CORRESPONDENCE BETWEEN THE GUERNSEY FINANCIAL SERVICES COMMISSION AND THE FINANCIAL SERVICES AUTHORITY

1. Letter from the Director General, Guernsey Financial Services Commission, to the Chief Executive, Financial Services Authority, dated 6 January 2009

LANDSBANKI GUERNSEY LIMITED (IN ADMINISTRATION) (LGL)

We have corresponded on previous occasions on the subject of inter-regulator cooperation. For example on 29 November 2007 you responded to my letter of 20 November, in the context of Northern Rock Guernsey, confirming that the FSA was committed to keeping the Commission informed of relevant developments. In your letter of 25 April 2008, addressed to our Chairman Peter Harwood, you referred to work that was being done generally to enhance supervisory collaboration, and confirmed that the Memorandum of Understanding between the FSA and the Commission (which was signed in July 2003) allows the exchange of confidential information. The Memorandum of Understanding explicitly recognises that cooperation in respect of such exchanges of information will enable both the FSA and the Commission to more effectively perform their respective functions.

In this context, I am now writing to explain our considerable concern over the effectiveness of the present level of collaboration, particularly in respect of matters relating to LGL. Please treat this letter both as an expression of our concerns generally and also as a formal request for consultation in respect of the issues raised below under clause 16 of the Memorandum of Understanding. For your information, the Commission will be making a submission on the morning of 12 January to the UK Treasury Committee inquiry into the banking crisis; that submission will include detailed reference to LGL and the Commission's concerns about the effectiveness of cooperation and information exchange between the FSA and the Commission.

I had hoped to be able to write to you with our concerns and then to have enough time to discuss those concerns with you at your convenience. In the event, however, work on the report on the Commission's role in the LGL affair (see below) was completed only yesterday, and we are due to make our submission to the Treasury Committee next Monday morning. The opportunity for us to meet and discuss matters is therefore, unfortunately, limited.

As I am sure you are aware, on 6 October 2008 the Board of Directors of LGL took the decision that it was in the best interests of depositors to put the bank into administration because of the refusal of Heritable Bank Limited (Heritable) to repay

funds deposited with it by LGL.

The Commission's involvement with LGL started in September 2006 when it was asked to approve the acquisition by the Landsbanki Group of the Guernsey subsidiary of the Cheshire Building Society.

The Commission approached the authorisation and subsequent supervision of LGL confident in our ability to rely on cooperation with the FSA in order to be able to act effectively to protect depositors. Regrettably, information we now have raises a very serious concern over the way in which the expected cooperation has operated in practice.

In April 2008 the FSA became fully aware (in the context of LGL) of our close interest in matters relating to Heritable, including our concerns in relation to Heritable's links with its parent Landsbanki Islands hf (Llhf). In particular, a letter dated 21 April 2008 from Dr Jeremy Quick to Mr Stephen Funnell explained those concerns and sought FSA confirmation that Heritable was "a UK-orientated, self-standing firm, with only limited Icelandic risk". The letter also asked questions of the FSA aimed at ensuring, by way of assurances from the FSA, that Heritable's exposure to Llhf, including in respect of dependence on funding lines, would be limited. Specific mention was made of our concern that LGL might become dependant on liquidity from Heritable. Mr Funnell responded, in a letter dated 25 April 2008, confirming the FSA's commitment to maintaining dialogue and stating that Heritable met the FSA's capital and liquidity guidelines. The letter also confirmed that Heritable was "a UK-orientated, self-standing firm, with only limited Icelandic risk". Mr Funnell continued, by stating that any Icelandic risk was "predominantly reputational ie by virtue of its parentage". Mr Funnell also mentioned that funding flows were in both directions, although at that time the movement of funds was from Llhf to Heritable and this situation was not expected to change.

On 11 July 2008, Mr Stuart Bailey of the Commission wrote to Mr Funnell asking for the FSA's confirmation that Heritable was "ring-fenced from Icelandic risk". On 16 July Mr John Brennan of the FSA responded in writing stating "I can confirm that our assessment of Heritable's exposure to Icelandic risk has not changed materially from Stephen's letter of 25 April 2008 to Jeremy Quick".

More generally the Commission took additional comfort from the greater attention paid by the FSA to liquidity given the market conditions in 2007-08. A core element of that assurance was the FSA's treatment of the liquidity of UK banks. As the Integrated Prudential Source Book (Volume 2 4/2) states "UK banks are expected to be able to stand alone, and therefore should normally monitor and arrange their own liquidity separately from the liquidity of other institutions in the group". At no time did the FSA tell the Commission that it had either informally or formally waived this requirement for Heritable.

The information provided to us by the FSA in April and July 2008 was a key determinant in our permitting funds to be placed with Heritable, as explicitly stated in Dr Quick's letter of 21 April 2008.

LGL was placed into administration in the early hours of Tuesday 7 October 2008, less than a day before Heritable itself was placed into administration. The reason for LGL's administration was the refusal of Heritable to repay funds, deposited with it previously by LGL, on 6 October and the prospect that they would not be released on 7 October.

Before raising our concerns with you, the Commission decided to examine our own handling of the matter. On 30 October 2008 I advised Jon Pain and David Strachan that an inquiry was to be carried out by Mr Michael Foot of Promontory Financial Group. A copy of Promontory's full report is enclosed for your information. Please note that this is provided to the FSA under paragraph 5 of the Memorandum of Understanding between the FSA and the Commission, and on the basis that it is confidential to the FSA and its legal advisers and that neither the report nor any part of it can be disclosed to any other third party without our consent. You will appreciate that paragraphs 14 and 15 of the MoU apply. We would be grateful for your assurance that the FSA will do all it can to resist pres sure to disclose the report and that the Commission will be consulted at the earliest possible point in any dispute over publication.

Please note that a separate version of the report—in which confidential information has been removed—has been prepared by Promontory and put in the public domain by virtue of its publication on the Commission's website earlier today. I have provided a copy of this redacted report to Jon Pain and David Strachan, and a copy of it will also accompany our submission to the Treasury Committee.

