Royal Bank of Scotland: A Case of Reputational Risk

THE EVENT

In October 2008, shortly after its 275 year milestone, the Royal Bank of Scotland (RBS) passed into Government majority ownership. Its CEO and Chairman resigned soon afterwards with the Bank’s reputation in tatters and its independence over. However this was not just a case of reputational risk being crystallised but also being played out at the centre of the biggest financial disaster in living memory in which the public, the media, and politicians emerged as key stakeholders.

BACKGROUND

The Royal Bank of Scotland Group plc is the holding company of one of the world’s largest banking and financial services groups with operations in the UK, US and internationally through its two principal subsidiaries, the Royal Bank and NatWest. In the US, the group operates through its subsidiary Citizens. It is headquartered in Edinburgh, UK and employs about 200,000 people. Since October 2008, it has been owned by the British government, which has an 84% controlling share.

RBS owns a number of international franchises that make it a leading global financial group operating in more than 50 countries and providing a range of retail and corporate banking, consumer finance, insurance and wealth management services. In 2007, The Banker ranked it as the seventh largest bank (by assets) in the world. The group ranks as number one in a wide
range of segments including UK payments, deposits, lending, asset finance, invoice finance and foreign exchange. In terms of retail banking in the UK, the group retains a very strong franchise operating under its RBS and NatWest brands for core products including residential mortgages, credit cards and personal loans. RBS Insurance focuses on the retail and SME markets and is the second largest general insurer in the UK (No.1 in motor insurance, No.2 in home insurance, No.3 in UK motoring assistance, No.2 in UK travel insurance). The group issues its own banknotes in Scotland and Northern Ireland which are legal tender throughout the UK.

Its heritage is a key part of its corporate brand and identity. Founded in Edinburgh in 1727, it was the first Scottish bank to install an ATM in 1967 and the first bank anywhere to make its ATMs available to all cardholders in 1997. Its pursuit of innovation has been demonstrated, for example, by its establishment of a company to sell car insurance directly to consumers through the telephone in 1985 (Direct Line Insurance).

In the largest hostile takeover battle in UK corporate history, it launched a hostile and successful takeover bid for its larger English rival, NatWest in 1999. This made RBS the second largest banking group in the UK after HSBC, though NatWest was retained as a distinct banking brand. This acquisition included Greenwich Capital, a US lender with exposure to sub-prime losses, which was to make a significant contribution to the recent losses of RBS. According to Forbes Global 2000, RBS was the tenth largest company in the world. From 2004 to 2009 it was the second largest shareholder in the Bank of China, itself the world's fifth largest bank by market capitalization in February 2008 (when the shares were sold in January 2009 RBS made no profit on the deal).

**REPUTATION IMPACT**

In October 2007 RBS took a step that was to prove fatal to its survival as a privately owned company when it formed a consortium with Fortis (a Dutch-Belgian bank) and Santander (a Spanish bank) to take over the Dutch bank ABN Amro. ABN Amro would become severely affected by poorly performing assets following the takeover, which appeared to take RBS by surprise. RBS's failure to recognise the scale of credit problems at ABN Amro prior to the takeover may have been linked to the fact that it had carried out due diligence on the transaction in May 2007, a full six months before the transaction was completed. In the interim, Northern Rock failed, and there had been a marked deterioration in the interbank credit markets. RBS carried out no due diligence on ABN Amro in that period of six months, instead choosing to rely on “very reassuring” public statements from ABN Amro about their resilience to the economic crisis.

This not only undermined RBS’s reputation as a leading bank but came to threaten its very existence. The EUR 71bn (£55bn) ABN Amro deal (of which RBS's share was £10bn) in
particular stretched the bank’s capital position - £16.8bn of RBS’s record £24.1bn loss is attributed to writedowns relating to the takeover of ABN Amro. As the Chairman told shareholders at the AGM on 3 April 2009, ‘it was the wrong price, the wrong way to pay, at the wrong time and the wrong deal.’

