8. The failure of the Royal Bank of Scotland

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This case tells the story of how a major corporate acquisition, coinciding with the 2008–2009 global financial crisis, brought about the near bankruptcy of the Royal Bank of Scotland (RBS). Referring to newspaper articles and other secondary material, it considers how subprime mortgages were securitised and sold throughout the global financial industry, creating systemic risk and leading to large losses when the American housing market went into recession, and how an ill-conceived acquisition came about because of overweening ambition, with catastrophic consequences.

'The failure of the Royal Bank of Scotland' is a 'raw case' – an open-ended, multi-perspective study that can feature thousands of pages of relevant material that students must analyse, such as statutory documents, analyst reports, news articles, stock charts and interviews with key players. This format reflects the way managers must access and analyse information to make informed business decisions.

The RBS case can be used to teach students about the global financial crisis, business strategy (mergers and acquisitions), leadership, governance and business ethics.

Guidance on how to write a case analysis can be found in Chapter 1, 'Business cases: what are they, why do we use them and how should you go about doing a case analysis?'.

A teaching note for this case is available to bona fide educators. To request a copy please email a.a.pepper@lse.ac.uk

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Introduction

In October 1999 Peter Burt, chief executive of Bank of Scotland (not to be confused with the *Royal* Bank of Scotland) launched an audacious bid for the National Westminster bank ('NatWest'). Bank of Scotland was a small retail bank headquartered in Edinburgh, Scotland. NatWest was a much larger commercial bank, based in London. Not to be outdone by their local rivals, the Royal Bank of Scotland (RBS), led by Sir George Mathewson, decided to launch a competitive bid for NatWest. RBS was ultimately the successful acquirer.[1]

The success of any business acquisition is typically heavily dependent on the achievement of cost savings. The post-acquisition integration of RBS and NatWest is often regarded as a model of its kind. It was led by Fred Goodwin, Matthewson's deputy at RBS. Goodwin was a tough taskmaster, relentless in his pursuit of efficiency, and known to his colleagues as 'Fred the Shred'. As one director of RBS put it: 'Fred was very good at delivery. He did the integration planning. His rigorous nagging saw the deal through. We truly delivered £3bn of synergies.'[2]

By 2007, RBS, now under the leadership of *Sir* Fred Goodwin (who had been knighted by the Queen in her 2004 Birthday Honours List for his services to the banking industry) was one of the largest banks in the world. It had become a universal bank, incorporating an investment banking division, Global Banking & Markets (GB&M) which accounted for almost half the group's total risk-weighted assets – £195bn out of a total of £482bn.

In October 2007, history appeared to repeat itself. In March, RBS's great rival, Barclays, led by John Varley, announced that it was in merger discussions with a Dutch bank, ABN Amro. Sir Fred had previously considered bidding for ABN Amro, in particular because of his interest in its US subsidiary, La Salle Bank, but the RBS board had been reluctant to pursue such a large and complex transaction. The Barclays announcement caused them to rethink. Spurred into action, in April 2007, RBS announced that it was leading a consortium of banks, including the Belgian bank Fortis and Spanish bank Santander, which was making a cash offer for ABN Amro valued at around $16bn.

ABN Amro's strong preference was to merge with Barclays, and in an attempt to thwart the RBS bid it sold its US subsidiary, La Salle Bank, to Bank of America. The board of RBS was determined to outbid Barclays and decided to proceed with the takeover at an unchanged offer price. A copy of RBS's press release justifying this decision is reproduced in the Exhibits section.

The Barclays bid for ABN Amro was an all-share offer, as opposed to the RBS-led consortium's all-cash offer. During August 2007, as the first signs of trouble in global financial markets began to emerge, Barclays' share price fell, reducing the value of its bid. By October, it had become clear that the RBS-led consortium would be the new owners of ABN Amro.

The global financial crisis

The global financial crisis (or 'GFC') provides the background to the RBS case. The roots of this crisis lay in the sale of 'subprime' mortgages by a number of US banks.