You will see that the report concluded that the Commission comfortably met international banking regulatory standards, did not act in bad faith, did not act unreasonably, and that there was no evidence of regulatory failure.

In paragraphs 7 to 25 of the full report, it examines the cross-border responsibilities of regulators. Apart from the assurances provided by the FSA as Heritable's home regulator, the Commission also took comfort in the host to host relationship with the FSA, given that the FSA also regulated a UK branch of Llhf (Icesave). During conversations with the FSA the Commission was given to understand that the FSA was maintaining a close watch over the group's management of its liquidity, not least as Icesave provided significant funding for Llhf. This appeared to involve the FSA in close contacts with the Icelandic authorities in respect of the wider affairs of the Landsbanki Group, enabling the FSA to have much greater access to information and greater power and influence over the affairs of the Landsbanki Group than the Commission. However, this did not lead to the FSA informing the Commission promptly about the October liquidity crisis; nor to clarify for the Commission that Heritable was dependent on group liquidity and therefore vulnerable to Icelandic risk.

You will see that paragraphs 67 and 69 of the Foot report refer to the comfort derived by the Commission from assurances given by the FSA in relation to the Heritable loan portfolio. Paragraphs 72—77 also address the matter of relations between the Commission and the FSA and our concerns, both in respect of

Northern Rock Guernsey and LGL.

As the Icelandic crisis deepened, following the nationalisation of Glitnir banki hf on 29 September 2008, the Commission's communications with the FSA became much more frequent and our dependence on the FSA's provision of information and support became critical.

The Commission understands that the FSA intervened at Heritable on Friday 3 October and again on Monday 6 October to prevent any payments being made by Heritable to LGL. By this time, LGL directors had made it clear orally to Heritable that they wanted all the LGL deposits with Heritable (which were repayable on demand) repaid. However, formal requests for repayment were made for only part of the funds to be repaid, apparently after the directors had been advised, again orally, that full payment would not be possible.

It is also of concern to the Commission that the FSA may have prevented the directors of Heritable from making repayments to LGL while, at the same time, allowing payments to be made to other creditors.

The FSA did not tell the Commission of its actions, nor explain to us any of the concerns which must have underlain them and which presumably led to the FSA placing Heritable into administration on Tuesday 7 October. The FSA will be aware that doubts have been expressed over whether this action was necessary.

Indeed, during a telephone conversation on 6 October 2008 between representatives of the FSA, the Commission and a director common to both LGL and Heritable, the FSA stated that Heritable did not have significant Icelandic exposure so there was no reason to think it was insolvent. During the day of 6 October, the dependence of Heritable on Uhf for liquidity first became apparent to the Commission and it also became clear that the FSA had allowed Heritable to become substantially dependant on Uhf for its liquidity without advising the Commission of this fact and despite assurances to us that Heritable had limited Icelandic risk.

It is particularly disappointing that at no stage did the FSA provide adequate information to the Commission to enable it to act effectively to protect LGL's depositors. The FSA did not, in the proper spirit of the Basel standards, the MoD between us, the assurances provided to us, and the confirmation provided to us, open and maintain a dialogue with the Commission that would have enabled a strategy to be agreed which could have protected the interests of the depositors in LGL as well as the interests of the depositors in Heritable. Instead, the unilateral actions of the UK authorities in placing Heritable into administration and removing all retail depositors from Heritable jeopardised the interests of the LGL depositors (some 33% of which by value are based in the UK) whilst protecting the retail depositors of Heritable. The FSA acted in this way in full knowledge of the Commission's concerns. The FSA must have been aware that its actions would effectively destroy the commercial viability of Heritable and LGL and their reputations. In addition the FSA must have been aware that its actions would make it virtually impossible to achieve a normal work-out of the loan portfolios, therefore

making it much less likely that LGL's depositors would be repaid in full.

The Commission would like to receive the FSA's comments on the following matters:

1. Did the FSA take actions on or before Friday 3 October and Monday 6 October to prevent Heritable repaying any or all of the deposits placed with it by LGL?
2. If it did take such actions, on what grounds were those actions taken?
3. Why did the FSA not advise the Commission of its concerns and its planned actions in accordance with the normal standards of supervisory cooperation, the MoD, and the assurances and confirmation to this effect that had been given to us?
4. Why did the FSA not open a dialogue with the Commission to seek a resolution to its concerns that could have sought to protect depositors in both Heritable and LGL?
5. Why did the FSA not advise the Commission that Heritable was substantially dependant on Llhf for its liquidity despite its assurances to the contrary?
6. Did the actions taken by the FSA and other UK authorities in relation to Heritable and its retail depositors amount to an unfair preference over LGL?

I look forward to hearing from you. Please let me know if you would like further information. I would be happy to come to London for a meeting to discuss these matters this week, if that would be helpful.

2. Letter from the Chief Executive, Financial Services Authority, to the Director General, Guernsey Financial Services Commission, dated 15 January 2009

LANDSBANKI GUERNSEY LIMITED (IN ADMINISTRATION) (LGL)

Thank you for your letter of 6 January. We have carefully considered the points you make and respond to your questions as follows.

1. *"Did the FSA take actions on or before Friday 3 October and Monday 6 October to prevent Heritable repaying any or all of the deposits placed with it by LGL"?*

As you would expect, we engaged in increasingly intensive supervision of the UK branch of Landsbanki and Heritable in order to protect consumers and market confidence as concerns about the Icelandic banking system developed. This process included the imposition of a requirement on Heritable on 3 October that prevented it transferring assets to other group companies without our consent. The effect of this requirement was that Heritable would have required our consent, on three days' notice. to rep ay any of the deposits made by LGL.

On 5 October, the firm gave notice to us of its intention to pay funds to LGL, when due, with effect from 8 October.