2008-2009 financial crisis

Even with signs of the current crisis being evident, RBS was amongst the most bullish in its optimism. Its Annual Report for 2007, published on 28 February 2008 declared that ‘we have a great deal to do in 2008 but we also have an unparalleled set of opportunities and their realisation will allow us to continue on the impressive growth trajectory that has characterised RBS over the past decade.’ This was despite warnings to the contrary from the Bank of England and the Financial Services Authority. One of the problems since identified by RBS was inadequate risk management systems with the most important issues relating to control - “control of risk and rules on size and concentration, types of risk and amounts of risk.” This included the identification, assessment and management of reputational risk.

After previous denials following press coverage, on 22 April 2008 RBS announced a rights issue which aimed to raise £12bn in new capital to offset a writedown of £5.9bn resulting from credit market positions and to shore up its reserves following the purchase of ABN Amro. This was, at the time, the largest rights issue in British corporate history. Just 0.24% of available shares offered to private shareholders were subsequently taken up with the result that the Government took up the remaining shares and therefore acquired a 57.9% stake in RBS in a move aimed at recapitalising the bank. As a consequence of the mismanagement which necessitated this rescue, the CEO Sir Fred Goodwin and Chairman Sir Tom McKillop resigned.

On 19 January 2009 the Government increased its holding in the bank from 58% to 70%. The same day RBS released a trading statement in which it expected to post full-year trading losses (before writedowns) of between £7bn and £8bn. The group also announced writedowns on goodwills (primarily related to the takeover of Dutch bank ABN Amro) of around £20bn. The combined total of £28bn would be the biggest ever annual loss in UK corporate history (the actual figure was £24.1bn). As a result, the group's share price fell over 66% in one day to 10.9p per share, from a 52-week high of 354p per share, itself a drop of 97%. Goodwin’s responsibility for the expansion of RBS, which led to the losses, drew widespread criticism.
In March 2009, RBS revealed that its traders had been involved in the purchase and sale of sub-prime securities under the supervision of Goodwin. On 03 April 2009 at the company’s AGM, 90% per cent of shareholders voted against the board's recommendation of the pay and benefits directors had set themselves.

RBS’s Greenwich Capital unit is part of a Securities Exchange Commission probe into the collapse of the subprime mortgage market. It is now public that RBS subsidiaries have received requests for information from ‘various US governmental agencies and self-regulatory organizations’ in relation to the sub-prime mortgage crisis. In particular, during March 2008, RBS was advised by the SEC that it had commenced a non public, formal investigation relating to RBS’ US sub-prime securities exposure and US residential mortgage exposures. RBS and its subsidiaries are known to be cooperating with these requests for information and investigations. If these investigations pinpoint inaccuracies in Greenwich Capital unit’s subprime related activities, then RBS’ reputation would suffer further and possibly result in financial disgorgement as well.
RI ANALYSIS

RBS’ growth strategy was unrealistic and proved hard to execute. In the words of the Parliamentary Committee on the Banking Crisis, RBS was undermined by its ‘self-styled “impressive growth trajectory”’. In other words it believed its own corporate hype that it was insulated from market risks. From 2001 to 2007, RBS’s assets quadrupled, its cost-to-income ratio improved markedly and its profits soared. By 2008 RBS was the fifth largest bank in the world by market capitalisation. The purchase of ABN Amro, which was intended to sustain RBS’ growth only served to prove how reckless its growth had become, how dysfunctional its Board and leadership were and how they had over-reached themselves. This led to negative perceptions by key stakeholders of the bank’s capabilities:

1) Performance: declining performance led to pressure on the bank to take riskier positions to generate returns. At the same time it had no systematic process in place for identifying, assessing and managing reputational risk

2) Governance: there were failed controls from the board downwards. Many key questions were not asked (focusing on the downside rather than the upside of an acquisitions-led strategy) and the make-up of the Board did not produce people who were able to challenge the CEO sufficiently or some of the (growth) assumptions that were made.

3) Leadership: The hubris and overconfidence of the CEO were exposed as customers, the general public, media and politicians saw his behaviour as self aggrandizing and nepotistic, made worse in a climate where leaders in public life were under more scrutiny than ever and trust was under pressure on several fronts.