RBS got into trouble for a number of reasons, but in particular because of its exposure to the subprime mortgage markets, which was exacerbated by the acquisition of ABN Amro. A subprime mortgage is a type of mortgage that is normally issued by a lending institution to borrowers with low credit ratings. As a result of the borrower's lower credit rating, a conventional mortgage is not offered because the lender views the borrower as having a larger-than-average risk of defaulting on the loan. Lending institutions often charge interest on subprime mortgages at a rate that is higher than a conventional mortgage in order to compensate for carrying more risk.

The banks initiating subprime mortgages, especially in the US, bundled them into securities, which were then sold on to other banks and investment companies. The securities (known as 'collateralised debt obligations' or 'CDOs') were stratified into tranches with different risk profiles (rated AAA, AA, A, BBB – all 'investment grade' – and BB, B, CCC, CC, C, D – all 'speculative' grade). The whole system was predicated on the assumption that house prices were bound to continue to rise, and worked well while they were rising, as repossessions of property on any forgone mortgages could be used to cover interest costs. However, when house prices started to fall in the US in 2007–2008, the value of CDOs crashed, leaving huge parts of the banking system facing massive losses. Banks around the world with substantial investment in CDOs found their capital bases significantly depleted, bringing their financial sustainability into question.

The bailout

Over the summer of 2007 as the battle raged for ABN Amro very strange things were happening in the credit markets. Back in February, HSBC had been the first bank to openly signal the problems it was having in the US subprime market and had fired the head of its US mortgage business as losses hit $10.5bn. For Johnny Cameron,[3] the HSBC announcement was his first indication of the problems in the US subprime market that would end up costing the bank several billion dollars. Calling up Jay Levine, the Chief Executive of RBS Greenwich, Cameron was assured that the bank's US investment banking arm was on top of the problem. 'We're ahead of the game,' Levine told Cameron, adding that RBS Greenwich, which ran with little oversight from London, had already sold down much of its portfolio of the most risky parts of subprime collateralised debt obligations. Crucially, though, the bank retained its holding of the triple-A tranches, which were thought to be a safe investment.[4]

After the consortium's completion of the purchase of ABN Amro, it quickly became apparent to analysts that the RBS board had made a major strategic error. Goodwin had been warned about ABN Amro's exposure to subprime mortgages. RBS itself, through GB&M, was heavily invested in CDOs. Fortis Bank was itself in financial difficulty and would eventually receive an emergency bailout from the governments of Belgium and the Netherlands before being broken up.

In October 2008, in order to prevent the collapse of RBS and the expected consequential systemic failure of the UK banking system, the UK government was forced to inject £45.5bn into RBS, becoming its major shareholder. Fred Goodwin was sacked and his knighthood subsequently annulled. Stephen Hester, chief executive of British Land and a non-executive director of RBS, was asked to take over as RBS's new chief executive, with a brief to sort out the catastrophic legacy of his predecessor.

Further information

This case study draws on an article in *The Telegraph* newspaper by Harry Wilson and Philip Aldrick, published on 5 March 2011 under the headline: 'Royal Bank of Scotland: The Full Story of How the 'World's Biggest Bank' went bust'. This can be found at https://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8363417/Royal-Bank-of-Scotland-investigation-the-full-story-of-how-the-worlds-biggest-bank-went-bust.html. Information about the case can be found in many other newspaper articles, with the caveat that it is always wise to check facts for accuracy and to take care when assessing journalists' opinions.

A BBC documentary entitled 'The Bank That Almost Broke Britain' was broadcast in September 2018. This can be found on YouTube at: https://www.youtube.com/watch?v=W_ZWGuQ07Q8

You should also draw on other material, including the following:

Financial Services Authority Board (2011) 'The failure of the Royal Bank of Scotland', December. https://perma.cc/QZH6-ST5W

Fraser, I. (2014) *Shredded – Inside RBS, The Bank that Broke Britain*. Edinburgh: Birlinn Ltd.