We had not responded to this when we were called by Jeremy Quick of the GFSC

at around noon on 6 October. He informed us that he had asked the LGL board, which was due to meet shortly, to call for the amounts on deposit with Heritable and that he would expect to see these repaid that day or the following day. In an email sent to the FSA at 12.43 he stated that "I would ask you to ensure that Heritable re lease the funds once they are requested to do so by Landsbanki Guernsey".

We understand there were discussions between LGL and Heritable about the possibility of repaying the deposits and that. as well as referring to the requirements we had imposed on the firm to obtain our consent, Heritable indicated to LGL that it did not have the funds to repay the LGL deposits in full at that time. As you indicate in your letter, there was then a discussion about partial repayment of the deposits. However, later in the day, we were informed by Heritable that LGL was no longer asking for the repayment of the deposits, as they believed that alternate funding was available.

We did not at any time advise Heritable that we would refuse to consent to it repaying the LGL deposits.

2. *"If it did take such actions, on what grounds were those actions taken"?*

The requirement to obtain our consent to intra-group transfers was to enable us to consider whether any such transfers were appropriate, before they were made, so as to protect the interests of consumers. It was not specifically aimed at LGL, rather it covered the group generally. As I have explained above, we did not make any decision on whether or not to approve any payments from Heritable to LGL.

3. *"Why did the FSA not advise the Commission of its concerns and its planned actions in accordance with the normal standards of supervisory cooperation, the MoD, and the assurances and confirmation to this effect that had been given to us"?*

Guernsey is outside of the EEA and, as the Promontory report recognises, the normal standards of supervisory cooperation in such cases are set out by the Basel Committee. Principle 25 of the revised Core Principles for Effective Banking Supervision and the supporting essential criteria in the Core Principles Methodology make it clear that information should normally always involve the home supervisor, that is, the information flows between the home supervisor and any host supervisors, rather than between hosts supervisors direct. In the case of the Landsbanki group, both the FSA and the GFSC were host supervisors and the FME was the home supervisor.

This position is not modified by the MoU between the GFSC and FSA, which generally deals with the provision of information in response to specific requests. While it recognises that information may be provided on a voluntary basis, it does not express any expectation that this will happen.

Of course, notwithstanding the fact that we were a host supervisor, we sought to operate in as helpful and cooperative manner as we could.

4. *"Why did the FSA not open a dialogue with the Commission to seek a resolution to its concerns that could have sought to protect depositors in both Heritable and LGL"?*

LGL was placed into administration in Guernsey on the night of 6 October on the application of its directors, before the FSA applied to the Court in Scotland for Heritable to be placed into administration. Therefore, the crucial events in Guernsey preceded our actions.

LGL, was only one of a number of unsecured creditors of Heritable. Our decision to apply for an administration order in relation to Heritable on the morning of 7 October was designed to ensure an equal treatment of all depositors and other unsecured creditors. The chief executive of Heritable indicated his support for this application.

The arrangements that were put in place in the UK to transfer certain deposits with Heritable to ING Direct depended on the application of the UK Financial Services Compensation Scheme, the provision of significant funding by the UK Government and the use of UK legislation.

5. *"Why did the FSA not advise the Commission that Heritable was substantially dependant on Llhf for its liquidity despite its assurances to the contrary"?*

I cannot accept your implication that the FSA misled the GFSC as to the level of dependence of Heritable on the provision of liquidity by Landsbanki.

Indeed, as you note, Stephen Funnell's letter of 25 April 2008 made it clear that at that time funding was being provided by Landsbanki to Heritable. It stated that: "... we have historically seen funding flows in both directions. At present, however, any movements are from Landsbanki to [Heritable], and we do not expect this to change.". This letter also made it clear that while we were not aware of any material exposures to Iceland in the course of Heritable's normal lending activities, Heritable was exposed to reputational Icelandic risk by virtue of its parentage. As events unfolded, this reputational risk crystallised. The collapse of confidence in the Icelandic banking system caused Heritable to lose wholesale funding. This, in turn, increased its dependence on its parent for funding.

You refer to our general guidance on liquidity. This makes it clear that a firm can rely on committed facilities from group companies where appropriate (see paragraph 21(d) of Section 7 of Chapter LM of our Interim Prudential Sourcebook for Banks). At no time did we indicate to you that we had restricted the firm's ability to rely on intra-group funding lines.

6. *"Did the actions taken by the FSA and other UK authorities in relation to Heritable and its retail depositors amount to an unfair preference over LGL"?*

No.

The requirement to obtain our consent to intra-group transfers was an entirely appropriate response to the circumstances we faced on 3 October. As noted above,

we did not advise Heritable that we would refuse to consent to it repaying the LGL deposits. While we understand there were practical limitation s on Heritable" s ability to repay all of the deposits at that time, it was seeking further funds from Landsbanki. When it became clear that such funds would not be made available, we applied to the Court to place Heritable into administration.

As noted above, the FSA's actions in applying for an administration order in relation to Heritable ensured the equal treatment of unsecured creditors.

The transfer of certain retail deposits from Heritable to ING Direct by a transfer order under UK legislation was funded entirely by the UK Financial Serv ices Compensation Scheme and the UK Government. They now stand in the shoes of those depositors as creditors in the administration of Heritable on an equal basis with all other unsecured creditors.

The information in this letter is provided in accordance with the confidentiality provisions in the MoU. Please do not to disclose it to any party outside of the GFSC without our consent in writing.

I trust that the clarifications provided in this letter will reassure you as to our actions and enable us to move forward in a productive spirit of cooperation, which will assist in the discharge of our respective obligations. Our ability to work closely and cooperate with the GFSC is particularly important given the activities of UK firms in Guernsey and we would be happy to consider any proposals for strengthening our cooperation arrangements.

3. Letter from the Director General, Guernsey Financial Services Commission, to the Chief Executive, Financial Services Authority, dated 23 January 2009

LANDSBANKI GUERNSEY LIMITED (IN ADMINISTRATION)

Thank you for your letter of 15 January 2009.