Then CEO Fred Goodwin was central to RBS’s building, diluting and ultimately destroying its reputation. The hostile takeover of an English bank—part of the national financial heritage - twice its size was an incredibly audacious achievement for RBS and it shook the financial world. The NatWest deal was the making of Goodwin, leading to his promotion to CEO in January 2001, soon after it was secured. Buoyed by a sense of invincibility, he led RBS on a spending spree—buying 26 banks in just seven years using this enlarged base to turn what was essentially a domestic player into a world force. He was the FTSE 100’s longest-serving CEO, led government task forces and became Chairman of the Princes Trust, the UK’s leading youth charity, founded by The Prince of Wales.

Then came the remarkable transition from Britain’s most successful banker to Public Enemy Number 1. As the leading business journalist Jeff Randall said ‘his crime, if it can be so described, was one of vainglorious incompetence, embroidered with insufficient contrition’ (The Sunday Telegraph 1 March 2009).
Market sentiment—a crucial component of reputational risk—turned as RBS steadily lost trust and mismanaged the expectations of key stakeholders, one by one. In December 2006 the CEO told shareholders that ‘we don’t need to make any big acquisitions now, and the real message in the trading update is that we are generating results ahead of expectations on a purely organic basis, and that feels like a pretty good place to be.’ It was a shock when management followed this statement with the disastrous acquisition of ABN Amro. In February 2008 RBS said confidently that ‘there are no plans for inorganic capital raisings or anything of that sort.’ It was stunning, therefore, when RBS contradicted itself by announcing only two months later a £12.5bn rights issue, the world’s biggest in a short, terse statement.

Pressed by the new controlling shareholder (now also its regulator)—the Government—Goodwin had to exit with his Chairman. On 11 October 2008, Goodwin announced his early retirement, effective from January 31, 2009 - a month before RBS announced that its 2008 loss totalled £24.1bn, the largest annual loss in UK corporate history.

Goodwin’s reputation—and the Board’s competence in managing him—was not enhanced by the news that emerged when he was questioned by the Treasury Select Committee of the House of Commons on 10 February 2009, to wit that he had no technical bank training or formal banking qualifications. The same day MP’s on the same Select Committee disclosed that they had been given testimony by Paul Moore, the former head of risk management at HBOS—also a beneficiary of state aid—in which he had identified “a total failure of all key aspects of governance” at the beleaguered bank which portrayed bankers with little regard or care for risk management.

In service-based industries such as banks, airlines and retailers as well as businesses with active founders and ambitious entrepreneurs—such as Dell, Fedex and Tata—there can be little distinction between the reputation of the CEO and that of the company. Goodwin’s story was also that of RBS’s transformation. While customer and investors were aghast by value destruction and reputational implosion at RBS, during the same period (specifically May 2009 onwards), the British public were shocked by the scale and flagrant manner in which MPs’ abused their positions in claiming Parliamentary expenses. Customers, investors and citizens were one and the same and their expectations of responsible behaviour fell seriously short at RBS (and at other banks) as well in Parliament.

Overall, RBS needed to strengthen the feedback linkages from stakeholders to company and put in place a credible and coherent risk management system. The combination of poor performance, faulty governance and defective leadership led to a downward spiral, exacerbated by failed communications with public and negative media coverage.
Traditional “bottom-up” risk management approaches often fail to expose important risks to reputation. Poorly designed structures can have major blind spots. There was a need to develop a structured system for reputational risk evaluation/reporting incorporated into existing planning and response work with the output used to focus risk planning/management meetings. Above all, reputational risk management should have been a top organisational priority and integrated into risk management and delivery of the business plan.

Further information

1. HBOS - Paul Moore, (former head of risk management)’s memo in full, 2009


3. House of Commons Treasury Committee Banking Crisis: dealing with the failure of the UK banks, Seventh Report of Session 2008–09
   Report, together with formal minutes and Volume I, Oral evidence, 1 April 2009
   [http://www.parliament.uk/parliamentary_committees/treasury_committee/bankingcrisis.cfm](http://www.parliament.uk/parliamentary_committees/treasury_committee/bankingcrisis.cfm)