numerous deadline extensions with the EU, Williams & Glyn had become an albatross around the bank's neck.



However, RBS now looks likely to escape the requirement to sell Williams & Glyn after the UK Treasury said on Friday that it had agreed a potential deal with Brussels for the bank to instead spend £750m on measures to bolster competition in small business banking.

Before this concession, criticism was already being aimed at Mr McEwan's failed attempt to create a technology platform for Williams & Glyn — costing more than £1.5bn — to prop it up as a standalone bank that could be separately floated. "This is one instance where you really could point fingers at current management and say that sticking to the requirements of the EU state aid ruling to the letter for so long was unfortunate," says another top 10 shareholder of the Edinburgh-based bank. "With hindsight it was poor judgment."

George Kerevan, an MP for the Scottish National party, says: “What McEwan should’ve done when he came on board was to go to the government and oppose the [Williams & Glyn] sell-off, to stop the cash drain on an IT project that was a living disaster.”

RBS ditched the flotation last year, blaming low interest rates after the Brexit vote. It was a blow to investors. The bank had made offloading Williams & Glyn a precondition for restarting dividends. Philip Hammond, the chancellor, warned last year that the UK government would not sell more of its stake until this hurdle, as well as the settlement with US regulators, was cleared.

“I do a huge amount of self-reflection on could we have gone faster, should we have made calls earlier,” Mr McEwan said before the potential deal with the EU was announced. “I pulled the plug on it because it just wouldn’t have got a licence. [Brexit] nailed it at the end.”

Other decisions by Mr McEwan have been called into question. RBS pulled teaser deals from its credit card and savings products for new customers in 2014, and later on home insurance offerings, a strategy that had proved a success in his previous role at Commonwealth Bank of Australia. But the move has backfired, hitting revenues. Credit card balances have fallen by about a third since the end of 2013.

“It has chosen not to grow in credit cards, a judgment I don’t agree with,” says Ian Gordon, analyst at Investec. “Stepping away from teaser rate products over a period where the credit card market has grown means RBS has had no growth.” The bank is now planning to reintroduce 0 per cent balance transfers for credit card customers if it can solve issues around fee transparency and debt repayment.

The number of people employed by RBS has fallen by more than half, and is likely to fall further © Bloomberg

"I am objecting to having customers trapped on zero balance and not paying their debts down," Mr McEwan says. "I'm objecting to customers getting caught with rates that shocked them at the end of the day. Those are the things I've asked the team to work through — you find a solution to that [and] I'm happy to be in that marketplace."

Core strength

Given Mr McEwan's focus on improving customer relations, he is particularly sensitive to criticism of RBS's treatment of small businesses, which has created a cloud over the culture of the bank.

RBS set up a £400m compensation pot in November for small business owners that allegedly suffered at the hands of its controversial restructuring unit in the aftermath of the financial crisis. RBS admitted it "could have done better" for the 12,000 small business customers handled by its now-defunct Global Restructuring Group.

The bank's creaking IT systems, which left customers without access to their accounts for over a week after an outage in 2012, are another major blockage. "What makes RBS such a nightmare is the complexity of its systems," says a former executive.

Yet signs of a profitable core bank are emerging. Mr McEwan outlined a five-year plan in 2014 to focus on UK retail and commercial banking by pulling out of overseas markets and scaling back investment banking. Capital reserves have been bolstered and riskier businesses offloaded.

The core business, which is mainly the UK retail and commercial bank, has generated more than £1bn of operating profit over the past seven quarters, excluding one-off items. Mr McEwan has also boosted its mortgage market share, from 8 per cent of new business to 12 per cent. But his plan has come under pressure from record-low rates, leading him to push back profit targets and leaving cost cuts as the remaining lever to boost profit.

“There is a poor record of banks trying to take out costs without damaging the underlying performance of the business,” says the second top 10 shareholder. “You can end up in this rather challenging vicious cycle, always chasing the costs down as revenues keep falling further.”

Some analysts are forecasting a small profit for the bank next year, but they warn even this could be threatened by further restructuring costs or huge charges. “In this environment, it will take at least five years to normalise RBS,” says a former board member. “But after that I don’t see why it can’t be an effective bank once more.”

Mr Gordon of Investec adds: “We are still at least three years away from achieving ‘normal’ profitability, and any full sell down of the government’s stake will take much, much longer.”