I do not propose in this letter to address your responses to the questions contained in my 6 January 2009 letter. They will be addressed in due course, as appropriate. This letter deals solely with the issue of confidentiality.

I note the reference in your letter to the confidentiality provisions under the Memorandum of Understanding between the Commission and FSA. I would like to stress that the Commission wishes, if at all possible, to resolve the issues raised in my 6 January letter in private.

However, as I indicated in my letter of 6 January 2009 would be the case, the Commission has now served written submissions on the Treasury Select Committee ("TSC") on 12 January 2009.

The Commission's submissions are on the TSC's website. I am scheduled to attend before the TSC to answer their questions on 3 February 2009. It is very possible that the TSC's questions will address some of the areas covered in my letter of 6

January 2009 and your response of 15 January. At present I do not have any indication of the subject matter of any questions and I will not know until very shortly before the hearing, if I have any advance warning at all.

The Commission has been considering with our legal advisors the obligations which arise in connection with giving evidence before a Select Committee, and our view is that I am required on threat of being in contempt of Parliament to answer fully and honestly any questions put to me. Not only do we believe that this is a legal duty applying to all witnesses appearing before such a tribunal but it is also the approach that we would be compelled to adopt having regard to the statutory functions of the Commission.

Notwithstanding this, I can assure you that, in the spirit of the MoD, every reasonable effort will be made to respect the confidentiality of our correspondence. However, you will appreciate that I cannot guarantee that it will be possible to avoid disclosure of otherwise confidential information if relevant questions are raised by the TSC. The purpose of this letter, therefore, is to put the FSA on notice that I may be required by law to make public certain otherwise confidential material. It should also be noted that the issues under investigation before the Select Committee go beyond Landsbanki Guernsey Limited, and my answers may therefore be required to reach into areas beyond the specific content of our recent correspondence and may also involve the Commission in being required to disclose otherwise confidential material.

The purpose of the TSC's enquiry is, of course, quite broad and every effort, therefore, will be made to confine our evidence to general matters and not to specific details of our otherwise private correspondence or other otherwise confidential communications. Please do not hesitate to let me know if the FSA considers that we would not be compelled to disclose otherwise confidential information to the TSC if asked particular questions and the reasons for taking such a view. We would be willing to pass on those reasons to the TSC. Of course, you may wish to approach the TSC directly if you have specific concerns.

4. Letter from the Chief Executive, Financial Services Authority, to the Director General, Guernsey Financial Services Commission, dated 29 January 2009

LANDSBANKI GUERNSEY LIMITED (IN ADMINISTRATION)

Thank you for your letter of 23 January.

I appreciate you taking the trouble to write to me, setting out your concerns about confidentiality, in advance of your appearance before the TSC to give evidence on 3 February. I quite understand how you have reached the view that, notwithstanding the confidentiality which usually attaches to exchanges between regulators, it is more important that you should answer fully and honestly any questions put to you by the TSC. That is the position we have adopted in our own dealings with the TSC, and we would expect to do so again in our own evidence to the Committee next month.

I note that you intend to respond more fully to my letter of 15 January in due course, which

response we look forward to receiving.

5. Letter from the Director General, Guernsey Financial Services Commission, to the Chief Executive, Financial Services Authority, dated 23 February 2009

LANDSBANKI GUERNSEY LIMITED (IN ADMINISTRATION) ("LGL")

I refer to my letter of 23 January 2009 and to your letter of 15 January 2009. 1am sure that you will be aware that I have now given evidence to the Treasury Select Committee and, to a certain degree, that evidence is relevant to issues that have been identified in our private correspondence. Whilst my obligations to the Treasury Select Committee required that I answer any questions put to me honestly and openly, it remains my wish to seek to resolve these matters by way of private correspondence.

Unfortunately, your reply does little to reassure either me or the Commission over the effectiveness and understanding of the present co-operation arrangements with the FSA, particularly at times of economic stress.

Whilst I understand that your letter has focused on providing specific answers to the questions raised in my letter of 6 January, the context within which those questions were raised (as expressly identified in paragraph 2) was to open a dialogue with you over the effectiveness of the present level of co-operation between the FSA and the Commission. Unfortunately, your letter served only to confirm that, as matters stand at present, there would appear to be a significant difference of opinion as to the scope and purpose of the present co-operation arrangements.

Your letter to Peter Harwood of 25 April 2008 emphasised that an integral part of your Supervisory Enhancement Programme was to strengthen liaison with international regulators "to improve crisis management for global groups". You also confirmed that the FSA would "need to look at how we more specifically link our domestic agenda with ideas being advanced in the international arena".

So far as LGL was concerned, you will know from the evidence that I provided to the Treasury Select Committee that my principal concern is that the FSA considered that it was entitled to act solely in pursuit of a domestic agenda at a time when what was needed was a co-ordinated interpretation of the steps required for effective "crisis management for global groups". There is no suggestion anywhere within your letter that the FSA acknowledges any legitimate criticism of its conduct in relation to LGL. The Commission does not accept that such a stance reflects a proper analysis of events.

I think that my point is illustrated by reference to a comment made in your letter under Question 4. My understanding of your comments in paragraph 2 is that your action in relation to Heritable Bank (which had a direct bearing on the

administration of LGL) was to "ensure an equal treatment of all depositors and other unsecured creditors". With respect, this observation is only true if it refers to a wholly UK domestic agenda. LGL is a significant creditor of Heritable Bank and was clearly disadvantaged by the action taken by the FSA. In reality (having regard to the nature of the LGL business), this harm was caused not to a Guernsey company, but ultimately to the individual depositors of that company, of which approximately one third by value were UK residents.