Martin, I. (2013) *Making it Happen: Fred Goodwin, RBS and the Men who Blew up the British Economy*. London: Simon & Schuster.

Preparing the case

In preparing the case analysis, and as you read the RBS case and reflect upon what happened, you might like to consider the following specific questions in particular:

1. Was it appropriate for brokers to sell mortgages to customers, some of whom they knew would struggle to make the interest payments, because the banks believed that they could cover their risks by repossessions?
2. Was RBS right to proceed with the acquisition of ABN Amro? What is the relevance of the expedited sale of La Salle Bank to Bank of America to this question?
3. Sir Tom McKillop, who became chair of RBS in 2006, had no prior experience in the banking industry. Did he act responsibly when agreeing to take on a role which, arguably, he was not competent to perform?
4. What caused RBS's corporate governance arrangements to fail so spectacularly?
5. What character traits exhibited by Fred Goodwin made him at first a very successful leader, but ultimately brought about his fall from grace? Could his demise have been predicted?
6. What ethical responsibilities do Sir Tom McKillop and Fred Godwin bear for the collapse of RBS?
7. Does high bankers' pay involve ethical as well as economic and business considerations?

Exhibits

Press release:

The Royal Bank of Scotland Group plc 16 July 2007

RBS's Acquisition of ABN AMRO Businesses[5]

Following the ruling of the Dutch Supreme Court regarding the sale of LaSalle, RBS, Fortis and Santander have today announced revised terms for their proposed offer for ABN AMRO as set out in the Banks' Press Release.

RBS's announcement of 29 May 2007 set out the rationale for its participation in the proposed offer to acquire ABN AMRO. That announcement remains unchanged except in relation to LaSalle.

RBS intends to continue with the acquisition of the Global Wholesale Businesses and International Retail Businesses of ABN AMRO ("the ABN AMRO Businesses"). Instead of acquiring LaSalle, RBS will acquire cash from the sale of LaSalle and, in the absence of LaSalle, the synergies anticipated in North America have been revised.

The consideration for the ABN AMRO Businesses net of the sale of LaSalle will be €16 billion, of which €5 billion will be financed by equity.

RBS believes that this transaction will provide enhanced growth prospects and attractive financial returns. As a result of the transaction, RBS expects to deliver cost savings amounting to €1,237 million (or €1,319 million, including its share of central cost savings) and net revenue benefits amounting to €481 million, by the end of 2010.

On RBS's forecasts for business growth and transaction benefits, the internal rate of return on the acquisition of the ABN AMRO Businesses will be 15.5% post-tax, well above the Group's hurdle rate of 12% post-tax. The acquisition is expected to deliver a post-tax return on investment(1) of 13.2% in 2010, and to increase Group adjusted earnings per share(2) by 2.0% in 2009 and by 7.0% in 2010.

Sir Fred Goodwin, Group Chief Executive, said:

"The acquisition of the ABN AMRO Businesses remains compelling from a financial point of view, as evidenced by the fact that it produces essentially the same earnings enhancement for the Group, despite the smaller size of the transaction. From a strategic perspective, whilst we would have preferred to acquire LaSalle as well, the businesses we are acquiring open up many new markets and growth opportunities, enabling us to significantly accelerate our strategic development."

(1) Return on investment defined as profit after tax plus post-tax transaction benefits over consideration plus post-tax integration costs

(2) Adjusted for purchased intangibles amortisation and integration costs

Important Information

In connection with the proposed Offer, RBS expects to file with the SEC a Registration Statement on Form F-4, which will constitute a prospectus, and the Banks expect to file with the SEC a Tender Offer

Statement on Schedule TO and other relevant materials. INVESTORS ARE URGED TO READ ANY DOCUMENTS REGARDING THE PROPOSED OFFER IF AND WHEN THEY BECOME AVAILABLE, BECAUSE THEY WILL CONTAIN IMPORTANT INFORMATION. Investors will be able to obtain a copy of such documents, without charge, at the SEC's website (http://www.sec.gov) once such documents are filed with the SEC. Copies of such documents may also be obtained from RBS and the other Banks, without charge, once they are filed with the SEC.