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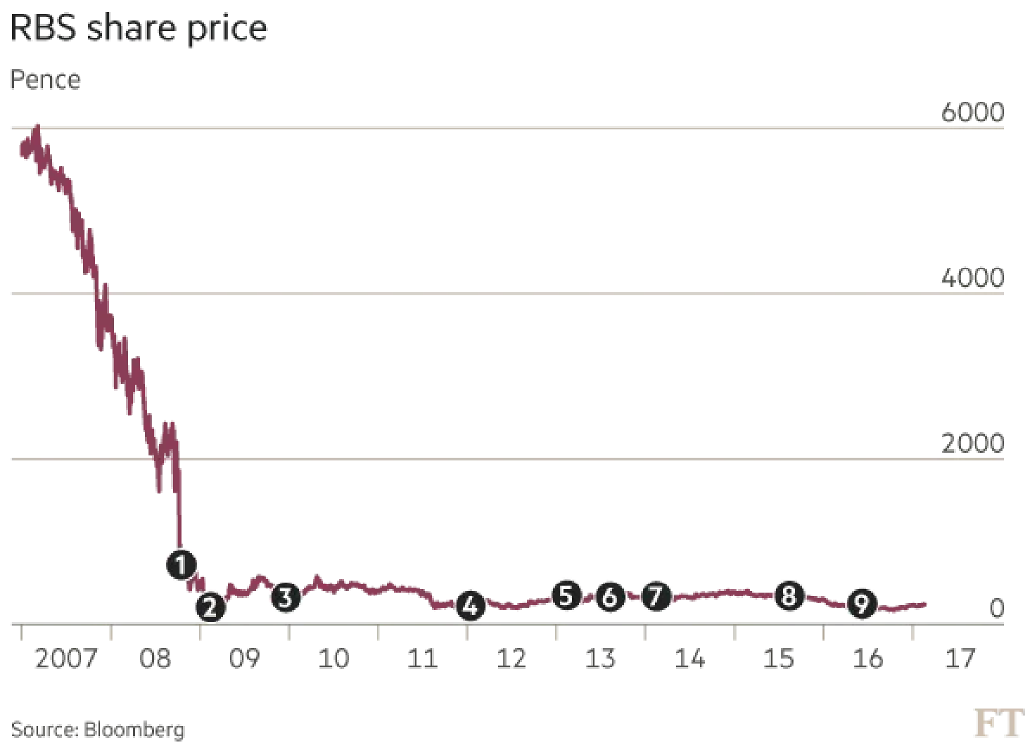
A turbulent decade



1. October 2008 Stephen Hester replaces Fred Goodwin as RBS chief executive a year after it completed the £48bn takeover of ABN Amro

2. February 2009 RBS reports a record £24bn net loss

3. December 2009 The government completes a £45.5bn bailout of the bank

4. January 2012 Fred Goodwin is stripped of his knighthood

5. February 2013 RBS is fined £390m for rigging Libor

6. August 2013 Ross McEwan takes over as chief executive two months after Hester quits

7. February 2014 RBS announces a five-year restructuring plan to refocus on the UK

8. August 2015 Government sells a £2.1bn stake in RBS at a loss

9. June 2016 RBS shares fall sharply after the UK votes to leave the EU

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Although approaching his 60th birthday, Mr McEwan dismisses the prospect of early retirement. He insists he is not motivated by pay, having earned nearly £3.8m for 2015 — far less than the £8.5m for Lloyds' António Horta-Osório.

"You don't do this job for the money," says the RBS chief. "I get paid well for doing this job, but I haven't taken a bonus in the first three years . . . The key for me is restoring the pride in this organisation."

Mr McEwan, who played more basketball than rugby in his youth, is confident that RBS is closing in on victory. "He's in the middle of a game, he doesn't want to be subbed now," says a former colleague. "He is the New Zealand rugby team, and he wants to win."

Small Business: Accusations of mis-selling bound for High Court

Christopher Pichon is an unfortunate enemy for a company like Royal Bank of Scotland to have made.

He is chairman of Wenta, the not-for-profit social enterprise that has incubated, advised and funded thousands of start-up businesses in north London and Hertfordshire. Two years ago, Mr Pichon was invited to Buckingham Palace and awarded the Queen's lifetime achievement award for enterprise promotion.

In other words, he is about as close as a small business leader comes to siding with the angels. And the 68-year-old feels wronged by RBS, which he says mis-sold Wenta a complicated interest rate derivative that cost it hundreds of thousands of pounds.

Wenta's £500,000 claim, which is heading for the High Court in October, is one of dozens of such cases against RBS. "Their behaviour has hardened our attitude to expose them and make them pay up in compensation," Mr Pichon told the Financial Times.

He argued the derivative was unsuitable for a small company that had only £5m revenues and 45 staff. Nonetheless, a local banker from RBS's NatWest subsidiary sat on Wenta's board and recommended it, he said.

“It was a case of bullying, a corporate position of bullying,” Mr Pichon said, describing his reaction after the bank turned down his application for compensation. “They said: ‘So you’ll have to sue us,’ assuming that we wouldn’t, of course. I feel we were basically hung out to dry.”

A Wenta lawyer said RBS often took a tougher approach than other banks to complaints by small businesses. Ali Akram of LexLaw, said: “This is their strategy in every single case. They drag it out as much as they can.”

Ross McEwan, chief executive of RBS, said: “I refute that.” He added: “We would love them to go as quick as the courts would move. I have no desire to hang on to these things.”