Our interpretation of the arrangements reflected in the Memorandum of Understanding, and as interpreted in the letter to Peter Harwood of 25 April, was that the FSA was looking to approach the crisis management for international banking groups such as Landsbanki, from the perspective of international collaboration rather than domestic protection—a view reinforced by the direct assurances given to the Commission by the FSA. This clearly did not happen with LGL and we believe that the FSA's practice is some way out of line with the views being expressed within the international regulatory context and indeed by your own more recent thinking as expressed in the FSA's Business Plan for 2009-11 which states that consideration needs to be given to whether there is scope for better coordination and cooperation between regulators in normal time s and during periods of crisis.

Turning to your specific answers, and adopting the numbering in your letter, the Commission comments as follows:

1. You refer to your requirements imposed on 3 October that prevented Heritable from transferring assets to other group companies without your consent ("the Consent Requirement"). We remain at a loss to understand why this requirement was not communicated to the Commission and would welcome an explanation.

It appears from paragraph 2 that, at the time the request for payment was received by Heritable, it may in fact have been in possession of sufficient funds to make the payment as it was contractually obliged to do. Please confirm that this is correct. Given that the Consent Requirement would clearly cause Heritable to breach the terms of its contractual arrangements with LGL, it would help to understand the statutory power under which the restrictions were imposed.

We note that you say that you were informed on 6 October (before you had come to any decision about Heritable's request for permission to pay funds to LGL) that LGL was no longer asking for repayment of its Heritable deposits, "as they believed that alternate funding was available". This is not a fair reflection of events. LGL had no choice but to seek alternative funding as it had been told (but without proper explanation) that the Heritable deposits were effectively blocked.

It is irrelevant (although apparently correct) that the FSA did not advise Heritable that it would refuse consent to repayment of the LGL deposits. The Consent Requirement was in operation and the FSA was in control of intra-group transfers and in fact the FSA put Heritable into Administration before the expiry of the FSA's 3 day time period for consideration of requests for payment. I fail to understand why the fact of the Consent Requirement was not communicated to the Commission. Instead, we were left to make decisions based on an entirely

insufficient understanding of the true position.

The FSA Consent Requirement appears to have been designed to protect the assets of Heritable from transfer out of the FSA's control, to the detriment of retail depositors in LGL. This is not consistent with the spirit of the MoU between our respective organisations and contrary to your wish to strengthen liaison with international regulators within the context of crisis management of global groups.

2. See above.

3. Your answer to this question ignores the spirit of the MoU and the sentiment of your letter of 25 April 2008. You say that information flows between host supervisors should always involve the home supervisor, in this case, the FME. While it is correct that both the FSA and the Commission were host supervisors, you stated that the Consent Requirement was imposed "to enable us to consider whether any such transfers were appropriate". This amounts to a statement that the FSA was taking control of the day to day business of Heritable and acting with the character of a home supervisor for that business, rather than merely acting as host supervisor.

You also state "notwithstanding the fact that we were a host supervisor, we sought to operate in as helpful and co-operative a manner as we could". Please explain why this co-operation did not extend to advising the Commission of the change in relationship between Heritable and its parent and of a significant regulatory action by the FSA.

4. You state that your decision to apply for the administration of Heritable was designed to "ensure an equal treatment of all depositors and other unsecured creditors". In the event, however, your actions were designed to protect only UK depositors at the expense of Guernsey depositors. At the very least, it would have been helpful and co-operative if the FSA had given the Commission advance warning of its intention to put Heritable into administration, given its knowledge of LGL's large placement with Heritable.

5. You refer to Stephen Funnell's letter of 25 April 2008 and its reference to "reputational risk". You state that this reputational risk crystallised, causing Heritable to lose wholesale funding. The basis for this statement is unclear. It does not accord with our understanding of Heritable's funding structure. Heritable was, as far as we understand the matter, reliant on retail deposits and not wholesale deposits. The only inter-bank deposits they had came from group sources namely LGL and LlHf. Please confirm whether this is correct.

It was fully understood by the FSA that the purpose of the redistribution of LGL's assets in April 2008 was to reduce the exposure to the perceived risks associated with the Icelandic banking sector. Is it your case that, at the time that it went into administration, Heritable was a UK oriented, self-standing firm with only limited (and predominantly reputational) Icelandic risk as the FSA had previously confirmed to the Commission?

6. Please confirm whether any payments were made to other creditors between 3

October and 6 October 2008. If it is the case that the FSA permitted payments to other creditors of Heritable, then our concern about preferences remains live.

You will no doubt wish to consider these points with your team. I would be happy to discuss any of these points with you either before or after your formal written response is provided. Going forward I still firmly believe that we need to build a workable consensus for effective global cooperation between regulators because, if that is not possible, the Commission will have no alternative but to approach the regulation of other banks operating in Guernsey, which have material links to the UK, on a stand-alone basis. This is not an approach which would be in the interests of the banks or our two economies.

6. Letter from the Chief Executive, Financial Services Authority, to the Director General, Guernsey Financial Services Commission, dated 29 January 2009

RE: LANDSBANKI GUERNSEY LIMITED (IN ADMINISTRATION) ("LGL")

Thank you for your letter dated 23 February. I have noted your wish to seek to resolve matters by way of private correspondence and agree this is the best way forward. I am of course fully aware that certain matters may have to be discussed publicly in forums such as the Treasury Select Committee to which I also gave evidence recently.

I am sorry if you think that my letter dated 15 January failed to engage fully with your concerns over the effectiveness of the present co-operation arrangements between the GFSC and the FSA. We remain committed to developing and strengthening our links with international regulators which have an impact on UK firms and markets, in which category of course I include the GFSC. I think we have reached the point where, in order to focus on future co-operation rather than past events, it would be more sensible to deal with the key themes emerging from your letter, rather than engaging in a point by point response.