This communication shall not constitute an offer to sell or the solicitation of an offer to buy any securities, nor shall there be any sale of securities in any jurisdiction in which such offer, solicitation or sale would be unlawful prior to registration or qualification under the securities laws of any such jurisdiction. This press release is not an offer of securities for sale into the United States. No offering of securities shall be made in the United States except pursuant to registration under the US Securities Act of 1933, as amended, or an exemption therefrom.

Forward-Looking Statements

This announcement includes certain "forward-looking statements". These statements are based on the current expectations of RBS and are naturally subject to uncertainty and changes in certain circumstances. Forward-looking statements include any statements related to the benefits or synergies resulting from a transaction with ABN AMRO and, without limitation, statements typically containing words such as "intends", "expects", "anticipates", "targets", "plans", "estimates" and words of similar import. By their nature, forward-looking statements involve risk and uncertainty because they relate to events and depend on circumstances that will occur in the future. There are a number of factors that could cause actual results and developments to differ materially from those expressed or implied by such forward-looking statements. These factors include, but are not limited to, the presence of a competitive offer for ABN AMRO, satisfaction of any pre-conditions or conditions to the proposed Offer, including the receipt of required regulatory and anti-trust approvals, the successful completion of the Offer or any subsequent compulsory acquisition procedure, the anticipated benefits of the proposed Offer (including anticipated synergies) not being realized, the separation and integration of ABN AMRO and its assets and the integration of such businesses and assets by RBS being materially delayed or more costly or difficult than expected, as well as additional factors, such as changes in economic conditions, changes in the regulatory environment, fluctuations in interest and exchange rates, the outcome of litigation and government actions. Other unknown or unpredictable factors could cause actual results to differ materially from those in the forward-looking statements. RBS does not undertake any obligation to update publicly or revise forward-looking statements, whether as a result of new information, future events or otherwise, except to the extent legally required.

Merrill Lynch International, which is authorised and regulated in the United Kingdom by the Financial Services Authority, is acting as financial adviser to Fortis, RBS and Santander and as underwriter for Fortis, RBS and Santander, and is acting for no one else in connection with the proposed Offer, and will not be responsible to anyone other than Fortis, RBS and Santander for providing the protections afforded to customers of Merrill Lynch International nor for providing advice to any other person in relation to the proposed Offer.

The Royal Bank of Scotland plc, which is authorised and regulated in the United Kingdom by the FSA, is also acting as financial adviser to RBS and is acting for no one else in connection with the proposed Offer, and will not be responsible to anyone other than RBS for providing the protections afforded to customers of The Royal Bank of Scotland plc nor for providing advice to any other person in relation to the proposed Offer.

Any Offer made in or into the United States will only be made by the Banks and/or RFS Holdings directly or by a dealer-manager that is registered with the SEC.

References

[1] Bank of Scotland subsequently merged with Halifax plc to become HBOS. Like RBS, HBOS got into difficulty during the global financial crisis and had to be rescued by Lloyds Bank plc. HBOS is now a wholly owned subsidiary of Lloyds Banking Group.

[2] Wilson, H., and Aldrick, P. (2011) 'Royal Bank of Scotland: The Full Story of How the World's Biggest Bank went bust', *The Telegraph*, 5 March. https://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8363417/Royal-Bank-of-Scotland-investigation-the-full-story-of-how-the-worlds-biggest-bank-went-bust.html

[3] Johnny Cameron was the head of RBS's GB&M division. After the failure of RBS, Cameron was reprimanded by the Financial Services Authority and barred from working full-time or holding a position of significant influence in the financial sector.

[4] Wilson, H. and Aldrick, P. (2011)

[5] Press release reproduced with permission from NatWest Group, plc. Text available from https://perma.cc/A2PU-YJ73