Lord Turner of Ecchinswell Chairman Financial Services Authority 25 The North Colonnade Canary Wharf London E14 5HS 15th April 2009

Following the Dunfermline Building Society collapse, I was approached by a well informed source who describes the way in which the sector was regulated. The attached commentary is a scathing indictment of FSA regulatory practice. This may not surprise you given the institutional self criticism in your report, but what may surprise you is the extent to which the problems continue and pose a threat to other societies like XXXXXXXXXX and XXXXXXXXXX.

The individual concerned does not wish to be identified and I have edited the text accordingly. It is worrying in itself that people who wish to act in the public interest should feel that there is a climate of fear and vindictiveness in the FSA. You should, I think, consider how to ease this fear; otherwise problems which you should know about and act upon will remain hidden. I would be grateful for your reaction.

Yours sincerely, Vincent Cable MP MP for Twickenham Liberal Democrat Deputy Leader and Shadow Chancellor of the Exchequer

Edited text of letter sent to Vince Cable MP by former FSA employee

My experience might surprise even the most cynical of the FSA's critics. Building societies are still generally considered to be safe and sound, but in fact they have become highly vulnerable in recent years due to lowered asset quality, increased reliance on wholesale funding liabilities, and undercapitalisation of the sector.

Current conditions differ crucially from those of the early 1990s recession when a few weaklings merged with larger societies -part of a trend that has persisted for decades - but the overall sector emerged relatively unscathed with no need for outside assistance. Today the mutual movement is no longer strong enough to take care of its own problems, as demonstrated by the taxpayer support provided in the Dunfermline bailout.

Building societies have only ever been able to do one thing well: provide residential mortgages to prime borrowers. They have never been proficient at anything else. However, in the early and middle part of this decade, the FSA allowed them to depart from their traditional core business model of taking retail deposits to fund residential mortgages, and move far up the risk curve into "specialised lending" like commercial real estate, sub-prime, self-certified and buy-to-let mortgages, and housing association lending. Societies also bought books of loans originated by other lenders. They were unsophisticated and inexperienced, and when they bought commercial loans or acquired mortgage books from lenders such as XXXXXXXXXXX, it was obvious they were "fools in the market" being exploited by Wall Street and the City of London. However, the FSA was purblind to the risks, and did nothing to prevent this across-the-board lowering of asset quality. The regulator did not even require societies

to increase their generally very modest levels of capital (reserves) to a level commensurate with the higher risk profile of the new assets on their balance sheets. Reliance on wholesale funding also grew, creating a funding gap not dissimilar to that which has proven disastrous for Britain's banks.

To give but one example of the abdication of regulatory responsibility, in 2005 and again in 2006 there were "Thematic Reviews" of mortgage books purchased by building societies from wholesale lenders. One XXXXXXXXX book that was XXXXXXXXXX I believe may have been bought by the Dunfermline, contained several thousand loans categorised as "full status" - i.e. mortgages with properly evidenced income - but on which not a single loan file contained any proof of the borrowers' income from payslips, P60s, audited tax returns or bank statements. We had unearthed incontrovertible proof that societies had been paying high prices for what were ostensibly the safest residential mortgages, but were in fact risky selfcertification loans. (Note that GMAC's toxic loans were a significant factor in the demise of Bradford & Bingley). FSA management turned a blind eye to that particular abuse, as it did to many others. XXXXXXXXXX was not reprimanded or sanctioned, and the societies who bought its loans were not directly contacted. The FSA's only action following the thematic review was to send a general "Dear CEO" letter to all building societies reminding them of the need to conduct thorough due diligence in advance of purchasing loan books from wholesale mortgage lenders.

...I was well aware of how badly underwriting standards had fallen in the years before 2007, and I thought there were tremendous latent risks both to consumers and the economy in the way that certain originators were lending with little or no concern about borrowers' creditworthiness or ability to repay, or the quality of security. Building societies unwittingly assumed enormous risks in their attempts to generate comparatively miniscule increases in yield, buying assets they would never have originated themselves and which they did not understand, and hence could not properly value.

I witnessed trusting and naive provincial building society executives and nonexecutives, who had no real understanding of securitisation or structured finance or any other aspect of the workings of global capital markets, being eaten alive by cynical, rapacious and short-termist investment bankers. I believe the problems at the Dunfermline will soon be mirrored by similar difficulties at societies such as Principality, Newcastle and West Bromwich. The sector is in real trouble and its capital remains at insufficient levels. Dunfermline showed that the Nationwide is unwilling to repeat Lloyds TSB's fatal error with the acquisition of HBOS. It has enough to contend with after its takeover of the Cheshire and Scarborough societies led to capital strain and downgrades of its credit rating. No other society can swallow other bad balance sheets whole, so in future there will be no mergers entailing lock, stock and barrel assumption of assets and liabilities. Therefore, taxpayers will take the strain of ensuring the survival of the building society movement.

In the run up to the crisis the FSA's attitude to the mortgage industry ranged from indifference to wilful ignorance. FSA management's mantra then was that "we don't regulate business models". Supervisors were told not to worry about building societies since if anything went wrong, Nationwide or another large society would always be willing and able to take over a failing smaller one "for the good of the movement".

FSA management felt that they had to allow the societies to diversify or else they would go out of business because for a few years the traditional business model no longer seemed to work. Competition from what is now known as the shadow banking system undermined margins on prime mortgage lending and, for the same reasons, societies were not competitive on savings products, either. The Building Societies Association lobbied discreetly but insistently that the fate of the sector was "diversification or death", and FSA management accepted this assessment unquestioningly. What actually followed was "diworsification" or "diversification and death". That is how the Dunfermline, after 140 years of adhering to its raison d'etre of the traditional business model managed in three short years to destroy itself by acquiring £500 million of toxic commercial real estate loans at the peak of the greatest asset and credit bubble in history.

Low calibre FSA management is perhaps the single biggest factor in this disaster. The key individuals in Retail Firms Division management from 2005 to date have no background in deposit-taking. Former director Sarah Wilson had experience in insurance and current director Sheila Nicoll was an IFA. Similarly, Julia Dunn, who for the past three years has been head of the department responsible for supervising all the building societies besides Nationwide, Britannia and Yorkshire, came from FSA Enforcement and has no qualifications or professional experience in deposit taking or retail financial services. The lower level managers have some experience dating back to the Building Societies Association, but in my view had neither the influence or the inclination to challenge the official "light-touch" laissez-faire regulation. A culture of apathy and complacency marked the FSA in the period of its nadir, with anyone standing up against light-touch official policy criticised for rocking the boat and branded a trouble-maker. In consequence, many talented and conscientious people retired or left for the private sector. FSA supervision was hollowed-out and its depleted ranks were staffed with mediocre people who cared little about the business of supervising firms. Then CEO John Tiner de-resourced front-line supervision of firms and increased the ranks of policy specialists and MSU staff (a form of internal management consultancy service). I fear that the FSA so degraded its capability that it will take many years to restore an acceptable quality of supervision for retail financial services firms