HOME/HOST SUPERVISION AND A "DOMESTIC AGENDA"

We are both familiar with the principles behind home/host supervision. For present purposes, it is relevant to focus on the situation where the bank's presence in the host state is a locally incorporated subsidiary, as it is subject to the laws of the host state, including the requirement that it be authorised and supervised by the host supervisor and that it is subject to the host state's insolvency regime. While, consistently with EC Directives and the Basel Core Principles, there has to be effective co-operation between home and host supervisors, the host supervisor will also have its own domestic law responsibilities in relation to the subsidiary. Nevertheless, it is clear that information flows should be through the home supervisor, which clearly needs to see the whole picture, rather than between two or more host supervisors.

In the case of the Landsbanki group, I think it is important to recognise that what the FSA and the GFSC were supervising were sister subsidiary companies. We were both host supervisors, with the FME being the home supervisor. Because

Heritable was a UK incorporated subsidiary, we had to comply with the UK's legal framework in carrying out our supervisory functions, as that is an unavoidable result of local incorporation and authorisation. While I can assure you it that the FSA regards international cooperation as necessary for effective crisis management, to ensure that regulatory decisions are based on accurate information and all those involved know to whom they are required to communicate what information, there is likely to be a time in any crisis when regulators have to make decisions to protect creditors within the jurisdiction for which they are responsible, even if those decisions have consequences for creditors outside the jurisdiction. In the case of Heritable this point came on 7 October, when Heritable indicated that the required funding would not be forthcoming from Iceland and we made the decision to apply for an Administration Order. You of course took similar action slightly earlier in Guernsey.

INSOLVENCY AND THE PROTECTION OF CREDITORS

Once it becomes apparent that a subsidiary supervised by a host supervisor no longer has any reasonable prospect of obtaining adequate funding, and has therefore lost its continuing ability to pay its creditors, I do not see that there is any alternative to putting the subsidiary into administration. In the absence of such action, the inevitable consequence would be that some creditors would receive 100% of what they are owed, while other creditors would (in the resulting, delayed insolvency) have a reduced recovery caused by a smaller pool of assets in the estate. I would stress that at the point of Heritable going into administration, and subsequently, all creditors (be they LGL depositors or Heritable depositors) have been treated equally. The only reason that Heritable depositors have been treated differently from other creditors is because the Treasury and the Financial Services Compensation Scheme placed amounts equivalent to their deposits into ING Direct, then stood in their shoes as creditors of Heritable on an equal basis with all other unsecured creditors. These were policy decisions which it would be open to the relevant authorities in other jurisdictions to take.

THE FSA'S SUPERVISORY RESPONSE

Up to the point of putting Heritable into administration all the actions we took were intended to ensure the bank remained a viable business. Ultimately, as indicated above, that proved not to be possible.

You ask a number of questions about the "consent requirement" we imposed on Heritable. The requirement was imposed under section 45 of the Financial Services and Markets Act 2000. The power is exercisable where a bank is or is likely to have inadequate resources or in order to protect existing or potential depositors. It is a long-standing power, having been used by the Bank of England when the Banking Act 1987 was still in force. During the dates that the requirement was in force, it was open to Heritable to ask for our consent to payments being made. They made a request on 5 October on three days' notice to repay, inter alia, the LGL deposits, but the administration intervened. In any event, we were told by Heritable, after they submitted the request, that the funds to make full repayment were unavailable to them and this was something they had communicated to LGL. While we understand that there were subsequent discussions on 6 October between LGL and Heritable,

as there were between the FSA, GFSC and Heritable, we did not receive a request on 6 October for approval of a payment from Heritable to LGL. We did give Heritable discretion to make some payments—between £2 and £3 million of BACS/CHAPS payments—on 6 October which were already in the system in the normal course of collection.

THE MEMORANDUM OF UNDERSTANDING

It is also clear from your letter that a continuing point of concern is the FSA's failure to inform the GFSC of the imposition of the Consent Requirement. In my letter of 15 January I set out why we were not obliged to do this, and indeed, our policy is not to disclose (at least in the short term) the existence of a requirement to any third party. This is to avoid the risk that our actions will become public, which could cause further difficulties for the bank concerned. Taking into account that Heritable was a UK subsidiary authorised by the FSA, I would not see our actions as having made the FSA the home supervisor: we were making the decisions required of us under UK law.

If the GFSC thinks that matters in the Memorandum of Understanding need amendment or clarification I would be more than happy for the FSA to address this with the GFSC as a matter of urgency. The FSA will be fully involved in any future discussions about changes to the current home/host supervisory regime. As you know, some possible shortcomings have been identified in the de Larosi€re Group's latest report and our Chairman, Lord Turner has made recommendations in this area in his report on banking supervision published this week. I would hope that any changes which are adopted will serve to increase understanding and cooperation between the FSA and GFSC should any future crisis occur.

HERITABLE'S FUNDING

You have asked some questions about Heritable's funding, most of Heritable's funding was from retail deposits (c£538 million), but wholesale deposits (c£420mn.) were also significant. The latter were mostly made up of deposits from various UK building societies and local authorities (in many cases these latter two sources of funding were required to withdraw their funding after the group was downgraded by the rating agencies in late September). I have reviewed the exchange of letters between Jeremy Quick and Stephen Funnell in April 2008. It appears from these letters Mr Funnell did not regard Dr Quick's request as being about wholesale funding, so Mr Funnell did not provide any information in this regard. It remains the FSA's view that while, at the point of administration, Heritable was a UK-oriented firm, with only limited direct exposure to Icelandic risk, it could not be isolated entirely from the problems of its parent or the wider Icelandic economy.

In conclusion, I would repeat that we want to work with the Commission to strengthen our relationship. I would be pleased to ask colleagues responsible for managing the relationship with the Commission to visit Guernsey in the near future, to discuss changes to the MoU and other practical measures we can take to achieve that end.

7. Letter from Neil Roden, Group Human Resources Director, RBS, to the Chairman of the Committee, dated 30 March 2009

RESPONSE TO TSC QUESTIONS ON LUMP SUM

Following the questions you posed to Lord Myners on 17 March, UKFI have asked RBS to provide you with some more information on the lump sum taken by Sir Fred Goodwin in exchange for part of his pension.

The ability to take a lump sum at the time of retirement in place of part of a pension is a very common provision in UK pension schemes, and in particular is part of the rules of the main RBS pension fund. This right applied to Sir Fred's pension from his funded un-registered pension scheme (his FURBS) as well as from the main RBS pension fund. A lump sum payable from a tax-registered pension fund is tax-free (within certain limits) but this does not apply to one from a FURBS. RBS agreed in 2007 that if Sir Fred exchanged part of his pension from the FURBS for a lump sum then (for a lump sum up to a certain amount) the FURBS would meet the tax due on this lump sum.

Sir Fred chose to exchange £186,979 a year of his pension for a lump sum of £2,781,317 of which £94,740 was paid from the main RBS pension fund. Sir Fred subsequently indicated that he was willing in principle to repay the lump sum, provided he incurred no tax liability. However, HMRC have clearly stated that tax will be payable on this lump sum even if it is repaid, and as a result the FURBS is liable to pay the tax on the part of the lump sum that was paid from the FURBS. In the light of this, Philip Hampton has asked Sir Fred to consider if he is prepared to waive part of his entitlement and Sir Fred is considering this.

We can confirm that no further contribution is required to the FURBS as a result of Sir Fred taking this lump sum and the tax that is due to be paid on it.

If you have any further questions, then please let me know.

8. Letter from Sir Tom McKillop to the Chairman of the Committee, dated 30 March 2009

Many thanks to you and your Committee colleagues for inviting me to make a written submission.

As I hope was clear from my letter to you dated 17 March, I was concerned that the evidence of Mr Moreno, Mr Kingman and Lord Myners might benefit from clarification, particularly in relation to the pension arrangements between Sir Fred Goodwin and the Royal Bank of Scotland.

As I wrote on 17 March, I have remained silent since my resignation from RBS because of my profound regret at events there and a desire not to create controversy that might harm the bank or the public interest. I remain acutely aware of the unhappiness that has been caused to investors and employees at the Royal Bank of Scotland. I am also keenly aware and appreciative of the Government support for

the RBS.

I have never sought to avoid accountability for my actions as chairman of RBS. I have apologised publicly both at the shareholder meeting and before your own Committee. Having said that, I must emphasise that there was no "elaborate ruse" by myself and Mr Scott to give Sir Fred any more than he was contractually entitled to and that we and, I believe, all the directors acted in what we judged to be the best interests of the shareholders, including the Government.

In that context the following points need to be made:

1. Sir Fred Goodwin was recruited by RBS and appointed to the Board in 1998 and the principles of his contract of service (including his pension entitlement) were agreed prior to the arrival of any director who was on the RBS board in October 2008.

2. These principles included him being treated, notwithstanding the pension cap, as if he was a member of the RBS pension fund for his full salary.

3. As part of these principles agreed by RBS in 1998, Sir Fred's benefits were calculated assuming a notional employment starting age of 20.

4. He also became subject to the RBS Fund rules which provided that employees leaving RBS early at the request of their employer received a pension as though they had attained age 60. The wording in the Annual Report is:

> "RBS Fund rules allow all members who retire early at the request of their employer to receive a pension based on accrued service with no discount applied for early retirement."

5. The requirement to treat Sir Fred as if he was a member of the RBS pension fund meant that any lump sum taken at the time of the pension payment being settled would (like a lump sum paid to any other RBS pension fund member) be received tax free in respect of pension accrued up to April 2006. In February 2007, in light of the implementation of "A Day" (the simplification of the pensions tax regime which had occurred in April 2006), RBS confirmed the application of this principle taking into account the Pension Act changes.

6. Ahead of October 2008, the Board concluded that no bonuses would be paid to senior executives for 2008.

7. In the days ahead of the weekend of 10-12 October 2008, RBS executives took part in confidential talks with HM Government about rapidly deteriorating asset quality, liquidity and share price. Details of these talks were leaked, principally to the BBC, exacerbating a difficult situation.

8. On Friday 10 October 2008, the non-executives (excluding myself) met and decided that Sir Fred would have to stand down. It was discussed and agreed at that meeting that it was necessary that Sir Fred's departure be managed carefully. Public confidence in RBS at that time was very low. Continuity and stability were very

important.

9. The Nominations Committee, with the benefit of soundings from board members, determined that Stephen Hester, who had recently joined as a non-executive director, was the most appropriate successor. He was then the Chief Executive Officer of British Land plc and it would be necessary to obtain agreement that British Land plc would release him sooner than his notice period at that company. The timing was not clear but we thought it was more likely to be months rather than weeks before Mr Hester could fully take up the role. This reinforced our belief that Sir Fred's departure needed to be carefully phased to ensure stability.

10. This was recognised in the Nominations Committee minute of the 10 October 2008 meeting:

> "The Committee discussed the process for selecting and appointing a new Group Chief Executive but recognised that this should take account of the need to ensure management stability and a smooth handover."

11. All of this meant that there would need to be a consensual departure of Sir Fred. He would be leaving at the request of the company with his full contractual entitlement to a pension and other items, as laid out in the Annual Report. As a result we secured continuity, stability and the continued cooperation of Sir Fred. That, in my judgement, was in the best interests of the shareholders of RBS.

12. On Friday 10 October, Sir Fred was advised of the Board decision. He accepted the decision and agreed to discuss his departure on a consensual basis.

13. On the evening of Saturday, 11 October 2008, Sir Fred, Bob Scott (the senior independent director) and I attended a meeting at the Treasury with Lord Myners, other Treasury officials and their advisors, including representatives from the Financial Services Authority and the Bank of England. The meeting was to discuss the terms of the proposed Government investment in RBS.

14. At the conclusion of this meeting, Lord Myners asked Mr Scott and I to join him for a private meeting. At this meeting, he explained that the Government expected Sir Fred to stand down as part of the recapitalisation process. I explained to Lord Myners that the Board had already reached that conclusion and had communicated this to Sir Fred. Lord Myners was told at that meeting that Sir Fred's pension benefit would be the sensitive issue and that it would be "enormous".

15. Lord Myners stated on the Saturday evening that the Government was concerned to ensure that there was "no reward for failure." We explained that the Board of RBS had already determined that there should be no bonuses for 2008.

16. The size and complexity of the Government recapitalisation made it all the more important that Sir Fred was willing and available to help negotiate and finalise the Government package, to launch that on Monday 13 October 2008 and to help in the preparation of the prospectus, as well as dealing with the ongoing integration of ABN Amro and all the other duties of the CEO until Mr Hester was

able to take those tasks over.

17. Mr Scott spoke to Lord Myners in the afternoon of Sunday 12 October 2008 and went through with Lord Myners the Remuneration Committee paper which set out the terms of the arrangement with Sir Fred. Mr Scott is certain that he discussed each element of the proposed terms of departure set out in the remuneration paper, including the pension. As well as referring to the undiscounted effect, and the consequence of early retirement and deemed service for the amount of the pension, Mr Scott also gave Lord Myners (in the conversation on 12 October 2008) a range of £15 million to £20 million as being Mr Scott's best estimate of what the pension liability might be.

18. It is not correct, as Lord Myners has suggested, that Mr Scott indicated that disclosure of Sir Fred's pension "could be spread over a couple of years to deflect adverse comment". The point made by Mr Scott was that accounting rules and the timing of arrangements with Sir Fred would determine in which financial year disclosure should properly be made. Mr Scott was aware that the pension arrangement would need to be properly disclosed and did not at any time suggest otherwise.

19. In a discussion on Sunday 12 October 2008 with Mr Scott, Lord Myners made it plain that he considered it appropriate to ask Sir Fred to give up part of his contractual entitlement (the payment in lieu of notice). Sir Fred agreed to give this up in discussion with Mr Scott, after, I believe Sir Fred and Lord Myners had discussed this matter directly.

20. At no stage did Lord Myners or any other representative of the Government ask the RBS directors to attempt to alter any of the contractual terms relating to Sir Fred's pension. Nor did Lord Myners attempt to discuss the matter with Sir Fred, as he did with the payment in lieu of notice.

21. Subsequently, on 2 November, Lord Myners contacted Mr Scott and said that the Government wished Sir Fred to waive certain share related benefits to which Sir Fred was contractually entitled. Sir Fred agreed in discussions with Mr Scott to forego these entitlements, on the basis that all other elements of his package would be honoured and would remain unchanged. Mr Scott passed this information on to Lord Myners, with particular reference to the pension arrangements being part of that remaining package.

22. In summary, there was no question of any discretion to be exercised in relation to Sir Fred's pension and no discretion was exercised in this regard by any RBS director. RBS considered itself contractually bound to pay the pension benefits which had crystallised by virtue of its request to Sir Fred to leave the company—but not to pay any more than the proper contractual obligation. Mr Scott and I had been informed by Lord Myners on the Saturday evening that RBS should mitigate liabilities but not abrogate contractual requirements. We had put in place mitigation measures (for example in relation to the payment in lieu, before it was given up) but had not sought to deny Sir Fred's contractual entitlements.

23. By contrast, the Government (through the actions of Lord Myners) made it

clear that they were willing to seek to encourage Sir Fred to forego contractual entitlements, and they did so in relation to the payment in lieu of notice and stock related benefits (successfully) but did not make any attempt to do so in relation to the pension.

24. It was clear to the Government (and indeed the public at large) that Sir Fred was departing on a consensual basis. The press release issued on 13 October 2008 expressly recognised that an agreement had been reached with Sir Fred. The release stated that Sir Fred would continue "for a short period" as chief executive to allow for a "smooth handover" with Stephen Hester. The contents of this and subsequent press releases were agreed with the Treasury after considerable scrutiny by them.

25. A subsequent press release agreed by the Treasury and issued on 17 October reinforced the agreed nature of Sir Fred's departure. It announced that Mr Hester would take over as group chief executive on 21 November 2008, and spoke of the desirability of Sir Fred remaining at the RBS Group until 31 January to ensure an orderly departure. At no stage did Lord Myners or another Government representative suggest that Sir Fred should be dismissed.

26. It has been suggested that Watson Wyatt advised RBS at some stage over the weekend that the manner in which RBS dealt with Sir Fred's departure would have "adverse consequences" and that "shareholders would not approve". Neither Mr Scott nor I have any knowledge of any such advice, from Watson Wyatt or anyone else. Watson Wyatt could not in fact be contacted for most of the weekend.

The Committee will appreciate that I have not sought to avoid my fair share of accountability for the circumstances in which RBS finds itself—as I made clear during my appearance before the Committee. I make the points above because I believe the circumstances relating to Sir Fred's pension have not been accurately represented to the Committee. In addition, I and other RBS directors have been the subject of allegations which are unfair and unjustified. In particular:

(a) there was no "elaborate ruse" (as it has been alleged) to pay Sir Fred any amount other than was contractually required in the circumstances—with particular reference to the best interests of RBS shareholders at a very difficult time. The arrangements were put before RBS's Remuneration Committee and the non-executives meeting as the Chairman's Committee;
(b) full disclosure was made to the Government of the position, as was necessary at the time. There was no concealment of any relevant matter. Mr Scott and I were keen to disclose the terms upon which Sir Fred was to depart (and indeed the terms on which his replacement would assume office). This was particularly the case in relation to the pension which was obviously a large and sensitive item. All requests from the Government were responded to constructively; and
(c) the suggestion that I or other directors in some way failed in our duty is inconsistent with others (Lord Myners and other Government representatives) approaching the matter in exactly the same way on the basis of the same relevant information—which is itself entirely consistent with the context and particularly the need for RBS to maintain Sir Fred's cooperation in the best interests of RBS shareholders.

Please note that Mr Scott has reviewed a copy of this statement and confirms that its contents are correct from his point of view.